

DECEMBER 30, 2011
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WEEKLY COMMENTARY: The US Treasury Exception

Major Developments:

Monday, December 26:

- Japan Vehicle Production increased 4.5% y.o.y. for November.

Tuesday, December 27:

- US Consumer Confidence Index increased to 64.5 for December.
- US S&P/Case-Shiller Home Price Index decreased to -0.62% m.o.m. for October.
- Japan Industrial Production growth decreased to -2.6% m.o.m. for November.

Wednesday, December 28:

- Germany CPI increased to 0.7% m.o.m. for December.

Thursday, December 29:

- Italy Business Confidence Index decreased to 92.5 for December.
- US Initial Jobless Claims increased to 381,000 for the week.
- US Pending Home Sales rate of growth decreased to 7.3% m.o.m. for November.

Friday, December 30:

- UK Nationwide House Prices decreased to -0.2% m.o.m. for December.
- Italy PPI decreased to 4.5% y.o.y. for November.

In the holiday-shortened week, the US Treasury bond market was trading relatively quiet with about half of the average daily volume. Risk-off trades prevailed, with US governments steadily improving as investors sought a safe-haven refuge given continued concerns about Europe's debt crisis and the European Central Bank (ECB) announcement of its record balance-sheet expansion stemming from last week's three-year Longer Term Refinancing Operation (LTRO). The US 10-year note ended the year at 1.88% (see the Chart of the Week, page 2). Despite Standard & Poor's cutting the AAA-rating of the United States in August, US Treasuries still earned 9.6% for the year according to Bank of America Merrill Lynch data. By comparison, German Bunds also returned 9.6%, and US corporate debt gained 7.3% for the year. Taking advantage of the positive market for high-quality issuers, Rabobank and General Electric were the largest bond issuers in 2011, issuing US\$42.4 billion and US\$33.1 billion, respectively.

With all of the uncertainty in the global markets over the last year, individuals, corporations and investment managers have been raising cash levels. Where does all of this cash go? Based on data from surveys, company financials and the US Federal Reserve, cash investments have been flowing into bank deposits, money funds and direct investments in US Treasuries. Money market deposit accounts (MMDAs) have risen more than 13% for the year and about US\$1.3 trillion over two years—a 28% increase. Cash on deposit at US banks reached an all-time high of US\$8.44 trillion in November according to the Federal Reserve. Ironically, these deposits drive up bank capital requirements and add to bank costs.

Overall money fund assets have dropped approximately US\$115 billion over the year but have stabilized around US\$2.7 trillion in assets. Retail fund assets were flat while institutional money fund assets declined. Figures for November show that within the institutional sector there has been a major shift out of prime funds—a drop of US\$185 billion—into Treasury and government money market funds, which have grown by US\$95 billion despite having yields close to 0%. The trend continued into December as investors have poured an additional US\$35 billion into money funds—mostly government funds—and it is a trend consistent with general risk aversion in the marketplace.

Within prime money funds, the uncertainty regarding the European sovereign debt crisis sparked a significant shift away from European financial commercial paper and bank deposits. By the end of November, money funds tracked by Crane Data invested 23% in repurchase agreements, almost 20% in US Treasuries and 15% in US Agencies. Commercial paper and certificates of deposit that include foreign names represented only 15% and 17%, respectively, of average fund assets. Fortunately for European banks, the ECB has provided liquidity by replacing much of the lost funding from money funds via several tender operations, including the record €489 billion three-year LTRO on December 21. These banks in turn have parked record amounts on deposit with the ECB, a high of €452 billion earlier in the week—yet another sign of banks' reluctance to lend money. While these operations relieve some of the short-term funding needs, the ECB has become the primary lender to the banks, and the banks will still need to continue to deleverage, face pressures of potential rating agency downgrades and deal with the slow pace of political progress in the euro area. As long as the uncertainty in Europe persists and banks are reluctant to lend to each other, LIBOR rates will remain stubbornly high relative to "risk-free" Treasuries.

Short-term investors, by nature, tend to be more conservative than other investors, but it is worth noting the paring of risk and the more than 50% concentration in securities of the US Treasury, US agencies, and repurchase agreements backed by US government securities. With all of the global uncertainties, fewer corporate bonds and mortgage securities, and the need for safe assets, expectations are for continued volatility for 2012 but for US Treasuries to remain well bid.

Chart of the Week: US Treasury Curve Spot Rates

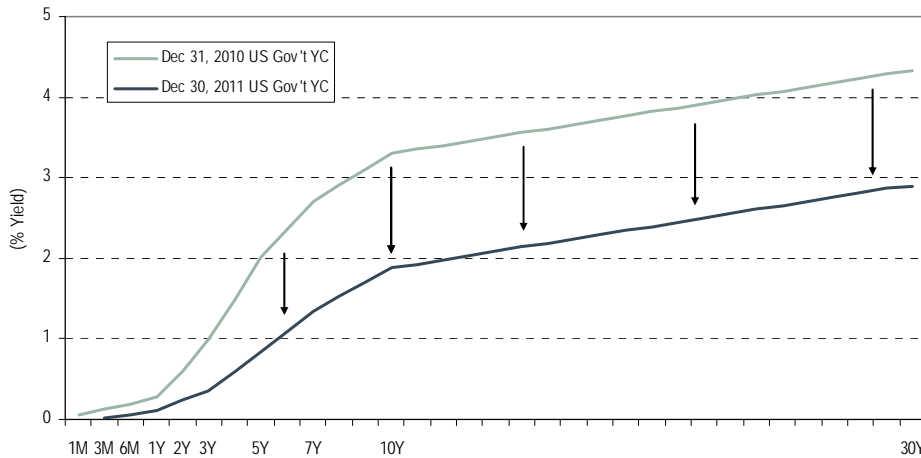


Chart Source: Morgan Stanley

Next Week:

Monday, January 2:

- Euro area PMI Manufacturing Index is expected to remain at 46.9 for December.

Tuesday, January 3:

- Germany Unemployment Rate is expected to remain at 6.9% for December.
- UK PMI Manufacturing Index is expected to decrease to 47.3 for December.
- US ISM Manufacturing Index is expected to increase to 53.5 for December.

Wednesday, January 4:

- France Consumer Spending is expected to increase to 0.3% m.o.m. for November.
- Euro area CPI is expected to decrease to 2.8% y.o.y. for December.
- US Factory Orders are expected to increase to 2.0% m.o.m. for November.

Thursday, January 5:

- Germany Retail Sales are expected to decrease to 0.2% m.o.m. for November.
- France Consumer Confidence Index is expected to increase to 80 for December.
- US ISM Non-Manufacturing Index is expected to increase to 53 for December.

Friday, January 6:

- Euro area Economic Confidence Index is expected to decrease to 93.3 for December.
- Germany Factory Orders are expected to decrease to -1.8% m.o.m. for November.
- US Unemployment Rate is expected to increase to 8.7% for December.

Source: Bloomberg

Central Bank Watch:

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on Mar 2012 Interest Rate Futures Contract	Next Meeting
Fed	-75 bps	December 16, 2008	0% - 0.25%	0.09%	January 25
ECB	-25 bps	December 8, 2011	1.00%	0.38%	January 12
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.34%	January 24
BoE	-50 bps	March 5, 2009	0.50%	1.12%	January 12

Market Review: Sovereign Bond Markets

United States

US Treasury yields declined modestly amid very thin trading conditions into year-end, with the 10-year benchmark yield falling to a low of 1.86% on December 30 before settling at 1.88%. For the week, the 10-year declined 15 basis points and it declined 142 basis points for the year.

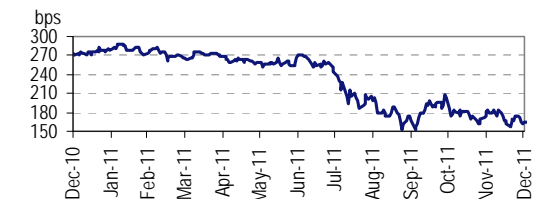
Europe & Japan

The year starts with a short week as many countries remain on holiday for the first one or two days of January. Euro area bond markets finished the year with further safe-haven flows and thin liquidity exaggerating the moves. The German 10-year Bund finished the year at 1.83%, down 13 basis points on the week. Peripheral spreads were generally wider, although with scant economic data over the holidays, flows were generally dominated by sentiment factors. The UK suffered more soft housing data in the last week of the year, and Gilts followed the rally in Bunds and US Treasuries with the 10-year finishing below 2%, at a yield of 1.98%.

Disappointing retail and industrial production data—alongside another step deeper into deflation—brought Japan's harrowing year to an end. Japan's November consumer confidence dipped lower to 38.1 from 38.6 in October. The Tertiary Industry Index moved up more than expected to 0.6% for the month of October from -0.7% in September. The yield on the 10-year Japanese government bond (JGB) touched 0.97% before closing the week at 0.99%. The 10-year JGB yield closed below 1% at 0.99%, just a few basis points off the lows of the year, which were seen in November. The Japanese yen rallied into the end of the year, closing at the ¥77/US\$ level. Japan remains on holiday until Wednesday, January 4.

2- to 10-Year Treasury Yield Spread

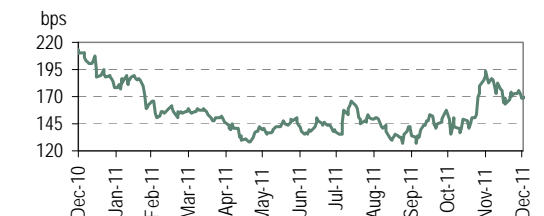
US	Change in Level (bp)			
	Current	1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.01	2	-1	-11
2 Yr	0.24	-4	0	-36
5 Yr	0.83	-14	-12	-118
10 Yr	1.88	-15	-4	-142
30 Yr	2.90	-16	-2	-144
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2 - Fed	-0.01	-4	0	-36
5 - 2	0.59	-10	-12	-82
10 - 5	1.04	0	8	-24
30 - 10	1.02	-2	2	-2



Source: Bloomberg

2- to 10-Year Bund Yield Spread

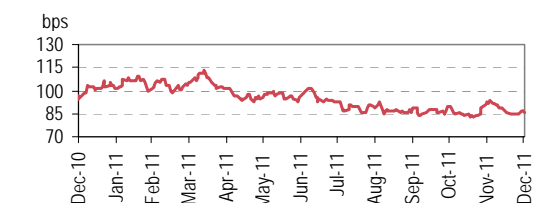
Europe	Change in Level (bp)			
	Current	1wk	MTD	YTD
ECB	1.00	0	-50	0
1 Yr	-0.07	-7	-45	-67
2 Yr	0.14	-8	-41	-72
5 Yr	0.76	-13	-41	-108
10 Yr	1.83	-13	-6	-113
30 Yr	2.37	-11	-27	-105
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2 - ECB	-0.86	-8	9	-72
5 - 2	0.61	-5	-1	-36
10 - 5	1.07	0	35	-5
30 - 10	0.54	2	-22	9



Source: Bloomberg

2- to 10-Year JGB Yield Spread

Japan	Change in Level (bp)			
	Current	1wk	MTD	YTD
BOJ	0.10	0	0	0
1 Yr	0.12	0	-1	-3
2 Yr	0.14	0	-1	-5
5 Yr	0.35	0	-2	-6
10 Yr	0.99	1	-4	-14
20 Yr	1.76	1	2	-14
30 Yr	1.93	-2	-1	-7
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2 - BOJ	0.04	0	-1	-5
5 - 2	0.21	0	-1	-1
10 - 5	0.64	1	-2	-8
30 - 10	0.94	-3	3	7



Source: Bloomberg

Market Review: Global Inflation-Linked Bonds

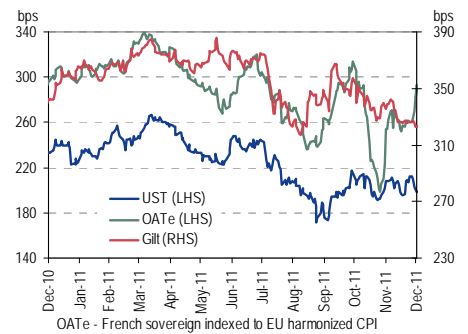
Trading volume in inflation-linked markets remained thin during the holiday season, where price action in real yields was largely driven by trading flows rather than by economic fundamentals.

In the United States, despite continued encouraging economic data releases, real yields generally underperformed their nominal comparators as selling needs from the month-end index-duration-contraction rebalancing event pressured breakeven inflation (BEI) rates lower over the week. Long-dated BEI spreads were the worst performers, with the 30-year BEI spread narrowing 14 basis points while the five-year BEI narrowed five basis points over the week.

In the UK, while the 10-year conventional Gilt rallied six basis points to reach a new low of 1.98%, real yields failed to keep up with the strong performance, resulting in a marginal narrowing of BEI spreads. Long-dated real yields are now back at their all-time lows of around -12 basis points.

The successful Spanish nominal bond auctions and a strongly received ECB three-year LTRO helped short-dated European peripheral government bonds to rebound from distressed levels. Short-dated Italian real yields benefited from the move and rallied 30-to-70 basis points in the two- to five-year sector over the week.

GILBs - 10-Year Breakeven Spreads



Source: Bloomberg, performance in percentage points (%)

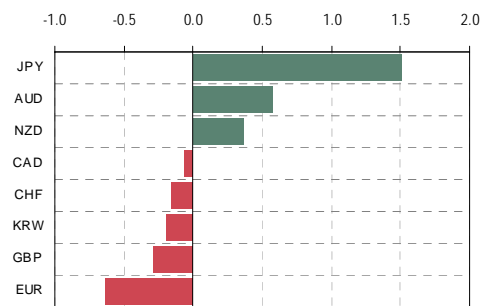
Market Review: Currency Markets

G10

Currency market flows were extremely light during the last week of the year. The Japanese yen was the best performer while the euro was the worst performer. The euro continued its underperformance and fell to a new intraday low of the year in the wake of a moderately positive Italian bond auction. Although the decline was short-lived, the poor growth outlook in the euro area remained the dominant theme in the market.

Meanwhile, the Chinese yuan was fixed 148 price interest points (pips) lower to close the year at 6.3009 (Chinese yuan per US dollar) to be the best performing currency of 2011. Chinese policymakers maintained a bias towards a gradual appreciation on the yuan amid a global growth slowdown.

US Dollar's WTD Performance Against Other Majors

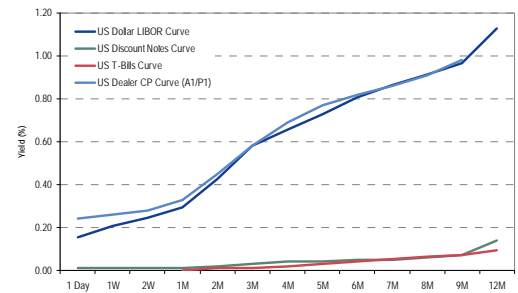


Source: Bloomberg, performance in percentage points (%)

Market Review: Money Markets

Position squaring going into year-end was the focus for short-term issuers and investors. Many issuers had already offered attractive levels earlier and further out the curve, leaving volumes light and typically limited to short maturities. Commercial paper outstanding declined by almost US\$23 billion in the last week, with the total of US\$982 billion well below the 2010 level of US\$1.057 trillion, not seasonally adjusted. With supply light, rates for high grade issuers in the market fell along with rates for overnight government-backed repos. While we would expect supply technical factors to improve somewhat after year-end, European bank issuers have the support of the ECB's extended tender operations to help with their liquidity needs for out to three years, which should mute the supply from that sector for awhile.

Money Market Yield Curves



Source: Bloomberg

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

US and European corporate bonds slightly outperformed government bonds for the two-week holiday period. Corporate bond secondary trading and new issue supply was predictably light. Italian government debt auctions were a heavy focus, and risk assets performed positively once the auctions were successfully completed. Italy was able to issue 3-year and 10-year bonds totaling €5 billion at lower yields than at the prior auctions. US economic data (initial jobless claims, consumer confidence and housing data) continued on a positive note, and investors appeared to be anticipating strong US ISM and payroll reports for December that will be announced the week of January 2. US high grade bonds had US\$686 million in inflows following last week's US\$1.4 billion of inflows. High yield bonds had US\$455 million in inflows versus only US\$260 million of inflows last week.

Mortgage-Backed Securities

Mortgages finished the last week of the year down two basis points versus duration-matched Treasuries but finished up 17 basis points for the month. Year-to-date relative performance is -113 basis points. Flows and headlines were quiet except for the last day of December, which saw a pickup in flows due to year-end rebalancing. The Federal Reserve's support for the mortgage sector has been positive. Given that primary mortgage rates have moved back to their lows—coupled with the expansion of HARP—we will keep a close watch for any indications that refinancing picks up. However, we do not believe refinance activity will increase materially in the current environment and expect the sector to continue to tighten. We are positive on structured products as we enter 2012.

Asset-Backed Securities

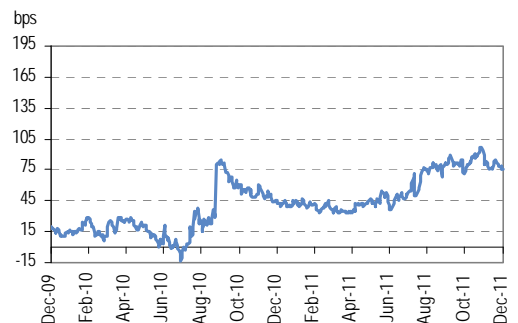
Asset-backed security markets were quiet during the holiday period. Despite the muted activity, a JPMorgan Chase credit card trust was able to price an AAA-rated two-year issue at LIBOR +12 basis points and was upsized from US\$500 million to US\$775 million, based on strong demand.

Investment-Grade Corporate Bond Index OAS



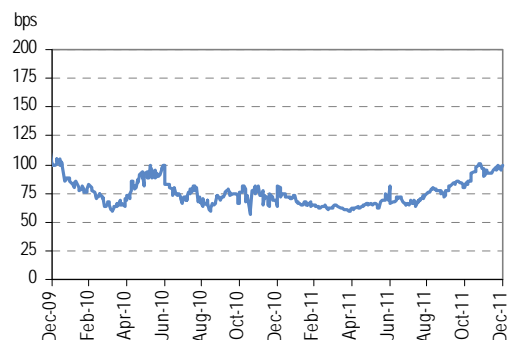
Source: Barclays Capital

Agency MBS Current-Coupon Fixed-Rate OAS



Source: Barclays Capital

Barclays Capital ABS Index OAS



Source: Barclays Capital

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