JANUARY 6, 2012
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WEEKLY COMMENTARY:

The Federal Reserve Gets Even Clearer

Major Developments:

Monday, January 2:

- Euro area PMI Manufacturing increased to 46.9 for December.

Tuesday, January 3:

- Germany Unemployment Rate declined to 6.8% for December.
- UK PMI Manufacturing Index increased to 49.6 for December.
- US ISM Manufacturing Index increased to 53.9 for December.

Wednesday, January 4:

- France Consumer Spending growth decreased to -0.1% m.o.m. for November.
- Euro area CPI decreased to 2.8% y.o.y. for December.
- US Factory Orders increased to 1.8% m.o.m. for November.

Thursday, January 5:

- Germany Retail Sales growth decreased to -0.9% m.o.m. for November.
- France Consumer Confidence Index increased to 80 for December.
- US ISM Non-Manufacturing Index increased to 52.6 for December.

Friday, January 6:

- Germany Factory Orders growth decreased to -4.8% m.o.m. for November.
- US Unemployment Rate decreased to 8.5% for December.

One of the surprises over the past quarter has been the extent to which data in the US has been unexpectedly positive relative to expectations, and the Chart of the Week (page 2) once again shows the Citi US Surprise Index. As a reminder, this series aims to show not whether data is strong or weak, or to indicate likely expansion or contraction in the economy in any absolute sense—like the ISM series, for example. Rather, it tries to capture the extent to which data releases are stronger or weaker than consensus estimates. While many professional forecasters may beg to differ, those forecasts are often a function of continuing an existing trend: for example, unemployment is high, so the best guess is that it will continue to be high. The usefulness of the Citi Surprise Index, then, is to graphically capture the difference between these forecasts and the actual releases, and to aggregate all of these forecasting errors into one series. The current data is doubly interesting. First, it is by design a relatively binary series—as forecasting errors catch up with the trend, we would expect to see errors fall, and for the series to return to zero—that is, that by and large economic forecasts are correct. As markets and economies are cyclical, in time this will reverse itself and weaknesses will start to manifest themselves, which once again will not be initially forecast by backward-looking economists. We are currently at the third-highest level since the series began in 2003. That suggests that economists incorrectly predicting a double-dip in the economy in the third quarter of 2011 have now adjusted their forecasts towards the soggy, anemic outlook FFTW and others have been predicting.

Unusually though, it looked like that process had already begun, with the series notably softening (not to belabor the point, this means that forecasts are getting more accurate) over December. But that softening reversed itself very strongly in January, reaching 91.90. This is only one data point, but it can be interpreted as showing that growth may not just be avoiding a double-dip, but rather may be stronger still.

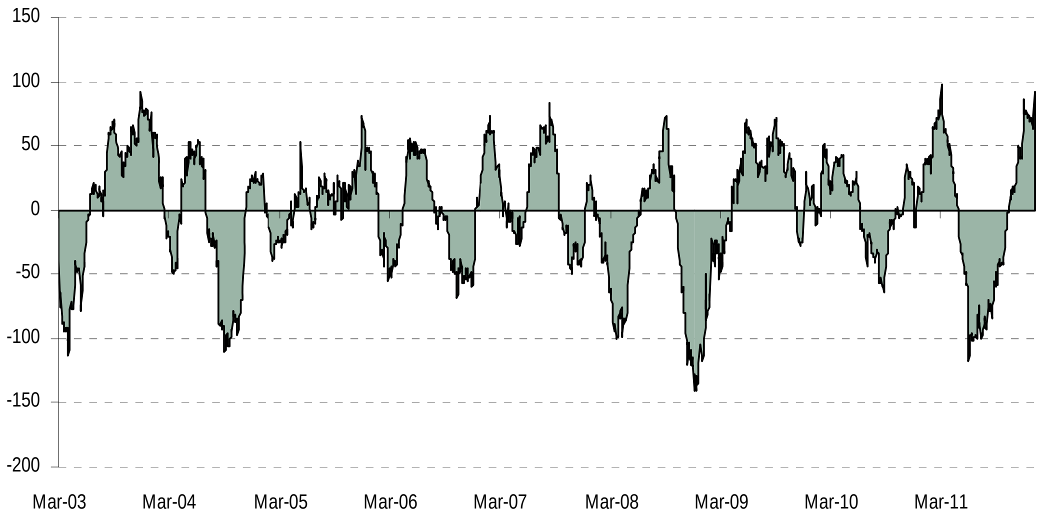
The underlying data has included very strong employment data from ADP, unremarkable but solid improvements in the weekly continuing claims data, releases in the Chicago PMI and ISM series that have come in better than expected, and to some extent foreshadowed by a much stronger-than-expected durable goods release. Housing data is not consistent, but the market also shows many of the signs of a solid bottoming, at last. This short trend has been continued with Friday's nonfarm payrolls data, and the unemployment rate, both of which were much better than forecast.

But all of this must be contrasted with the economic news getting the most attention during the week: the minutes of the Federal Reserve meeting of December 13, which were released on January 3. Starting with its meeting on January 24-25, the Federal Open Market Committee (FOMC) will be adding its expectations of the Fed-Funds target rate to the raft of other indicators that it already publishes. This is significant because the Federal Reserve can explicitly indicate the likely path of future interest rates in response to changes in economic data—something which is now only implied from the futures market. But, they will also remove the guesswork even from this, because FOMC members will be providing an estimate of when the first hike will come. This moves even further down the path of the Federal Reserve not merely holding rates at exceptionally low levels, but also communicating for how long they will stay there, a really quite remarkable degree of transparency. The market also expects that by using the vehicle of its forecasts, the Federal Reserve will be able to engineer a third quantitative easing (QE3) package, likely focused on MBS buying, in the spring.

One challenge for market participants, then, may be to marry US economic data, which is less dismal than first thought and seemingly getting better still (albeit from a low base) with a Federal Reserve that continues to broaden the range of tools it uses to keep monetary policy very accommodative.

As this week also marks FFTW's annual Investment Offsite, we will return to our outlook for 2012 next week, and we wish all our readers a very happy—and successful—New Year.

Chart of the Week: Citi US Surprise Index March 1, 2003 – January 9, 2012



Data Source: Citigroup

Next Week:

Monday, January 9:

- Germany Industrial Production is expected to decrease to -0.5% m.o.m. for November.

Tuesday, January 10:

- France Industrial and Manufacturing Production is expected to decrease to -0.2% and -0.4% m.o.m. respectively for November.
- Bank of France Business Sentiment Indicator is expected to remain at 95 for December.

Wednesday, January 11:

- Germany GDP growth is expected to decrease to 3.0% y.o.y. for 2011.

Thursday, January 12:

- France CPI is expected to decrease to 2.3% y.o.y. for December.
- Germany CPI is expected to remain at 2.1% y.o.y. for December.
- UK Industrial and Manufacturing Production is expected to increase to -0.1% and -0.2% m.o.m. respectively for November.
- US Initial Jobless Claims are expected to increase to 375,000 for the week.

Friday, January 13:

- US Import Price Index is expected to decline 0.1% for December.
- US University of Michigan Consumer Confidence Survey is expected to increase to 71.5 for January.

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%	0.33%	January 12
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.34%	January 24
BoE	-50 bps	March 5, 2009	0.50%	1.10%	January 12

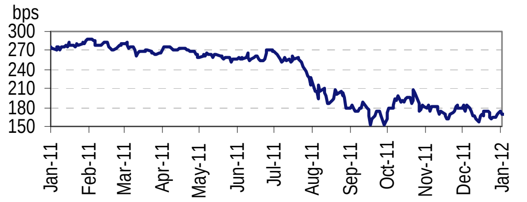
Market Review: Sovereign Bond Markets

United States

US Treasury yields declined despite stronger-than-expected labor market data released on Friday. Comments from New York Federal Reserve President William Dudley suggested a willingness to provide additional stimulus, given the lack of progress on unemployment and the obstacles to growth created by the housing market.

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	0	0	0
2 Yr	0.26	2	2	2
5 Yr	0.86	2	2	2
10 Yr	1.96	8	8	8
30 Yr	3.02	12	12	12
2 - Fed	0.01	2	2	2
5 - 2	0.60	1	1	1
10 - 5	1.10	6	6	6
30 - 10	1.06	4	4	4



Source: Bloomberg

Europe & Japan

Recent data from the euro area is adding pressure on the European Central Bank (ECB) to lower the benchmark interest rate from the current 1.0%. The PMI Manufacturing Index for the euro area remains weak despite increasing from 46.4 to 46.9 m.o.m. and still shows signs that Europe's economy continues to edge closer towards a recession as governments enforce budget cuts to contain the region's debt crisis. The PMI Services Index for the euro area strengthened to 48.8 from 48.3 in October, where analysts had expected it to remain for the month of November. Euro area CPI inflation fell as expected to 2.8% y.o.y. for December from 3.0% in November, while euro area consumer confidence dipped lower to 93.3 in December from 93.7 in November.

Germany's unemployment rate for the month of December fell to 6.8% from 6.9% a month earlier due to stronger exports of cars and machinery. The number of people out of work fell by 22,000 (compared to an expected reduction of 10,000) to 2.89 million. Retail sales in Germany unexpectedly fell for a second month from a drop of 0.2% in October to a decline of 0.9% in November. Economists had originally forecast a gain of 0.2%. Factory orders for the month of November declined 4.8% m.o.m. (against an expected drop of 1.8%) after increasing 5% in October. The yield on 10-year German Bunds increased three basis points over the week to 1.85%.

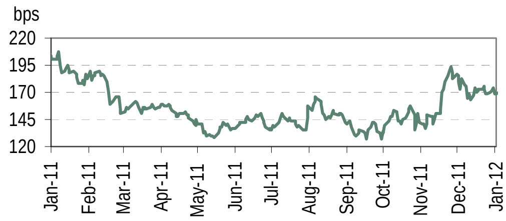
In France, consumer spending rates reversed, declining 0.1% m.o.m. in November compared to an expected increase of 0.3%. Consumer confidence data for December held constant, as expected, at 80. The yield on 10-year French government bonds increased 22 basis points over the week to 3.37%.

The PMI Manufacturing Index for the UK increased from 47.6 to 49.6 compared to an expected decline to 47.3. The PMI Services Index showed an expansion from 52.1 to 54.0 and beat the mean forecast of 51.5. The yield on 10-year UK government bonds increased four basis points over the week to 2.04%.

The yield on 10-year Japanese government bonds declined one basis point over the week to 0.99%.

2- to 10-Year Bund Yield Spread

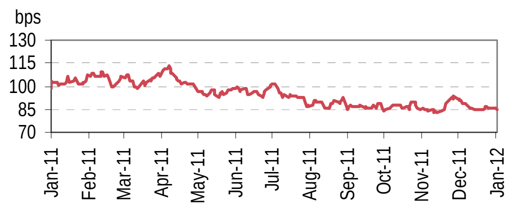
Europe		Change in Level (bp)		
	Current	1wk	MTD	YTD
ECB	1.00	0	0	0
1 Yr	-0.06	0	0	0
2 Yr	0.17	2	2	2
5 Yr	0.78	3	3	3
10 Yr	1.85	3	3	3
30 Yr	2.45	8	8	8
2 - ECB	-0.83	2	2	2
5 - 2	0.62	0	0	0
10 - 5	1.07	0	0	0
30 - 10	0.59	5	5	5



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	0	0
2 Yr	0.13	0	0	0
5 Yr	0.34	-1	-1	-1
10 Yr	0.99	-1	-1	-1
20 Yr	1.76	0	0	0
30 Yr	1.94	1	1	1
2 - BOJ	0.03	0	0	0
5 - 2	0.20	-1	-1	-1
10 - 5	0.65	0	0	0
30 - 10	0.96	2	2	2

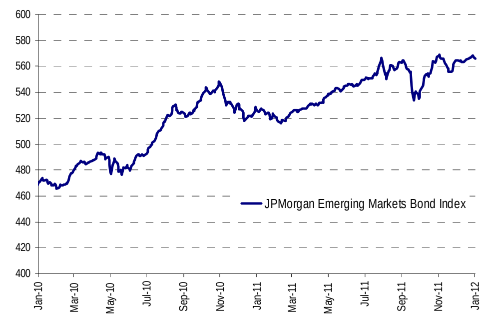


Source: Bloomberg

Market Review: Emerging Markets

Risky assets started the year with a positive step. Economic data from the US support the ongoing recovery story. In the first week of trading in 2012, emerging market (EM) currencies (except EM Europe) have generally appreciated, while the euro continues to decline. Oil markets have also started the year on strong footing, supporting commodity currencies, such as the Columbian Peso. In EM credit, Hungary and other Central and Eastern European credits have come under pressure this week. EM assets registered US$750 million of inflows in the week to January 4, of which bond funds registered inflows of US$227 million. In a continuation of the trend seen at the end of 2011, inflows into EM dedicated bond funds were driven by hard currency funds, while local currency funds experienced small outflows.

JP Morgan Global Emerging Markets Bond Index



Source: Bloomberg

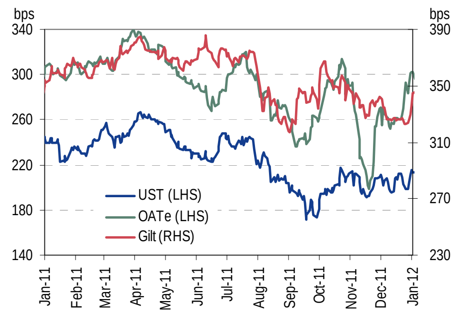
Market Review: Global Inflation-Linked Bonds

In the US, stronger-than-expected employment data, higher energy prices on the back of geopolitical tension in the Middle East, and investors' interest in TIPS supported breakeven inflation (BEI), with front-dated BEI being the best performer over the week. US 10-year BEI closed the week at 2.1%, about 10 basis points higher than the previous week's close.

In Europe, the inflation market focused on the French government's proposal of a hike in VAT rates in exchange for reduced tax burden on employers. While the VAT tax hike talks are still preliminary, European inflation-linked securities, particularly short-dated inflation-linked bonds (ILBs) referenced to domestic French CPI, performed strongly on the back of the news. BEI spreads on euro HICP ILBs widened 10-to-20 basis points across the curve, and BEI on shorter-dated French domestic ILBs widened more than 30 basis points.

This week, UK BEI benefited from stronger-than-expected PMI survey results and pent-up demand from investors who were previously constrained by year-end balance sheet issues. Index-linked Gilts rallied and outperformed their nominal comparators, with BEI widening 10-to-13 basis points in the 10-year sector. Longer-dated BEI performed less well, as impending supply (UKTI 2047 to be reopened on January 10) and unattractive levels of real yields weighed on the long-end of the curve.

GILBs - 10-Year Breakeven Spreads



OATe - French sovereign indexed to EU harmonized CPI

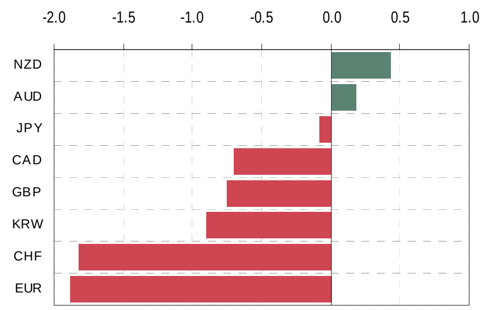
Source: Bloomberg, performance in percentage points (%)

Market Review: Currency Markets

G10

The first week of 2012 saw a series of upside surprises to cyclical data, especially data out of the US. Even European data has started to show some stabilization, which suggested that the global growth slowdown might be overdone. However, the euro was the weakest performer last week on further expectations of looser ECB policy and that a weaker euro will be one of the key components to solving the financial crisis. Meanwhile, cyclical currencies and EM currencies were the outperformers as risk sentiment improved.

US Dollar's WTD Performance Against Other Majors

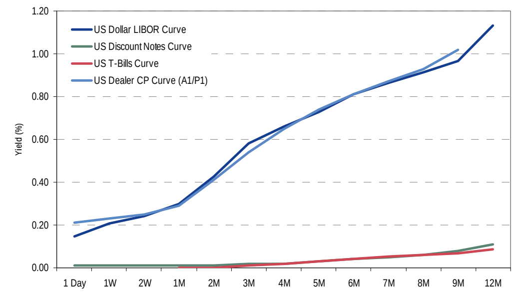


Source: Bloomberg, performance in percentage points (%)

Market Review: Money Markets

A dearth of European sovereign developments plus a string of positive domestic economic indicators encouraged investors to unwind their year-end liquidity buffers, increasing their term purchases and supporting robust new issuance in CP and CDs. Daily CP volume hit a robust US$107 billion this week (+14% from December's average). Investors moved to re-establish portfolio durations at a moderate 36 to 40 days, reflecting the benign Federal Reserve outlook offset by uncertain credit spreads, which were flat this week after months of widening. Investors absorbed large US$2-US$5 billion CD issues in longer 3-to-6 month terms from the expected Scandinavian, Canadian and Australian banks, but better Japanese, German and UK issuers participated noticeably, reflecting investors' returning risk appetite after sticking to a particularly strict holiday diet.

Money Market Yield Curves



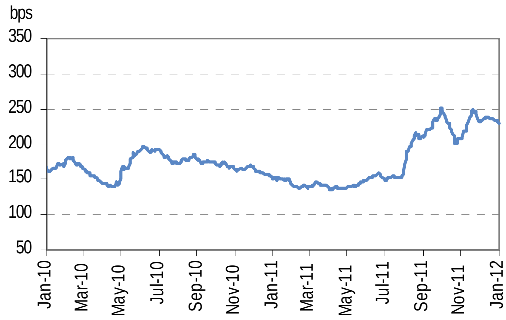
Source: Bloomberg

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

US and European corporate bonds outperformed government bonds for the third consecutive week. New issue supply picked up to meet investor demand that built over the last few weeks in the absence of negative news out of Europe. US economic data continued on a positive note (ISM manufacturing, December auto sales and employment data). US high grade bonds had US$1.1 billion inflows following last week's US$686 million inflow. High yield bonds had US$774 million of inflows versus US$455 million of inflows last week. US corporate bonds delivered +0.36% excess return over Treasuries for the period and closed the week at 230 basis points (-9). European corporate bonds outperformed government bonds by +0.84% and ended the week at 321 basis points (-11).

Investment-Grade Corporate Bond Index OAS

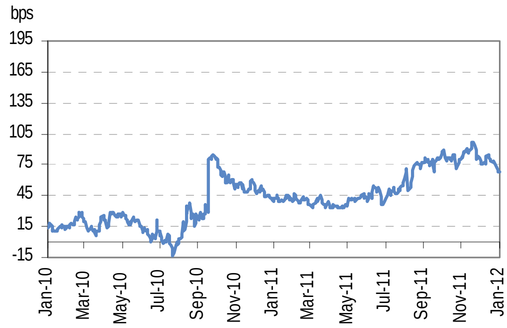


Source: Barclays Capital

Mortgage-Backed Securities

The mortgage sector started off the new year strongly, outperforming duration-matched Treasuries by 18 basis points. Positive economic data led interest rates to move higher, while lower coupon MBS moved higher in dollar price. GNMA MBS underperformed conventional MBS. Proposed Federal Reserve guidelines could move away from the preferential treatment GNMA receives for liquidity purposes. Higher-coupon MBS suffered as a result of some political maneuvering by the President as well as a white paper issued by the Federal Reserve. This was ultimately discounted and the White House said it was not planning to announce any mass-refinance programs. We remain positive on structured products, including MBS, CMBS and non-agency RMBS.

Agency MBS Current-Coupon Fixed-Rate OAS

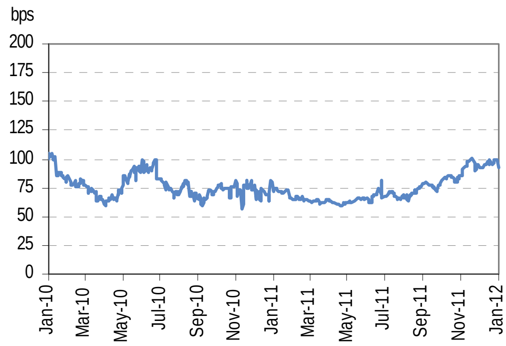


Source: Barclays Capital

Asset-Backed Securities

ABS issuance ended 2011 at US$135.8 billion, with auto ABS accounting for US$58 billion and US$14.3 billion in bank cards. Of 2011 issuance, 45% was floating-rate bonds. Spreads held in for short-duration ABS as investors continue to seek cash surrogates in 2012. AAA-rated two- and three-year prime fixed auto ABS spreads tightened two basis points each.

Barclays Capital ABS Index OAS



Source: Barclays Capital

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