APRIL 20, 2012
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WEEKLY COMMENTARY:

Argentina & Oil & Populism

Major Developments:

Monday, April 16:

- US Empire Manufacturing Index decreased to 6.56 for April.
- US Advance Retail Sales growth was 0.8% m.o.m. for March.

Tuesday, April 17:

- Japan Consumer Confidence Index increased to 40.3 for March.
- UK CPI increased to 3.5% y.o.y. for March.
- US Housing Starts decreased 5.8% m.o.m. for March.
- US Capacity Utilization decreased to 78.6% for March.

Wednesday, April 18:

- UK ILO Unemployment Rate decreased to 8.3% in March.

Thursday, April 19:

- US Existing Home Sales decreased 2.6% m.o.m. in March.

Friday, April 20:

- Germany Producer Prices increased to 3.3% y.o.y. for March.
- UK Retail Sales growth increased to 1.8% m.o.m. for March.

The biggest news in the markets this week was not likely the weakening Chinese data or the first round of the French elections. Arguably the most important development was the decision by Argentina President Cristina Kirchener to expropriate the shares of the oil company YPF held by Spain's oil giant Repsol. Readers may have seen this news described as a nationalization, but it is the intent of the Argentinian government to effect this change in ownership without consideration being offered–or to be blunt, without paying a cent. This should tell investors a great deal about risk perceptions in emerging markets, and also about how resource constraints globally may be changing power dynamics in ways that it is useful to understand better.

YPF was an Argentinean oil exploration company. It was privatized by reforming President Carlos Menem in 1993, and what had been a chronically loss-making company became profitable. Spain's Repsol purchased the company in 1999, but entered into a partnership with the Petersen Group which over time saw its share decline to 58% of the company, now known as Repsol YPF. Argentina was never in the big leagues of oil production, and output was declining. This was set to change: in November 2011, a shale oil find known as Vaca Muerta (literally, "dead cow") was set to catapult the country into third place in the list of shale-oil producers, behind the US and China. (Note: shale oil is not the same kind of oil as that found in the Alberta tar sands and the deposits in Argentina are not of that size.)

The rise in oil prices however has created perverse effects in Argentina: production has declined, and incentives to invest in extraction technologies are not there. This is because Argentina under its current president and her predecessor (and husband) Nestor Kirchner has set a national oil price which is considerably below the market level. This may be one reason why production has plunged. In turn, this has meant that Argentina has been forced to import much of its oil, generating a huge trade imbalance and further fuel-pump subsidies that need to be paid for. While one way of looking at the problem is perhaps to blame a subsidy regime for distorting the market, one can understand that the resource-nationalist perspective instead wonders how the former oil champion has led its host country to the position where it is exploring less even while reserves are increasing, and importing more. Repsol was also looking to sell its stake in the YPF subsidiary to China's Sinopec. It has been suggested that exploring this sale is what triggered the expropriation: sale of a national asset such as oil to a company controlled by a foreign country, and one as powerful as China, was perhaps a final insult. Against this, it is hard not to notice that the acquisition of the privatized YPF by the foreign Repsol in the first place does not seem to have been particularly controversial (there were certainly opponents of Menem's program, but generally more the privatizations themselves rather than the identity of the purchasers), and furthermore, President Kirchner had not kept her ambitions secret. They may not have been taken seriously by many observers, but she did not dissemble.

The value of YPF was not huge–Antonio Brufau, the CEO of Respol, valued it at US$10.5 billion. The problem is that development of Vaca Muerta is estimated to need around US$250 billion over the next decade. Mexico's President Felipe Calderon was nothing if not succinct in saying, "No one in their right mind would invest in a country that expropriates investments". His country's own (state-owned) oil producer, Pemex, owns 9.5% of Repsol. Likely there are ways forward for Argentina's oil exploration: in particular, analysts believe a company such as Brazil's Petrobras may be well placed geographically and politically to weather these risks. However, the whole affair serves to remind investors of two things. First: emerging markets offer tremendous value, but are not without their risks. Risks need careful and active management.

The second may be more worrying. That is the rise in populism. Argentina's move may prove to be tragically short-sighted– on balance this does seem a more likely outcome. Observers note that this looks worryingly like the path Venezuela took. Yet, it may not be isolated. We referred in the opening to the French elections, the first round of which has seen a record vote go to third-placing Front National candidate Marine Le Pen: Ms. Le Pen seems to have attracted a considerable "protest vote" against the front-running parties. On April 23, the Dutch government seemed likely to fall when Geert Wilder's Freedom Party pulled its support, rejecting austerity measures. On May 6, not only will the French go to the polls for a second time but also will the Greeks. While a government of national unity is the most likely outcome, the two mainstream parties are both enfeebled by association with dramatic budget cuts and look likely to need propping up by more populist Greek politicians, chafing at austerity. For some time now, we have viewed fiscal retrenchment in very technocratic terms, as one of a range of choices open to policymakers. It looks like choices may be about to get harder.

Next Week:

Monday, April 23:

- Euro-Zone PMI Manufacturing and Services Surveys are expected to increase to 48.1 and 49.3, respectively, for April.
- France Business Confidence Indicator is expected to remain at 96 for April.

Tuesday, April 24:

- US Consumer Confidence Index is expected to decrease to 69.6 for April.
- US New Home Sales growth is expected to increase to 2.2% m.o.m. for March.

Wednesday, April 25:

- UK First Quarter GDP is expected to decrease to 0.3% y.o.y.
- US Durable Goods Orders are expected to decrease 1.7% m.o.m. for March.
- UK Nationwide Consumer Confidence Index is expected to decrease to 43 for March.

Thursday, April 26:

- Germany CPI is expected to decrease to 2.0% y.o.y. for April.
- Japan Industrial Production growth is expected to increase to 2.3% m.o.m. for March.

Friday, April 27:

- France Consumer Spending is expected to decrease 1.9% m.o.m. for March.
- US University of Michigan Consumer Confidence Index is expected to remain at 75.7 for April.

Source: Bloomberg

Central Bank Watch:

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on June 2012 Interest Rate Futures Contract	Next Meeting
Fed	-75 bps	December 16, 2008	0% - 0.25%	0.13%	April 25
ECB	-25 bps	December 8, 2011	1.00%	0.35%	May 3
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.33%	April 27
BoE	-50 bps	March 5, 2009	0.50%	1.01%	May 10

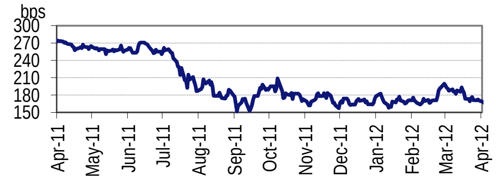
Market Review: Sovereign Bond Markets

United States

Treasury yields ended the week lower than the previous week with the current 10-year closing at 196 basis points versus 198 basis points in the previous week. Concerns about the euro area's debt situation along with some disappointing US economic data led to a risk-off sentiment driven rally in Treasuries. In economic data, US Retail Sales for March came in higher than expected at 0.8% m.o.m. versus an expected 0.3%. However, there was disappointment in other economic data. The initial jobless claims number for the previous week came in at 386,000, higher than the expected 370,000. There was also an upward revision to the previous initial jobless claims number to 388,000 from 380,000. On the housing front, existing home sales during March fell 2.6% m.o.m., compared to expected growth of 0.5% m.o.m. The Philadelphia Federal Reserve's Business Outlook Survey also came in lower than expected at 8.5.

2- to 10-Year Treasury Yield Spread

US		Change in Level (bp)		
	Current	1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.07	-2	0	6
2 Yr	0.27	0	-6	3
5 Yr	0.84	-1	-20	1
10 Yr	1.96	-2	-25	9
30 Yr	3.13	0	-21	23
2 - Fed	0.02	0	-6	3
5 - 2	0.58	0	-13	-2
10 - 5	1.12	-1	-5	8
30 - 10	1.16	2	3	14



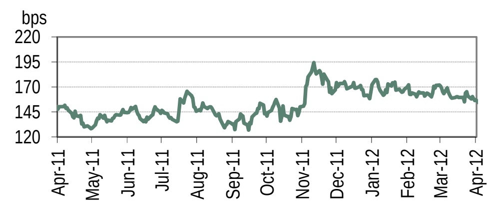
Source: Bloomberg

Europe & Japan

In Europe this week, auctions were the focus of attention. Due to its front - loading of issuance this year, Spain was able to announce smaller deal sizes than expected. Spreads continuing to widen helped to ensure the deal was well-received and in the end €3.18 billion was placed compared with the maximum €3 billion target. On review, the auctions were quite weak, with the 10-year coming at a yield of 5.74% and the two-year at 3.46%. Compare this with Germany's ability this week to issue two years at 0.14% and still get the order covered 1.8 times and this gives some idea of ongoing safe haven investor appetite. Economic data was decent, especially from Germany, with the ZEW and IFO data both continuing to rise where consensus was for a mild drop. Germany Bunds were little changed at 1.71% for 10-year bonds. Anything French was given a rough ride this week as we approach the first round of the elections. Five-year credit default swaps on French treasuries widened by 15 basis points to 200 basis points over the week.

2- to 10-Year Bund Yield Spread

Europe		Change in Level (bp)		
	Current	1wk	MTD	YTD
ECB	1.00	0	0	0
1 Yr	0.09	0	-4	15
2 Yr	0.14	1	-7	-1
5 Yr	0.67	0	-12	-9
10 Yr	1.71	-3	-9	-12
30 Yr	2.40	0	-6	3
2 - ECB	-0.86	1	-7	-1
5 - 2	0.54	-1	-6	-8
10 - 5	1.04	-3	4	-3
30 - 10	0.69	3	3	15



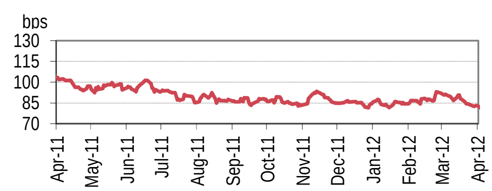
Source: Bloomberg

The UK showed some signs of life as we reached 100 days until the Olympics. The Rightmove house price index leapt by 2.9% in April, unemployment fell by 0.1% to 8.3% and retail sales were over 1% better than expected at +1.8% m.o.m. However, CPI rose by 0.1% to 3.5% in March. As Bank of England (BoE) policy maker Adam Posen alluded to this week, if CPI fails to fall it makes the case for further stimulus much weaker and consequently Gilts have been underperforming other major bond markets this week. The 10-year Gilt yields rose 14 basis points to 2.18%.

In Japan, y.o.y. data, such as department store sales and trade exports spiked higher as the disruption from the disaster in March last year fell out of the measures. Equities were down on the week, helping Japanese Government Bonds (JGBs) to hold on to their recent gains and yields edged one basis point lower to 0.94% on 10-year JGBs.

2- to 10-Year JGB Yield Spread

Japan		Change in Level (bp)		
	Current	1wk	MTD	YTD
BOJ	0.10	0	0	0
1 Yr	0.11	0	-1	-1
2 Yr	0.11	0	-1	-3
5 Yr	0.28	-1	-3	-7
10 Yr	0.94	-1	-5	-5
20 Yr	1.73	0	-3	-3
30 Yr	1.93	1	-2	0
2 - BOJ	0.01	0	-1	-3
5 - 2	0.17	-1	-2	-4
10 - 5	0.66	0	-1	2
30 - 10	0.98	1	2	5



Source: Bloomberg

Market Review: Emerging Markets

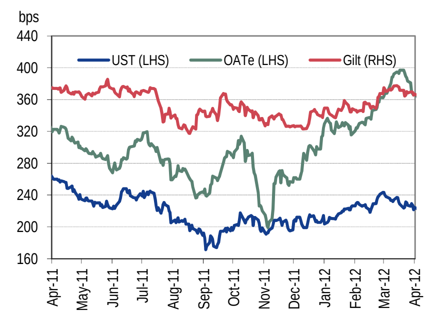
JP Morgan Emerging Markets Bond Index Global

Source: Bloomberg

The week began with a risk rally after concerns over Spain's economy were abated by a successful sovereign debt auction. The resulting increase in investors' risk tolerance was further strengthened by a series of positive earnings announcements in the US. However, later in the week, lukewarm data releases in the US, renewed concerns about Spain's future, and even the expropriation of YPF by the Argentinian government were followed by more cautious trading activity. In Asia, India surprised the market with a 50-basis-point cut in the repo rate; expectations were for a 25-basis-point cut. The Reserve Bank of India remains concerned about inflation, but cut rates due to disappointing growth. In Eastern Europe, Hungary kept its policy rate at 5.75%. In Latin America, the Copom cut the selic rate 75 basis points, to 9.0% as expected. However, authorities were more dovish than we expected, indicating that this is not the end of the monetary cycle.

Market Review: Global Inflation-Linked Bonds

GILBs - 10-Year Breakeven Spreads



OATe - French sovereign indexed to EU harmonized CPI

Source: Bloomberg, performance in percentage points (%)

In the US, a decline in gasoline futures prices and a supply concession pressured shorter-dated breakeven inflation (BEI). BEI spreads in the 5- to 10-year sector narrowed three-to-five basis points over the week while long-dated BEI spreads were largely unchanged. The new US$16 billion five-year issuance cleared at -1.08%, about two basis points cheaper than pre-auction levels.

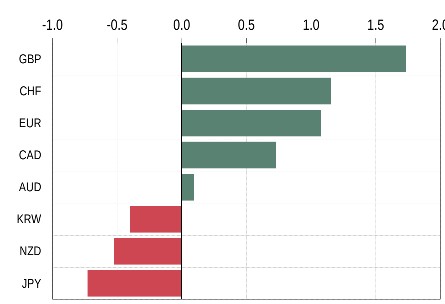
In the UK, headline CPI rose, for the first time in six months in March to 3.5%, higher than the 3.4% expected level. Core CPI also surprised to the upside at 2.5%, while the market was expecting 2.3%. RPI readings, however, fell in line with expectations to 3.6%. The stickiness of core inflation in the UK has led Monetary Policy Committee (MPC) member Adam Posen to change his vote to "no change" in the size of quantitative easing (QE) at the April MPC meeting, from a vote for a £25 billion of expansion in March. While the removal of technical support to nominal Gilts should be favorable to BEI, the increasing odds that QE will end in May have yet to help BEI to perform. UK BEI rates were largely unchanged over the week.

In the euro area, BEI spreads in the 5- to 10-year sector narrowed 6-to-12 basis points to make room for the new French inflation linked bond (ILB) OATei 2018 auction. The new bond cleared at a real yield of 0.55%, but BEI spreads did not recover much after the auction, as the market remains nervous ahead of Italian ILB supply in the coming week.

Market Review: Currency Markets

G10

US Dollar's WTD Performance Against Other Majors

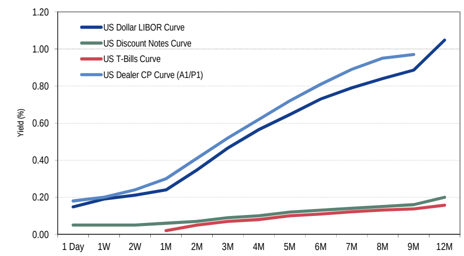


Major currencies have been trading broadly in a range over the past few weeks, particularly for the majority of G10 and emerging market (EM) currencies. Economic data from the US and China have been rather mixed and inconclusive, and renewed concerns in the Euro area, particularly Spain, has left most currencies in a trendless trading range. The euro managed to rally 1% for the week, while the Japanese yen was slightly weaker.

Of all the central banks meetings this week, the Bank of Canada has reverted to a tightening bias on the back of a stronger domestic growth momentum and a firmer inflation profile. Meanwhile, the minutes to the BoE meeting showed a material shift away from support for further asset purchases, and the Riksbank did not follow up on its February rate cut as some market participants expected. Markets have moved to reduce expectations of further easing in all three markets, which supported the strength in the Canadian dollar, the British pound, and the Swedish krona. In EM currencies, the Brazilian real was the weakest on the back of lower rates expectations and central bank intervention.

Market Review: Money Markets

Money Market Yield Curves



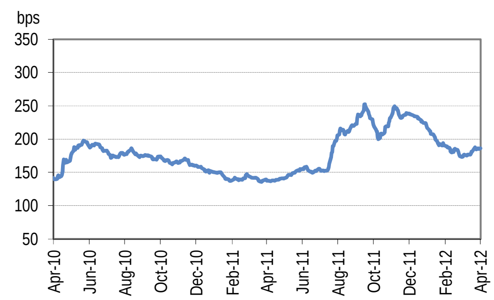
Source: Bloomberg

With tax receipts filling the Treasury's coffers and nearly US$50 billion in maturing Treasuries reducing supply in the markets, the long anticipated decline in repo rates finally arrived with overnight rates dropping from a high of 0.22% to 0.09% by week's end. Short Treasury bill rates declined as well with one-, three- and six-month bills each down around one basis point. Early in the week, volume of commercial paper was high as demand rose for tier-one issuers. However, by week's end and despite solid corporate earnings announcements, money market participants pulled back from trading in European bank names due to uncertainty regarding the French elections, the Spanish and Italian economies, and the International Monetary Fund's (IMF's) ability to raise funds for its war chest weighing on the markets. Despite this, LIBOR rates were nearly unchanged. The week ahead will be dominated by the Federal Open Market Committee (FOMC) meeting with investors looking for insights as to the Federal Reserve's inclination for more QE.

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

Investment-Grade Corporate Bond Index OAS

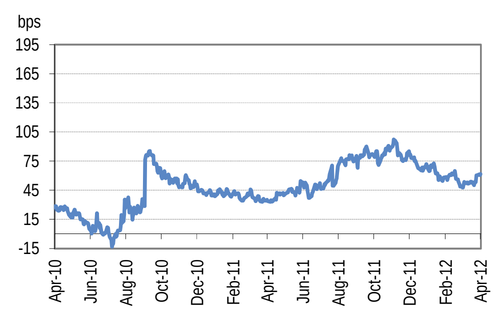


Source: Barclays Capital

European corporate bonds slightly outperformed government bonds after the prior three consecutive weeks of underperformance. US corporate bonds continued to underperform government bonds for the fifth consecutive week. European concerns continued, centered primarily in Spain and France's first-round election scheduled to take place over the weekend. US Treasuries maintained their flight to quality status (10-year yields were down two basis points to 1.96%). Issuance was light as the first-quarter earnings season for key US financial institutions was in full swing and generally reported fairly well. High-grade bonds had US$1.7 billion of inflows versus US$873 million last week. High-yield bonds experienced an outflow of US$637 million relative to an inflow of US$1.3 billion last week, leading to a year-to-date increase of US$14.8 billion. European corporate bonds outperformed government bonds by 0.07% and ended the week at 239 basis points (three basis points wider). US corporate bonds underperformed Treasuries by 0.22% for the period and closed the week at 186 basis points (one basis point wider).

Mortgage-Backed Securities

Agency MBS Current-Coupon Fixed-Rate OAS

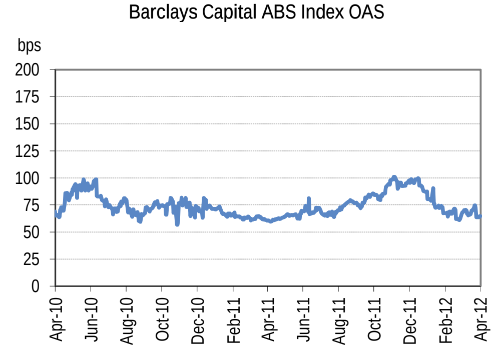


Source: Barclays Capital

The mortgage sector underperformed duration-matched Treasuries by eight basis points this week. Mortgage performance was mixed throughout the week and ended marginally lower. Despite the underperformance, realized volatility has moved lower and demand for structured product is strong. We remain cautious on prepayments and the impact of government refinancing (e.g., HARP initiatives). We are positive on structured products, including MBS, CMBS and non-agency RMBS.

Asset-Backed Securities

Barclays Capital ABS Index OAS



Source: Barclays Capital

Spreads in the ABS market remained steady as US$6 billion of new issues hit the market to good demand. Honda, BMW, and Ford came out with large prime auto deals that tightened from initial estimates and were upsized to meet demand. Credit card ABS performance remains strong with delinquencies trending down as the macroeconomic environment stabilizes and underwriting standards have tightened. Bank cards outperformed private label credit cards on average.

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