

JANUARY 20, 2012
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WEEKLY COMMENTARY: Risk On, For Now

Major Developments:

Monday, January 16:

- Japan Consumer Confidence Survey increased to 38.9 for December.

Tuesday, January 17:

- UK CPI decreased to 4.2% y.o.y. for December.
- US Empire State Manufacturing Survey increased to 13.48 for January.
- Euro area CPI decreased to 2.7% y.o.y. for December.

Wednesday, January 18:

- UK ILO Unemployment Rate increased to 8.4% for November.
- US PPI was 4.8% y.o.y. for December.
- UK Nationwide Consumer Confidence Survey decreased to 38 for December.

Thursday, January 19:

- US Housing Starts decreased 4.1% m.o.m. for December.
- US CPI decreased to 3.0% y.o.y. for December.

Friday, January 20:

- Germany PPI was 4.0% y.o.y. for December, lower than expected.
- UK Retail Sales growth increased to 0.6% m.o.m. for December.

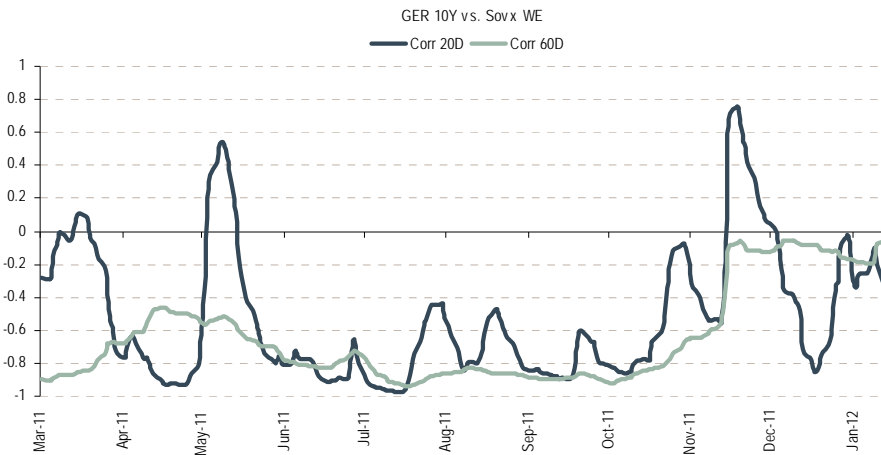
The Chart of the Week is part of a series that has become an FFTW favorite and looks at the drivers of bond yields. Today's chart (page 2) shows the 20-day and 60-day moving average of changes in the correlation of German Bund yields to a basket of Western European credit default swap (CDS) contracts known as the iTraxx SovX Western Europe, or SovX WE for short. Allowing for weekends and holidays, the 20-day line shows an approximation of a monthly moving average, while the 60-day indicator approximates a quarter's data. These time periods remove noise and allow some perspective. If the line is close to 1, the movement in Bund yields is highly correlated with positive changes in SovX WE—which means that spreads will be narrowing, reflecting investors' belief that a solution is to the fore, or at least that there is reduced likelihood of contagion and EMU break-up risk. For much of 2011, though, the line was close to -1. This is the inverse: it means that there is a negative correlation, so bond yields are falling as SovX WE is widening. This is a classic flight-to-quality indicator. What this chart shows is a good proxy for risk appetite: when the moving average approaches 1, fears surrounding the euro area are receding. When the moving average approaches -1, investors are seeking safety. In passing, readers may note the highly binary nature of the market throughout 2011 as sentiment violently flip-flopped between euphoria and despair.

That seems to have changed. Currently, those indicators are not far from zero—meaning, no correlation. For the first time in many months, it would appear that a primary driver of changes in German interest rates is not what happens in the periphery but rather with respect to other considerations, and in particular, changes in expectations of monetary policy. What does this mean? What it does not mean is increased faith in resolution, because we are not seeing these moving averages at a high positive value. What the chart suggests is that as a causative factor (with apologies to correlation/causation absolutists) what is happening in the periphery is no longer a principal driver of returns. In short, for now, we are back in a normal world, although with 10-year yields still below 2% in the US and Germany, perhaps "quasi-normal" would be a better way of expressing it.

No one is forecasting a growth surprise in Europe: GDP data is released on February 15, so it is too early to have an official consensus forecast. However, many forecasters are predicting a recessionary print with even the more optimistic outliers expecting a number barely above 0%. But this needs to be put into perspective. Against expectations, the European Central Bank (ECB)'s three-year long term refinancing operation (LTRO)—whereby European banks could borrow an unlimited amount of money from the ECB against a wide array of collateral—seems to have been a success and done much to improve sentiment by removing banks' possible difficulties with rolling over debt and to counter investor skepticism about exposures to peripheral Europe. It helped that the LTRO coincided with recognition that US data, in particular the unemployment series, seemed to have turned for the better.

In addition, weekend headlines have been suggesting, again to some surprise, that an agreement between Greece and the Institute of International Finance looks possible. Indeed, it even seems possible that the exchange may appear to be just voluntary enough not to trigger CDS payments. Readers may be forgiven for wondering why anyone cares about what seems to be an increasingly arcane technicality given the now-undisputed reality that holders of Greek debt, in the aggregate, will not see their entire principal repaid. The casual observer could certainly be forgiven for assuming this was a default. The answer seems to be a political determination (though even that seems now to have faded as reality looms so large) coupled with fears as to what default would mean for the ECB's balance sheet: the ECB is the single largest holder of Greek debt, much of it in the form of collateral for loans to Greece's banks. Avoiding this outcome does not solve Greece's long-term funding needs. It does not answer the question as to whether the Troika of the IMF, European Commission, and ECB will provide another package in time for the March coupon payments and bond maturities. What it may do, though, is kick the can down the road for another two months, and tactically, that seems like a long time to some market participants; it really isn't.

Chart of the Week: German 10 Year Bund Yield vs. SovX WE 20-day and 60-day Moving Correlation, 3/1/2011 – 1/21/2012



Next Week:

Monday, January 23:

- France Business Confidence Indicator Index is expected to increase to 95 for January.

Tuesday, January 24:

- Euro area PMI Manufacturing and Services Surveys are expected to increase to 47.3 and 49.0 respectively for January.
- US Richmond Federal Reserve Manufacturing Index is expected to increase to 7 for January.
- President Obama to give 2012 State of the Union Address.

Wednesday, January 25:

- UK 4th Quarter 2011 GDP growth is expected to increase to 0.8% y.o.y.
- US Pending Home Sales are expected to decrease 0.1% m.o.m. for December.

Thursday, January 26:

- Germany GfK Consumer Confidence Survey is expected to remain at 5.6 for February.
- US Durable Goods Orders growth is expected to decrease to 2.0% m.o.m. for December.
- Japan CPI is expected to increase to -0.2% y.o.y. for December.

Friday, January 27:

- US 4th Quarter 2011 GDP growth is expected to increase to 3.0% annualized q.o.q.
- US University of Michigan Survey of Consumer Confidence is expected to remain at 74.0 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%	0.34%	February 9
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.33%	January 24
BoE	-50 bps	March 5, 2009	0.50%	1.05%	February 9

Market Review: Sovereign Bond Markets

United States

This week saw a sell-off in Treasuries amid signs that the US economy is strengthening and Europe is moving closer to resolving its debt crisis. Housing market data showed that home sales rose for a third straight month and the number of mortgage applications rose more than expected. On the inflation front, the December CPI report showed that US inflation is in check, which was in line with expectations. Initial jobless and continuing claim numbers showed fewer people filing for unemployment. In Europe, Greek debt-swap talks seemed to be progressing towards a consensus, which, along with successful European bond sales, eased the refuge appeal of Treasuries. The 10-year TIPS auction saw record demand, with the -0.046% yield at auction being the lowest on record.

Europe & Japan

European governments have seen a strong start to what many had expected to be a difficult year for financing debt. Spain had another successful debt auction on Thursday when the Spanish Treasury sold €6.6 billion, well above the minimum target of €3.5 billion. The average yield on the Spanish 10-year bond fell to 5.40% versus 6.98% on similar bonds sold in November, while the bid-to-cover ratio rose to 2.17 from November's 1.54. Spain's shorter-term 2016 bonds, meanwhile, were sold at a slightly higher yield than an auction earlier this month, rising from 3.912% to 4.021%.

France shrugged off losing its AAA credit rating and sold €3.4 billion in five-year bonds, €3 billion in three-year bonds and €1.6 billion in four-year bonds at lower yields than when these maturities were last sold. France's business confidence indicator unexpectedly fell from 94 to 91 points against an expected score of 95. The yield on the 10-year French government bond increased one basis point over the week to 3.09%.

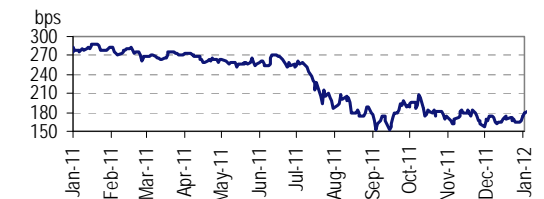
Euro area CPI eased to 2.7% y.o.y. in December from 3.0% in November. In Germany, producer prices increased 4.0% y.o.y. compared to an expected 4.6%. The yield on the 10-year Bund grew by 16 basis points over the week to 1.93%.

The UK on Thursday issued £4 billion of four-year bonds at a yield of just 0.89%. UK December inflation was 4.2% y.o.y. as discounted clothing and petrol prices fell, and December retail sales improved 0.6% m.o.m. The UK unemployment rose to 8.4% in November versus an expected 8.3%. December consumer confidence slipped lower to 38, as expected, from 40 in November. The yield on the 10-year UK Gilt rose 15 basis points over the week to 2.11%.

In Japan, the December consumer confidence survey increased from 38.1 in November to 38.9 and beat the expected score of 38.5. The country's all-industry activity index fell 1.1% m.o.m. in November compared to an expected fall of 0.9%. The yield on the 10-year Japanese government bond increased three basis points over the week to 0.99%.

2- to 10-Year Treasury Yield Spread

US	Change in Level (bp)			
	Current	1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.04	2	3	3
2 Yr	0.24	2	0	0
5 Yr	0.89	10	5	5
10 Yr	2.03	16	15	15
30 Yr	3.10	19	21	21
2 - Fed	-0.01	2	0	0
5 - 2	0.65	8	5	5
10 - 5	1.14	6	9	9
30 - 10	1.08	3	6	6



Source: Bloomberg

2- to 10-Year Bund Yield Spread

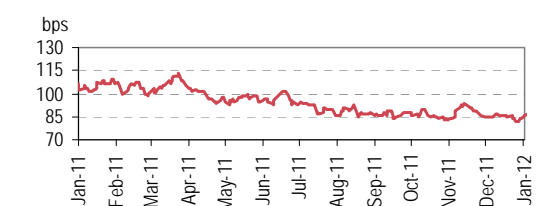
Europe	Change in Level (bp)			
	Current	1wk	MTD	YTD
ECB	1.00	0	0	0
1 Yr	0.08	1	15	15
2 Yr	0.21	6	6	6
5 Yr	0.89	14	13	13
10 Yr	1.93	16	10	10
30 Yr	2.55	20	18	18
2 - ECB	-0.79	6	6	6
5 - 2	0.68	9	7	7
10 - 5	1.04	2	-3	-3
30 - 10	0.62	3	8	8



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	-1	-1
5 Yr	0.34	1	-1	-1
10 Yr	0.99	3	-1	-1
20 Yr	1.76	1	0	0
30 Yr	1.95	1	2	2
2 - BOJ	0.03	0	-1	-1
5 - 2	0.21	1	0	0
10 - 5	0.64	3	0	0
30 - 10	0.96	-2	3	3



Source: Bloomberg

Market Review: Emerging Markets

Emerging markets (EM) fixed income rallied last week as risk aversion abated. The JP Morgan Global Emerging Markets Bond Index gained 1.01% and spreads tightened 28 basis points over the week. EM currencies appreciated across the board with the Egyptian pound, Chinese yuan and Argentine peso as the only exceptions. US numbers continued to surprise to the upside, and the IMF proposed to expand its lending resources to safeguard the global economy against any worsening of Europe's debt crisis. EM assets registered US\$2.1 billion of inflows in the week up to January 18. Bond funds recorded inflows of US\$226 million, and equity funds registered inflows of US\$1.85 billion (0.3% of the market universe).

JP Morgan Global Emerging Markets Bond Index



Source: Bloomberg

Market Review: Global Inflation-Linked Bonds

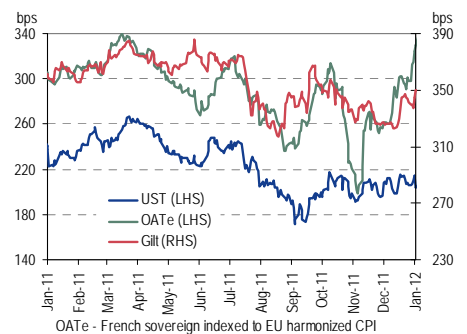
In the United States, while the non-seasonally adjusted headline CPI came in below expectations, core inflation continued to show signs of bottoming with consistent increases in owners' equivalent and primary rent. Despite the larger-than-normal issuance size, the new 10-year TIPS (Tii Jan 2022) auction was met with good demand; the bond cleared at -0.046%, about three basis points in yield richer than pre-auction trading levels.

Similarly, the reopening of French inflation-linked bonds (ILBs) BTNi 2016, OATe 2022 and OATe 2040 was well received, with strong demand coming from those seeking to unload their Italian ILB holdings. Even though Italy remains in the most-widely-followed ILB indices (despite the country's recent S&P two-notch downgrade), investors deem further downgrades by either Moody's or Fitch imminent and are keen to start replacing their Italian holdings with France.

In the UK, while CPI data was in line with expectations, retail price index (RPI) prints surprised slightly to the upside, giving a boost to breakeven inflation (BEI).

Despite recent announcements of utility price cuts, UK BEIs steadily widened five basis points over the week.

GILBs - 10-Year Breakeven Spreads



Source: Bloomberg, performance in percentage points (%)

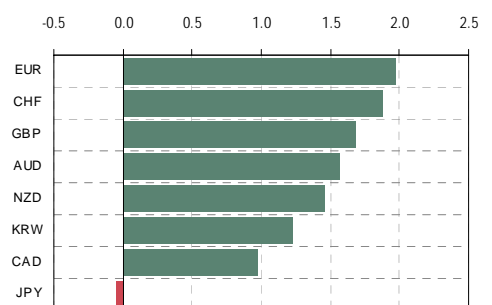
Market Review: Currency Markets

G10

The US dollar and Japanese yen, both safe-haven currencies, were the worst performers on the week. Recent signs of economic stability, particularly those from the United States and China, have helped to boost risk appetite. Despite the S&P downgrade of several European countries and the uncertainty surrounding the Greek PSI negotiation, the euro rallied 2% this week.

The recovery in risk appetite suggested that a benign outcome to the euro area has largely been priced, which led to short covering in Scandinavian currencies. EM currencies have also been performing well in a positive risk environment.

US Dollar's WTD Performance Against Other Majors

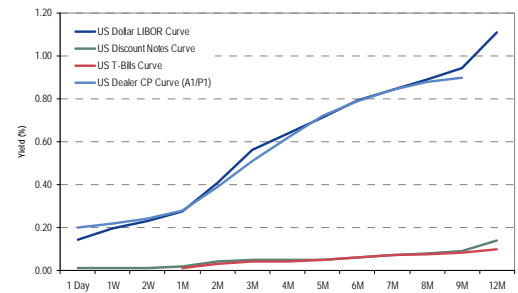


Source: Bloomberg, performance in percentage points (%)

Market Review: Money Markets

Despite S&P downgrading nine euro area countries, several sovereigns were able to issue sizeable new debt, adding to the positive tone in the markets since year-end. Government repos traded at elevated levels throughout the week, reflecting an expansion of dealer balance sheets and providing an attractive alternative to short commercial paper (CP). Also reflecting the increase in investor risk appetite, longer-maturity CP issued by high-quality Canadian and Australian banks continued to capture a large share of new issuance, despite yields steadily dropping. The sizeable Japanese bank issuance was also notable and extended out to maturities of three months. With funding pressures abating, LIBOR appears to have topped out, dropping an additional basis point in the three-month sector to 0.56%.

Money Market Yield Curves



Source: Bloomberg

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

US and European corporate bonds outperformed government bonds for the fifth consecutive week. The ECB's LTRO bought European policymakers time to implement needed fiscal consolidation and support program specifics. The additional tail risk of a hard landing in China seems to be dissipating. US economic reports continue to provide some hope this week, with lower-than-expected initial jobless claims. US fund inflows moderated. High-grade bonds had US\$844 million of inflows, down from US\$1.8 billion last week. High-yield bonds had US\$1.3 billion of inflows versus US\$1.8 billion last week. US corporate bonds delivered +0.46% excess return over Treasuries for the period and closed the week at 217 basis points (8 basis points tighter). European corporate bonds outperformed government bonds by +0.48% and ended the week at 300 basis points (17 basis points tighter).

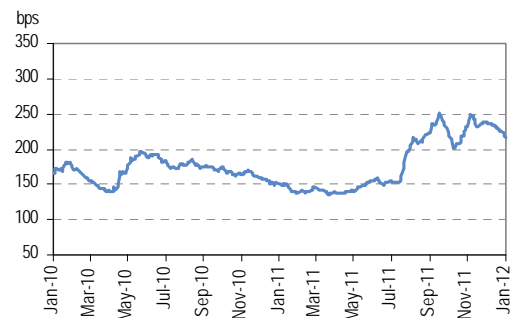
Mortgage-Backed Securities

The mortgage sector outperformed duration-matched Treasuries by six basis points. Positive technical factors continue to drive performance. The primary theme continues to be strong US Federal Reserve demand outpacing supply. Dollar roll markets are strong, and prepayments are benign. We remain positive on structured products, including MBS, commercial MBS and non-agency RMBS.

Asset-Backed Securities

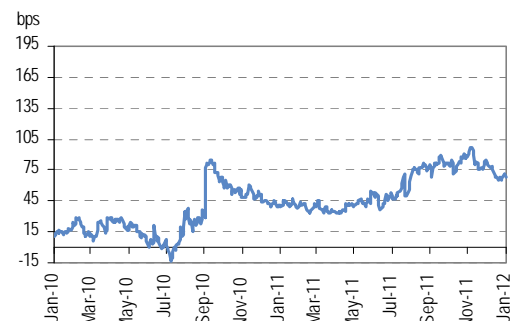
The ABS market has seen a flood of new issuance that has been well absorbed; month-to-date new issuance of US\$12 billion has already surpassed entire January volumes observed in each of the past three years. Ford and Volkswagen both issued new deals that were upsized and priced inside of initial guidance. A US\$500 million, three-year GE private-label credit card deal also came to market and was upsized to US\$845 million due to high interest. The deal priced well at the tight end of guidance. The student loan sector was little changed even as S&P issued downgrades due to changes in counterparty criteria.

Investment-Grade Corporate Bond Index OAS



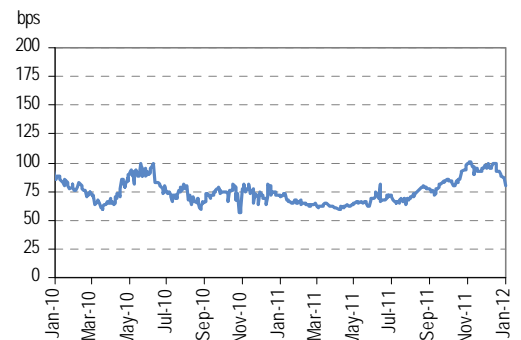
Source: Barclays Capital

Agency MBS Current-Coupon Fixed-Rate OAS



Source: Barclays Capital

Barclays Capital ABS Index OAS



Source: Barclays Capital

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