FFTW

Fischer Francis Trees & Watts

Weekly Strategy Review: Week Ending June 13, 2008

Sally Chen • schen@fftw.com

Major Developments:

Monday, June 9:

- UK May input PPI rises 3.8%, m.o.m.; core output PPI rises 1.2%, m.o.m.

Tuesday, June 10:

- US April trade gap widens from $58.2 billion to $60.9 billion
- Japan April machine orders rise 1.4%, m.o.m.
- US May retail sales rise 1.0%, m.o.m.

Friday, June 13:

- US May headline CPI rises 4.2%, y.o.y; core CPI rises 2.3%, y.o.y.
- BoJ meets and leaves policy rate unchanged at 0.50%

Theme of the Week

- **Inflation End Game Elusive; FOMC Action in 2008 Likely Limited**

Inflation End Game Elusive; FOMC Action in 2008 Likely Limited

We are in a new inflation regime. Inflation is becoming a globalized phenomenon; food and energy prices will likely remain elevated for the intermediate future.

The changes in official rhetoric in recent weeks – noting the role of the US dollar in inflation and the need to contain the second-round effect of a wage-price inflation spiral – signal a shift in central banks' focus away from crisis management to containing inflation. Accordingly, financial markets have priced in the probability of a series of rate hikes, including those from the FOMC by year end. Indeed, some Fed officials have advocated a swift reversal of monetary easing to anchor inflation expectations. **To the extent that the financial market is fully anticipating rate hikes, the FOMC could seize the momentum and raise rates this summer.**

Still, rate hikes are far from certain. **Some of us find good reasons to resist the call for higher rates just yet. First, downside risks to growth remain sizeable and there is still scant evidence that high inflation expectations have translated into wage demand in the US.** We suggested recently that the proper policy response in the current environment is patience – rising food and energy prices are likely to dampen demand and prices for other items and thus do not represent a rise in the *general* level of overall inflation. Indeed, FOMC Vice Chairman Kohn advocated just as much in a speech last week: "an appropriate monetary policy following a jump in the price of oil will allow, on a temporary basis, both some increase in unemployment and some increase in price inflation."

Second, the window for rate cuts this year is small. Forecasts suggest that headline inflation will peak by August and moderate thereafter. Tax rebate checks have lifted chain store sales in recent weeks and allayed growth concerns. But growth concerns are certain to resurface as food and energy prices rise further and consumer spending falters. As the benefits of the tax rebate fade, growth data will be less supportive of rate hikes. Thus, if the FOMC were to reverse some of its policy accommodation, the most opportune time would be this summer. Besides, policy tightening in a weak growth environment is more difficult in practice than in theory. Since the Great Inflation of the early Volcker years, the FOMC has never tightened policy amid consecutive losses in job growth, nor has the Fed been able to tighten when economic growth hovers just around 1 percent, far below potential.

So, yes, the FOMC will raise its interest rates to help fend off inflation, but that move is likely at least a few months off. **In any case, the rate hike versus on-hold debate is but one of the many considerations we face in a global inflation regime**. Above all, it is important to remember that the US is not the source of current global inflation; the Federal Reserve, though an important contributor, is not, and should not, be the nexus of inflation outlook and resolution. To the extent that high food and commodity prices are fueled by robust demand from developing nations whose growth will continue to outpace developed countries, increases in food and energy prices will be durable; headline inflation will remain elevated globally. The inflation endgame therefore, rests not with the Fed, but with emerging market central banks.

Market Review: Sovereign Markets

United States

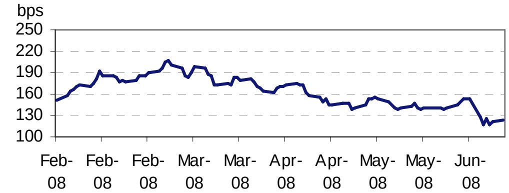
> Duration: Neutral

> Yield Curve: Neutral

US Treasury yields sold off significantly, lifting the 2-year yield to above 3%, the highest level since December 2007. The epic collapse in Treasuries was prompted by Bernanke's unusual reference to the weak dollar and its role in elevating inflation expectations two weeks ago. Such comments and similar concerns from other Fed officials recently signal a policy shift from risk management to containing inflation and prompted interest rate futures to price in three full rate hikes by year end, despite ongoing downside risks to growth. A lackluster demand in the 10-year note reopening auction, stronger-than-expected May retail sales, and a higher-than-expected increase in May CPI, which rose to 4.2% on a yearly basis from 3.9%, all helped to push Treasury yields higher.

Two- to 10-Year Treasury Yield Spread

US		Change in Level (bp)		
	Current	1wk	MTD	YTD
Fed	2.00	0	0	-225
3 Mo	1.97	13	9	-127
2 Yr	3.04	66	39	-2
5 Yr	3.73	55	31	29
10 Yr	4.26	35	20	23
30 Yr	4.79	17	7	34
2 - Fed	1.04	66	39	223
5 - 2	0.69	-11	-9	30
10 - 5	0.53	-20	-11	-5
30 - 10	0.53	-18	-12	10



Europe

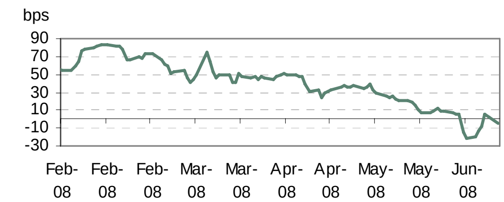
> Duration: Neutral

> Yield Curve: Neutral

The European bond market sell-off was sparked by yet another record high UK PPI. Core PPI reached 5.9% on a yearly basis, well above the long-run average, and prompted investors to price in the probability of rate hikes from the BoE. Correspondingly, gilts suffered a sharp front-end-led sell-off, with the 2-year gilt yield rising nearly 50 basis points to above 5.50%. Meanwhile, ECB Board member Stark dampened speculation of a series of rate hikes, saying that they may only raise rates in July. Still, regional inflation outlooks have been rising: German wholesale prices rose, and French and Spanish CPIs were both above expectations.

Two- to 10-Year Bund Yield Spread

Europe		Change in Level (bp)		
	Current	1wk	MTD	YTD
ECB	4.00	0	0	0
1 Yr	4.62	8	35	55
2 Yr	4.62	-1	31	66
5 Yr	4.66	23	36	54
10 Yr	4.64	22	24	33
30 Yr	4.86	16	5	26
2 - ECB	0.62	-1	31	66
5 - 2	0.04	25	5	-11
10 - 5	-0.02	-1	-12	-21
30 - 10	0.22	-6	-19	-8



Japan

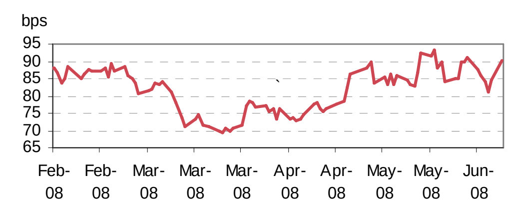
> Duration: Long BEI

> Yield Curve: Neutral

Japanese data were slightly better than expected, though the global bond market sell-off was likely the main impetus behind JGBs' bear-flattening trend in a volatile market. Bank lending continues to trend higher, while machine orders in April rose 5.5% on the month, better than expected. Domestic corporate goods prices jumped 4.7%, helped in part by the reinstatement of the gasoline tax. Meanwhile, sentiment surveys continue to worsen: consumer confidence fell to a six-year low, and the corporate sentiment watcher survey also showed further deterioration. In line with expectations, the BOJ kept its policy rates unchanged by a unanimous vote. Our view on monetary policy remains unchanged as we expect the BOJ to stay on hold in 2008.

Two- to 10-Year JGB Yield Spread

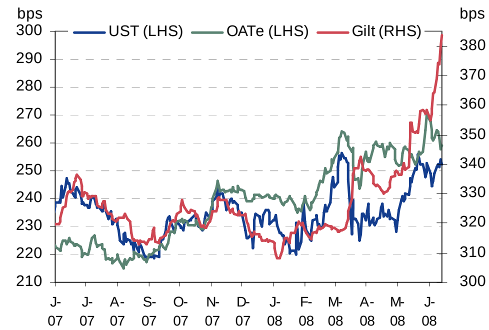
Japan		Change in Level (bp)		
	Current	1wk	MTD	YTD
BOJ	0.50	0	0	0
1 Yr	0.73	5	3	15
2 Yr	1.02	14	11	31
5 Yr	1.54	18	21	53
10 Yr	1.87	7	11	36
20 Yr	2.39	4	9	29
30 Yr	2.56	2	6	20
2 - BOJ	0.52	14	11	31
5 - 2	0.52	4	10	22
10 - 5	0.32	-11	-10	-17
30 - 10	0.70	-5	-5	-16



Market Review: Global Treasury Inflation-Protected Securities (TIPS)

> Duration: Long 20-year US BEI; Flattening bias in Europe

Global Linkers - 10-Year Breakeven Spreads
Source: Bloomberg



OATe - French sovereign indexed to EU harmonized CPI

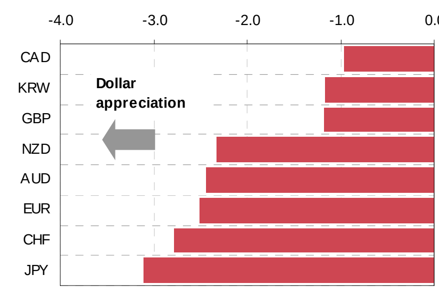
Despite hawkish comments from the Fed and its intention to contain inflation expectations, US breakeven inflation rates performed well. A high CPI print and the rise of the gasoline price to above $4 per gallon all provided support to TIPS. Headline CPI rose 0.6% in May, bringing the yearly inflation rate to 4.2%. Breakeven inflation rates rose 15 to 30 basis points in the 2- to 7-year sector, and 2 to 10 basis points at the longer end. In Europe, German HICP was revised slightly higher, suggesting small risks of an upward revision to the flash estimate of 3.6% Euro HICP. The market will be looking into the breakdown of HICP for evidence of pass-through from food and energy prices into core inflation. The backdrop of a hawkish monetary stance limited the rise in breakeven inflation, with spreads in the intermediated sector widening 2 to 6 basis points while long-dated spreads narrowed slightly. In terms of supply, the Bundei 2016 auction was very well received, and the French Trésor will be reopening OATei20 and OATi23 next week. In the UK, the much-higher-than-expected PPI, together with a rise in inflation expectations, set the tone for the UK linker market. Also, the BoE/GfK survey for February showed that 1-year inflation expectations jumped from 3.3% to 4.3%, while expectations for current inflation rose from 3.9% to 4.9%. Breakeven inflation spreads widened 20 to 30 basis points in the 5 to 20-year sector. The widening of spreads in the 30- to 50-year sector was more contained as breakeven rates are already trading above 4%.

Market Review: Currency Markets

G3

> Position: Long CHF vs. USD

US Dollar's WTD Performance Against Other Majors



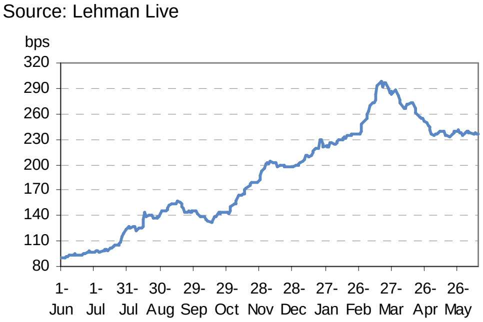
The US dollar rallied against all major currencies and was one of the best performers after a few Latin American currencies. The euro failed to sustain its gains after the ECB hinted an upcoming rate hike. Instead, the market switched its focus to the Fed's inflation concerns. The substantial repricing of US rates has moved interest rate differentials in favor of the USD. The weekend G8 meeting and a "NO" vote from Ireland on the Lisbon EU Governing Treaty also weighed on the EUR's outlook. Elsewhere, the Bank of Canada surprised the market by not easing its policy and joined other central banks in fighting inflation.

Market Review: Credit

US Corporates

> Position: Modest Underweight

Investment-Grade Corporate Bond Index OAS
Source: Lehman Live



Risk markets endured a volatile week. Hawkish comments from the Fed as well as negative financial sector headlines – highlighted by Lehman's first quarterly losses in Q2 and its dismissal of two senior-level officials – left a negative tone in the market. Still, the credit market was surprisingly resilient and ended the week little changed. The investment grade CDX index was 2 basis points tighter on the week at 114 basis points and the high-yield index was little changed on the week.

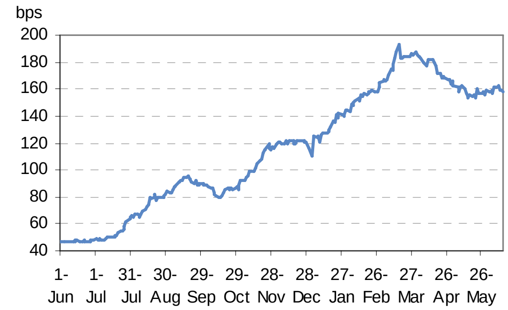
Market Review: Credit (continued)

European Corporates

> Position: Neutral

Once again, oil prices and equity market performance set the market tone for European Credits. Crude oil prices moderated from the historical high seen in the previous week, and major equities were little changed by the end of the week. Surprisingly, the higher-than-expected US CPI print and regional European inflation data, as well as rising inflation expectations, did little to dent corporate market performance. The Xover index ended at 470 basis points after trading above 500 basis points. Trading activity in the primary market was decent with supply easily absorbed.

Euro-Aggregate Corporate Index OAS
Source: Lehman Live



Mortgage-Backed Securities

> Position: Modest Overweight

Mortgages underperformed comparable-duration Treasuries by 46 basis points as the sharp rise in rates and flattening of the yield curve put pressure on the sector. Correspondingly, convexity-related hedging flows weighed on the sector, particularly as rates moved out of the recent range. Still, swap spreads remained relatively contained and swaption volatility actually moderated later in the week; these factors likely helped to contain the widening in mortgage OAS.

.

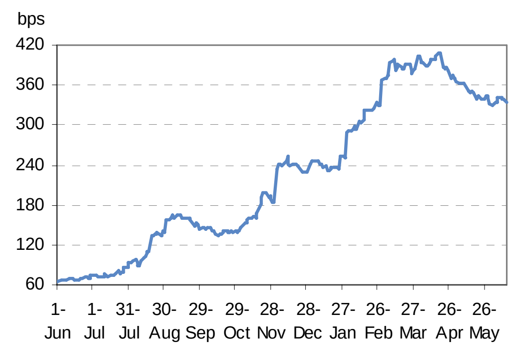
Agency MBS Current-Coupon Fixed-Rate OAS
Source: Lehman Live

Asset-Backed Securities

> Position: Modest Overweight

Issuance was stable last week with US$6.3 billion brought to the market in six deals, including two Auto, two Credit Card, and one Student Loan paper. Demand continued to be strong with high reverse inquiry. Most deals priced toward the tight end of original estimates as spreads continued to tighten moderately. Specifically, the Prime Auto sector tightened by 10 basis points and BBB Credit Cards tightened by 20 basis points. ABX prices declined over the past week, but this was largely seen as a purely technical move and not reflective of any fundamental deterioration in value.

Lehman ABS Index OAS
Source: Lehman Live



Next Week:

Monday, June 16:

- EU May HCIP to rise 3.7%, y.o.y.

Tuesday, June 17:

- US May headline PPI to rise 6.8%, y.o.y.; core PPI to rise 3.0%, y.o.y.
- US May housing starts to fall from 1.03 million to 980 thousand units
- UK May CPI to rise 3.2%, y.o.y; RPI to rise 4.2%, y.o.y.
- June German ZEW survey to deteriorate further

Thursday, June 19:

- UK May retail sales to fall 0.1%, m.o.m

Central Bank Watch

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on June 2008 Interest Rate Futures Contract	Next Meeting
Fed	-25 bps	April 30, 2008	2.00%	2.82%	June 25
ECB	+25 bps	June 6, 2007	4.00%	4.97%	July 3
BoJ	+25 bps	April 27, 2007	0.50%	0.84%	July 15
BoE	-25 bps	April 10, 2008	5.00%	5.95%	July 10

This Weekly Strategy Review is not to be construed as an offer to buy or sell any financial instrument. It is presented only to provide information on investment strategies and current financial market trends. The analyses and opinions contained in this Weekly Strategy Review are those of Fischer Francis Trees & Watts, and are based upon information obtained by Fischer Francis Trees & Watts from sources which are believed to be reliable. Fischer Francis Trees & Watts provides no assurance as to the completeness or accuracy of the information contained in this Weekly Strategy Review. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Investment strategies which utilize foreign exchange may entail increased risk due to political and economic uncertainties. The views expressed in this Weekly Strategy Review may change at any time. Information is provided as of the date indicated and Fischer Francis Trees & Watts assumes no duty to update such information. There is no guarantee, either express or implied, that these investment strategies work under all market conditions. Past performance is not a guarantee of future results. Readers should independently evaluate the information presented and reliance upon such information is at their sole discretion.

Fischer Francis Trees & Watts, Inc. is registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940, as amended.

Fischer Francis Trees & Watts is authorized and regulated in the UK by the Financial Services Authority. Products and services of FFTW are directed exclusively at market counterparties and intermediate customers as defined by the rules of the Financial Services Authority. Products and services are not available to private customers. FFTW UK is also registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940, as amended.

Fischer Francis Trees & Watts (Singapore) Pte Ltd is registered as an exempt investment adviser with the Monetary Authority of Singapore. FFTW Singapore is also registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940, as amended.

Fischer Francis Trees & Watts K.K. is licensed (registered) by Financial Services Agency (previously by Ministry of Finance) and registered by Director-General of Kanto Regional Finance Bureau as a discretionary investment adviser in Japan. FFTW K.K. is a member of Japan Securities Investment Advisers Association. Security Investment Advisory Business Registration Number: Director of Kanto Local Financial Bureau No. 310 Discretionary Investment Advisory Business Approval Number (License Number): Ministry of Finance No. 189 Japan Securities Investment Advisers Association Membership Number 011-00310. FFTW K.K. is also registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940, as amended.