

FFTW QUARTERLY COMMENTARY

Fourth Quarter 2010

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Outlook

We expect solid global growth to continue in 2011, with a better balance between developed and developing economies. Growth in developing economies is expected to remain strong, but also expected to be capped by the need to offset rising inflationary pressures. Growth in developed countries looks to be more secure, supported by final sales growth rather than by government spending or the end of inventory liquidation.

Deflation risks in the developed world seem to have been averted in 2010. We expect inflation to rise gradually while remaining at generally low levels in the developed world, and to rise even further while remaining at manageable levels in the developing world. More countries are likely to embark on monetary tightening in 2011.

Bond yields are likely to drift upwards in 2011. We have a clear preference for longer-dated securities in countries that are already well advanced in their monetary tightening cycles, a strategy that is apparent in both our developed and emerging market portfolios. Carry and roll-down strategies at the short end of yield curves remain attractive in countries that are expected to be slow to start normalizing rates.

We maintain a positive bias towards credit. Securitized credit is favored over corporate bond investment due to the market's increasing focus on capital structure positioning and recovery rates, rather than default probabilities alone. We like agency mortgage-backed securities (MBS) and commercial mortgage-backed securities (CMBS), and we prefer high yield to investment grade corporates and US to European issuers.

Emerging markets are expected to continue to benefit from strong inflows. We prefer higher beta sovereigns, corporates and currencies.

Stronger growth and higher long-term bond yields are expected to support the US dollar against the euro and Japanese yen. We prefer dollar bloc and Scandinavian currencies from countries that not only enjoy relatively healthy growth but also are willing and able to tighten monetary policy.

Political event risk remains high. Successful investment in 2011 will be as much about correctly reading the changing political and regulatory landscape as it will be about understanding macroeconomic developments.

Global Recovery: Better Balance between Developed- and Developing-Country Growth

One of our key themes for 2010 was that of an uneven global recovery, in which sluggish, debt-constrained growth in the developed world contrasted with booming developing economies. In this dichotomy, the developed world enjoyed only a weak recovery as the need for continued deleveraging of public and private sector balance sheets constrained spending versus income growth, exacerbated by a weakened banking sector. Meanwhile, the shift towards greater government involvement in the economy and the concomitant increase in supervision, regulation and taxation dampened "animal spirits" and prevented a faster normalization of investment and hiring intentions. Weak growth did little to close already large output gaps, keeping downward pressure on core inflation and allowing G10 central banks to keep policy rates "lower for longer."

The picture looked much better in the developing world, which had already undergone its cleansing deleveraging cycle following the 1998 Asian crisis. With fiscal and current account imbalances already restored to health, and improved fiscal, corporate and banking sector governance, emerging market (EM) countries were well poised to recover from the recent global recession. Fast growth, currency appreciation and rising policy rates became the norm for most of the developing world in 2010.

The theme of uneven growth between the developed and developing world is now widely understood and largely reflected in market pricing. In our view, the story is now showing signs of evolving into a new phase, in which developing growth remains strong but is capped, while growth in the developed world moves onto a more sustainable footing.

EM countries have enjoyed a strong cyclical recovery since the 2008 crisis. Output gaps have been closed and, in some cases, capacity pressures are already evident. Inflation is either already on the rise, or expected to soon materialize. Developing countries are under pressure to tighten macro policy, either through higher policy rates, through tolerating greater (upward) currency flexibility, or both. These moves are expected to cap growth, albeit at relatively healthy levels.

In contrast, many developed economies are finally showing evidence of sustainable growth, driven by underlying domestic demand rather than fiscal pump-priming or a post-recession end to inventory liquidation. This trend was already becoming evident in the post-summer economic data releases, even before the US Federal Reserve decided to embark on another round of quantitative easing, or QE2. Bank lending standards are finally easing, and private sector credit creation has resumed. QE2 has further boosted confidence, largely through raising equity prices. The transmission mechanism from higher equity prices to higher retail sales seems to be working more quickly in this cycle than previously. The US midterm elections received less attention than QE2, but may ultimately prove to be a stronger, if quieter, catalyst. Republican victories seem to have spurred a move towards the center by the Obama administration, and a shift away from perceived anti-business rhetoric. This perception—that we may have hit a turning point in the trend towards “bigger government” combined with easier lending standards—is resulting in promising signs that “animal spirits” are finally reviving. Business confidence among small- and medium-sized companies has increased significantly in recent months, and the labor market is firming. The extension of Bush-era tax cuts combined with additional fiscal measures should help to underpin this renewed growth momentum, although at the cost of further delaying difficult decisions on fiscal consolidation.

US prospects for 2011, however, look much healthier overall than they did several months ago. Strategists, economists and investors have been scrambling to raise their growth forecasts, leading to upward pressure on yields. Substantial obstacles to strong growth remain: deleveraging is incomplete, state and local spending is being cut, the United States' fiscal position is unsustainable in the long term, the banking system may be getting better but is still weak, and home prices are still falling. However, all of these problems have been known for a long time, and seem less worrying now than they were a year ago.

Interest Rates: Caution Required

This year we expect above-trend growth, stabilizing inflation, the completion of the QE2 program without further extension, and that the Federal Reserve will remain on hold until well into 2012. We believe that inflation expectations, as reflected in inflation swaps or breakeven inflation rates on Treasury inflation-protected securities (TIPS), will remain under upward pressure, even though expectations have largely normalized following the introduction of QE2 in the fourth quarter of 2010.

This outlook argues for a contained rise in yields over the course of this year, and we forecast 10-year yields to rise a little more than implied forwards, ending the year near, but below, 4%.

Our US rates outlook for the first quarter of 2011 is more sanguine: a modest, counter-trend rally is possible after the recent sharp sell-off, private sector long positions have been cut, and the Federal Reserve's buying offsets government issuance.

Europe faces some strong headwinds, namely the twin problems of peripheral sovereign debt and an undercapitalized banking system. Concerns are likely to come to a head in the first quarter of 2011. Portugal, Ireland, Greece and Spain are on negative watch by the major ratings agencies, with decisions due this quarter and heavy sovereign supply and bank issuance in the first four months of the year. A record supply of new bank paper will occur against a backdrop of bank stress test results and new European Union (EU) proposals on bank bail-ins, which raise uncertainty over the treatment of investors at different points in the capital structure in a credit event. To make matters worse, political risk is increasing: new parliamentary elections loom in Ireland amid talk of renegotiating, or even rescinding, the recent bailout by the European Financial Stability Facility (EFSF); a schedule of regional elections in Germany begins in March; the German constitutional court is soon to deliver its verdict on the legality of recent EU bailouts; and the governments of Spain, Portugal and Italy remain vulnerable. Increasing political risk is a key theme for 2011; if 2010 taught us anything, it was that politics are more inextricably intertwined with macroeconomic and financial market developments than ever.

Market commentary is sometimes dismissive of the progress on Europe's twin problems. This skepticism is understandable—a definitive solution is not yet in sight, many of the initiatives seem to have been poorly thought out or rushed, and communication on more permanent crisis resolution mechanisms for both sovereign and banking sector debt has been poor and uncoordinated. This creates both dangers and opportunities.

That said, much has been achieved in Europe over the past year. The outlines of a new fiscal governance to replace the discredited Stability and Growth Pact has been put in place, and implicit support for EU states has become explicit but highly conditional. Precedents for bailouts addressing moral hazard issues have been set, new institutions and mechanisms have been established, and stronger, more permanent versions are under construction. Troubled sovereigns may access liquidity, but at penal or semi-penal rates; they are also subject to the fulfillment of tough fiscal consolidation criteria. Less progress has been made in recapitalizing Europe's banks and in making the extent of bad debts more transparent, but a new round of bank stress tests will take place between February and June of this year. Proposals on bank bail-ins may add to short-term uncertainty but do address long-standing moral hazard issues for previously "too big to fail" financial institutions. Market debate has switched from concerns about the likelihood of default or restructuring to loss severity in the event of a default.

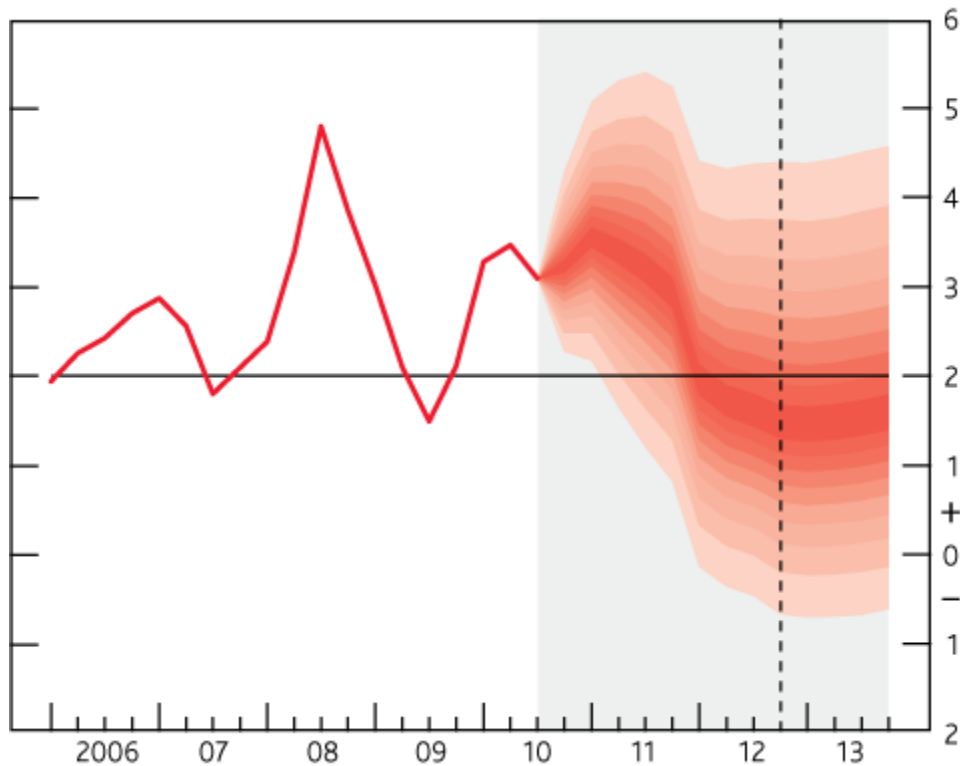
Ultimately, any sovereign default or restructuring event in Europe will be a political decision. Political considerations argue for policy makers to try their hardest to avoid a sovereign credit event while contagion effects could be at their strongest and to simultaneously prepare for the possibility of an orderly default or restructuring of one or more of the smaller European peripheral sovereigns after 2013.

Spain is widely perceived to be "too big to bail." Spain's debt trajectory, even if it is forced to recapitalize its banks, appears sustainable. Furthermore, Spain's fiscal consolidation program is on track despite weak growth in 2010. We expect further pressure on Spanish government debt this quarter but are looking for opportunities to move from a tactical underweight position to a strategic overweight position, as we think current spreads make little sense in the long term. Similar considerations apply to other semi-core countries, such as Italy and Belgium, for which the risk of failure seems overpriced.

Europe is growing despite sovereign debt and banking concerns. Inflation has returned, exceeding the European Central Bank's (ECB) target of just below 2%. We believe that continued growth will trigger a shift towards a more hawkish ECB as soon as it becomes clear that sovereign debt and banking sector concerns are easing and may be containable. Indeed, we may have witnessed the beginnings of this shift in rhetoric at the ECB meeting in January, 2011. If debt concerns start to ease from the second quarter of 2011, we may see the first rate hikes from the ECB in the second half of this year. We expect higher yields across the German yield curve in 2011 and a convergence of Spanish, Italian and Belgian spreads (versus the Bund) after this quarter.

UK inflation is currently above target and is set to rise further in the near term (See Chart A). The Bank of England's relaxed attitude towards inflation overshoots may change, leading to earlier-than-expected rate hikes. However, until or unless this happens, we see good risk reward in being long front-dated UK inflation breakevens.

Chart A: UK CPI Projection (% increase in prices y/y)



Source: <http://www.bankofengland.co.uk/publications/inflationreport/irfanch.htm>

We are more positive on dollar bloc and Scandinavian bond markets: monetary tightening is generally more advanced, currencies have appreciated, debt levels are relatively low and deficits manageable while curves are flattening. We are most positive on the long end of the Australian and New Zealand bond markets.

Yield Curves: Diverse Opportunities

Sustained, structural flattening of spot yield curves is normally associated with central bank tightening and is a bearish phenomenon, i.e., yields rise, more so for shorter-dated tenors than longer-dated ones. This is why we see the best prospects for sustained curve-flattening in countries that have already embarked on monetary tightening—such as Australia, Canada, New Zealand, Sweden and Norway—or are close to doing so. In our view, the eurozone is getting closer to fitting into the latter category. Surprise rate hikes, if delivered, should result in a material flattening of the German yield curve.

We see no prospects of the Bank of Japan tightening this year, and few prospects for meaningful fiscal consolidation. This is a recipe for a continued steep Japanese government bond yield curve.

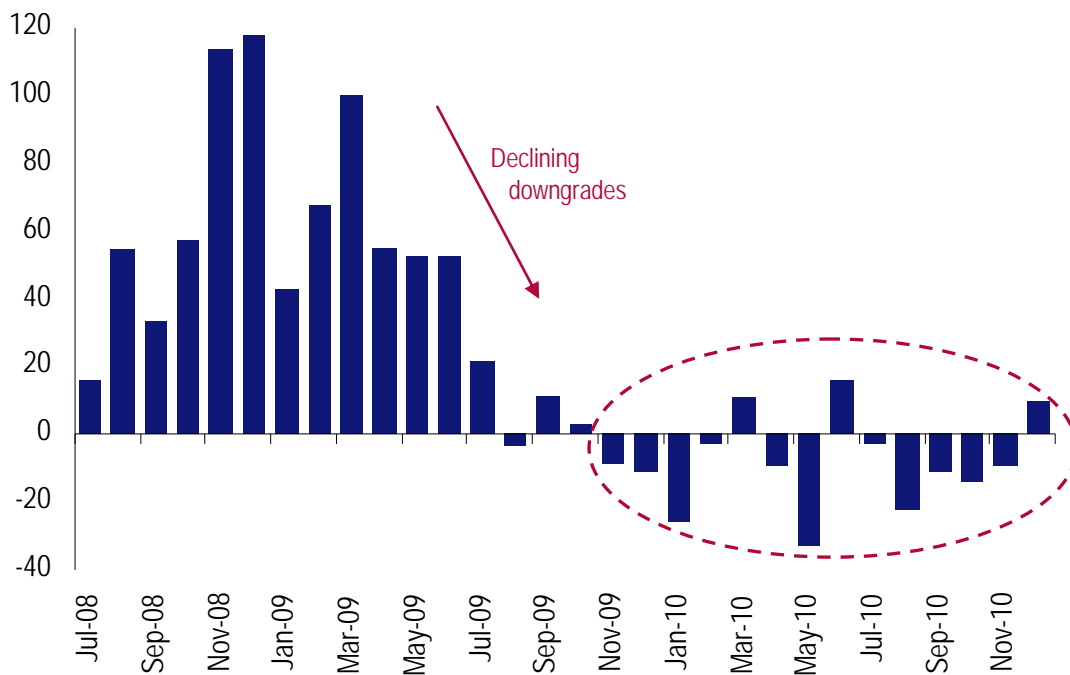
Strong growth in the United States may both raise fears of an early Federal Reserve exit and contribute to tactical curve flattening moves. However, we think it is extremely unlikely that the Federal Reserve will hike rates in 2011, and that carry and roll-down trades at the short end of the Treasury yield curve will be rewarded over the course of the year, as the pull towards near-zero rates is very powerful for short-dated securities. The belly of the curve is likely to move in line with nominal growth and is more likely to sell off, implying continued steep US yield curves this year and a steepening of the slope between 2- and 10-year Treasuries versus implied forwards.

Favorable Outlook for Credit Markets

We maintain a positive bias towards credit overall. The changing political and regulatory landscape argues for a greater need for differentiation among asset classes.

Corporate balance sheets are in surprisingly good shape considering the severity of the recent recession; profit margins are above average, profits and cash flows are growing strongly, debt and interest rate coverage ratios are healthy and corporate attitudes towards investment and hiring remain cautious. Default rates have fallen sharply and are already well below historic averages despite a relatively tepid recovery. Improving credit quality is reflected in rating agencies' upgrades, which now outpace downgrades (see Chart B). Demand for incremental yield without negative headline risk remains strong.

Chart B: Volume of High Yield Net Downgrades



Source: BofA Merrill Lynch Global Research

We maintain a positive bias on investment grade corporates. Valuations on industrial investment grade corporates are now fairly full—we see some, but limited, potential for further tightening overall and expect that most of the incremental return versus government bonds will come from yield advantage rather than further spread compression. We believe that the spread between US banks and US industrials is excessive and can converge this year. We maintain a preference for US corporates over euro corporates on growth, macro policy and health of banking system considerations.

European Union bank bail-in proposals threaten to undermine the demand for senior European bank bonds at a time of heavy bank issuance driven by refinancing and recapitalization needs. Covered bonds are unaffected by the new proposals. Supply is likely to switch from senior unsecured to senior secured issues as a result. European bank spreads are likely to remain under pressure for now, with covered bonds tending to outperform senior unsecured paper.

High yield securities have performed strongly over the past few months but have room for further spread compression if experience in past recovery periods repeats itself. We prefer high yield to investment grade corporates.

The changing regulatory landscape in the post-crisis world underlines the importance of capital structure analysis. Subordination has been repriced, and senior debt secured on strong cash flows is becoming the asset class of choice. This reinforces the attractiveness of high quality, securitized issuance, with agency MBS being an obvious beneficiary of this perceived-as-enhanced safe-haven status. Both strong demand

for high quality assets and reduced supply given low refinancing (both because of low housing turnover and still-tight credit conditions) argue for a risk-adjusted MBS outperformance.

We continue to favor CMBS, despite recent outperformance. Valuations remain compelling, and losses are finally abating.

Emerging Markets: Still the Sweet Spot

EM remains in a sweet spot. The combination of low debt and low fiscal deficits, high growth, strong balance of payments and higher yields will support EM assets, and the trend of long-term investor portfolio allocation flows to EM will continue. Inflation pressures, although rising, are generally manageable. The relatively strong fundamentals for developing versus developed markets are widely appreciated, although, to date, positioning has lagged sentiment. Inflows into the asset class are expected to remain strong as a result. We think that 2011 will prove to be another strong year for emerging market debt. We like higher yielding sovereigns, corporates and currencies.

The interest rate outlook is more challenging this year because stronger growth will push yields upward. We see value in carry and "pre-normalized" curves (i.e., curves that price a significant amount of rate hikes for the year). We have a negative bias in countries in which capacity constraints present a clear inflation threat. We are tactically neutral on duration overall, but we will look for levels to re-enter into duration-hedged positions to focus on carry and spread compression.

For sovereigns, the low level of yields and the volatility of the US Treasury yield curve make us see the best value in spread duration positions. We like the long end of high beta sovereign issuers. EM corporates remain an undervalued asset class; issuance and liquidity are growing, valuations are attractive and the sector remains under-researched, offering many opportunities for investors with a sound credit process. We expect higher yielding EM corporates to outperform investment-grade issues, and our portfolios reflect this higher beta bias.

In currencies, we have taken profit on our longstanding Asia and Latin America regional overweight positions versus Europe underweight, given our expectations of growth acceleration and improved risk appetite. We prefer to have relative value positions intra-regions to positions on local dynamics. At this stage of the cycle, equity momentum will have a potentially greater impact than debt flows on currency performance. Currencies offering a favorable combination of carry and strong growth momentum will outperform in this environment, particularly if they have the additional bonus of commodity linkage.

Currency Markets Reflect Growth and Interest Rate Expectations

The outlook for the US economy has improved following the introduction of QE2, Republican victories in the midterm elections, the extension of the Bush-era tax cuts and additional fiscal measures. Business and consumer confidence have both increased, and economic indicators have recovered noticeably, raising both long-term yields and equity valuations. The US dollar is beginning to find firmer footing. We expect these trends to continue, driving the outlook for major currencies, and we expect the US dollar to outperform the euro and the Japanese yen.

Sovereign debt concerns are likely to continue to weigh on the euro during 2011. However, we are hopeful that the improved global growth outlook and the political resolve of core European countries to preserve the currency union will prevent a recurrence of the extreme turbulence and uncertainty that plagued the euro in 2010. Our forecasts envisage an orderly decline of the euro in order to help alleviate the economic stresses faced by peripheral European currencies. We expect that this trend will be most pronounced against the UK sterling, the Swedish krona and the Norwegian krone. We are more neutral on the euro's prospects versus the Swiss franc, given the latter's elevated valuation level.

The Japanese yen is similarly reaching an extreme of overvaluation. Given this, and in addition to higher yields in the United States and increasing global risk appetite, we believe that the opportunity is to underweight the Japanese yen, particularly against the US dollar. In this exercise, both understanding

sentiment and positioning and correctly identifying catalysts and their impact on market dynamics are the keys to success. We may increase positions as conviction in the outlook solidifies further.

We have a mixed outlook for commodity bloc currencies tied to the US dollar. We favor the Canadian dollar for its proximity to the US economy. Chinese tightening measures and recent floods in Queensland make us cautious on the Australian dollar. We are negative on the New Zealand dollar due to relatively weak economic growth and the dovishness of the Reserve Bank of New Zealand.

EM currencies were soft in the fourth quarter of 2010. Currently, we are lightly positioned in global portfolios. However, we still believe that the EM carry trade makes sense, and we are likely to add higher yielding EM currencies via our EM carry model, should global equity markets continue to do well. Within dedicated EM portfolios, we are overweight Asian and Latin American currencies.

Risks to Our Outlook

Many of the risks to our somewhat benign outlook have been present for some time, and they are well-known and largely reflected in market pricing. European sovereign debt issues remain a concern and may contribute to periods of volatility, but they are unlikely to have a sharply negative impact on global financial markets unless an actual sovereign default is threatened. An orderly restructuring would be temporarily disruptive but might not have a significant lasting impact. Neither eventuality is expected this year. We continue to believe that Chinese policy makers have the tools, and the skills, to avoid a hard landing. The failure of the US to address its fiscal situation poses a long-term threat but is unlikely to be felt acutely this year unless debt sustainability fears coincide with a reduction in central bank willingness to recycle current account surpluses into US Treasuries, perhaps sparked by an unforeseen political or geopolitical event. Similarly, should EM inflation pressures lead to a greater willingness to tolerate currency appreciation, the associated reduction in currency intervention-related Treasury purchases may lead to both a period of indigestion in that market and sharply higher yields in the belly of the US curve. The US housing market remains weak. We continue to believe that a further, orderly 5%-to-10% decline in US housing prices is manageable and would weaken—but not derail—the US recovery. Sharper losses than this might endanger the US banking system and lead to a credit-contraction-related slowdown, or even a double-dip recession.

We have already spoken of the increasing importance of the changing political, legislative and regulatory landscapes and the importance of political analysis in determining macroeconomic and financial outcomes. Our list of downside threats in the short-to-medium term is dominated by political event risks and unexpected geopolitical outcomes.

In the longer term, our concerns are more conventionally macroeconomic in nature. Stronger growth complicates the outlook for monetary policy, particularly given the unusual juxtaposition of significant excess capacity with rising commodity prices in much of the developed world. However, inflation is not as much of a risk, per se, as unexpected inflation. To be more precise, an inability to understand and explain inflation outcomes should be our biggest concern. Inflation in the UK has been persistently higher than expected, despite record output gaps. However, the Bank of England remains confident that inflation will soon mean-revert, and UK fixed income markets have remained relatively stable. If central banks lose faith in their ability to understand the determinants of inflation, their future reaction functions become unpredictable, and the outlook for monetary policy—and therefore fixed income—become highly uncertain. This is not a story for now, but upside surprises in growth and inflation, if witnessed, may ultimately result in significantly increased uncertainty and volatility at some point and represent longer-term threats to our “muddle through” scenario, with its associated benign implications for financial assets.



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