FFTW QUARTERLY COMMENTARY

Second Quarter 2011

By Guy Williams, Global CIO

Outlook Overview

We expect that the current soft patch in global economic activity will come to an end and that there will be growing evidence of a modest cyclical reacceleration in global growth over the next few months. While inflationary pressures are starting to ease in developing economies, the rise in G10 inflation expectations has stalled. This has led to a delay in rate normalization and is working to extend economic cycles.

We are selectively underweight duration in developed markets, but as the rhetoric around central bank tightening has faded, our risk positions have been trimmed. We see more opportunities in relative value, particularly within European Union (EU) sovereign debt.

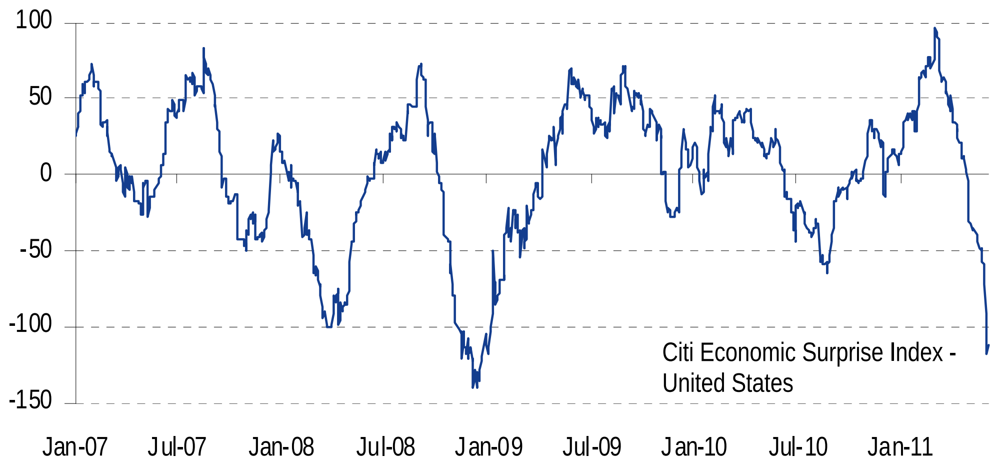
We maintain a positive bias towards credit, are overweight investment grade corporates as well as high yield, and look to reinforce positions in periods of uncertainty. Commercial mortgage-backed securities (CMBS) remain attractive, but technicals are poor. We are looking to cautiously re-enter positions.

Emerging markets (EM) are well poised to benefit from the expected recovery in risk appetite; value has been restored and positioning is defensive. We are increasing our EM exposure in global portfolios as well as raising risk levels in dedicated EM accounts.

Our foreign exchange positioning is light, and we continue to favor growth and interest rate differentials. This leads us away from heavy positioning in G4 currencies and towards a greater interest in the peripheral dollar bloc and Scandinavian currencies. The decline of the US dollar seems to be over—for now.

We are more concerned about long-term secular issues than we are about obvious near-term risks, risks we believe we can successfully navigate our way around. We are optimistic that the second half of 2011 will witness a resumption of global growth and a better environment for risk-taking.

Citi Economic Surprise Index: US

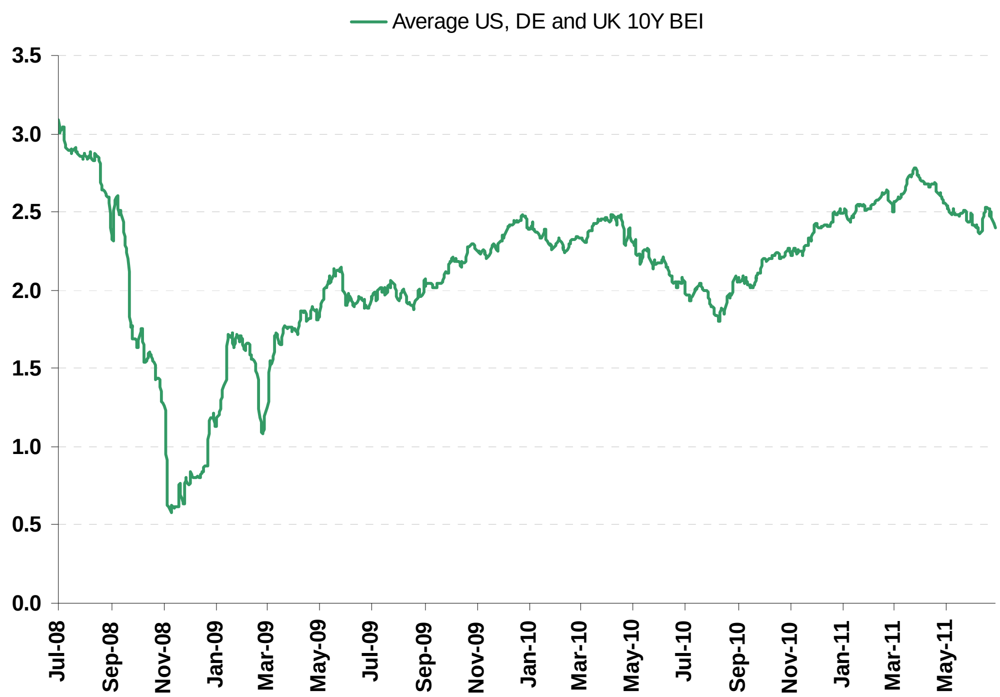


Source: Bloomberg, Citi June 2011

The Second Quarter: Worse Than Expected Economic Data

The second quarter of 2011 did not meet our expectations. Our hopes for stronger and more sustainable developed-market growth were frustrated by a continuous stream of worse-than-expected economic data. Global activity slowed due to Japan's earthquake and tsunami, supply chain disruptions in the US auto industry, and the effects of a mini inventory cycle. Furthermore, renewed sovereign debt fears in Europe and uncertainty over the prospects of higher taxes in the US as politicians struggle to arrive at a compromise over fiscal consolidation all seem to be suppressing the "animal spirits". Commodity price strength weakened later in the quarter, particularly for oil prices.

Our "muddle-through" scenario for EU sovereign debt has been challenged by renewed fears of an imminent Greek debt restructuring. Relief from the March agreement to expand the scope and size of the European Financial Stability Facility (EFSF) proved to be short-lived. Concerns intensified over the quarter for many reasons: Portugal was forced to request assistance from both the EFSF and the International Monetary Fund (IMF); Greece missed their fiscal consolidation targets; and a dangerous game of brinkmanship among EU policy makers was played; and the European Central Bank (ECB) and a weak Greek government fanned speculation in June that Greece might face imminent default. Although these concerns have recently abated following the successful passage of new austerity measures through the Greek parliament, risk assets have been disturbed by slowing global growth and renewed EU sovereign debt fears. Government bonds rallied, and curves generally steepened as the markets moved quickly to price out imminent central-bank tightening. Our theme of rate normalization has gone into abeyance. Similarly, weaker growth, falling oil prices and risk aversion have halted increases in inflation expectations for now. Breakevens and inflation swaps have eased slightly since the end of the first quarter, and inflation curves have steepened significantly. By contrast, the idea that EM inflation fears were exaggerated has proved to be true. Inflation releases have been relatively benign compared to expectations, and there is growing evidence that EM headline inflation rates have either peaked or are in the process of peaking. We expect this evidence to become stronger in the coming months, as headline inflation rates start to fall more generally throughout the third quarter onwards.

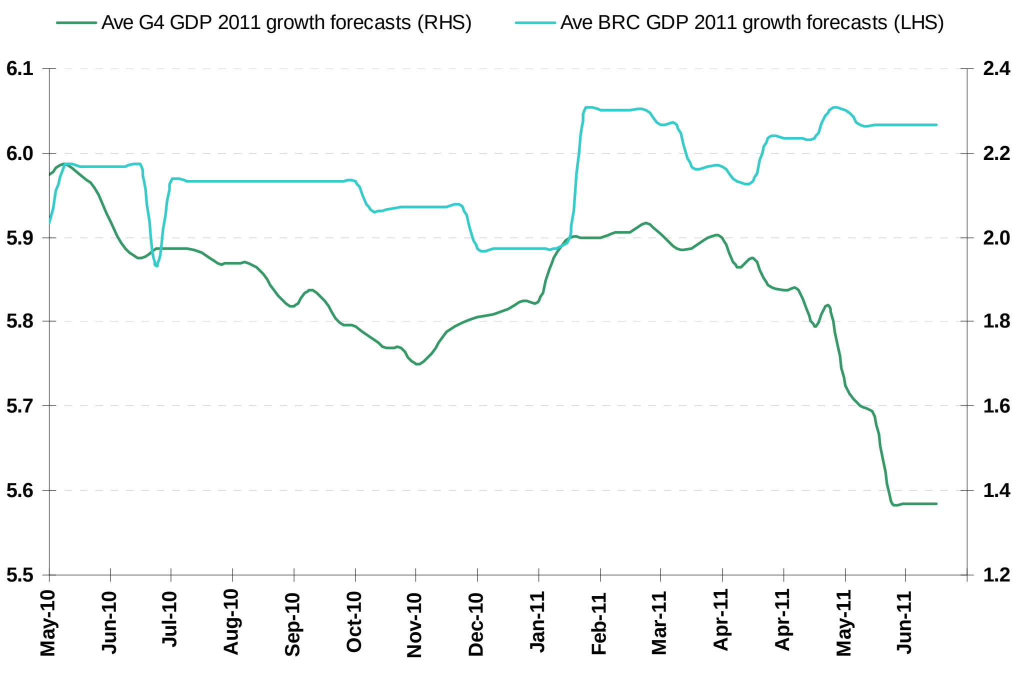


Source: Bloomberg July 2011

Third Quarter Views: Developing World More Interesting

We are hopeful the global soft-landing of the second quarter will be followed by a soft take-off in the third quarter as the effects of the Japanese natural disasters and US auto supply interruptions wear off. US production may be strengthening while Japanese economic activity rebounds strongly after the country's tsunami. Lower oil and food prices along with falling yields should also act to support growth. Conversely, G10 authorities have run out of policy tools. Monetary easing outside of the euro area is constrained by near-0% official rates absent another round of quantitative easing. (We continue to believe that the obstacles to a third round of quantitative easing remain very high, given the increase in inflation expectations and headline and core inflation rates since the summer of 2010.) Fiscal relaxation is, more or less, out of the question in G4 economies. The rebound in developed growth is likely to be mild as the imperative of fiscal consolidation and household deleveraging remains strong, and housing sectors remain structurally weak. While growth may become a greater possibility, it is likely to be uninteresting.

The outlook in the developing world appears to be more promising: oil and global food prices have fallen considerably in recent weeks, helping to temper inflation risks in the second half of the year. A significant sequential easing of headline inflation rates can be expected in the coming months as the base effects of last year's price surge lessen. The threat of hard economic landings in the developing world as a result of policy over-tightening to combat rising inflation seems to have been averted. Markets and authorities appear to be recognizing this now, while we at FFTW have been ahead of the game in downplaying EM inflation concerns.



Source: Bloomberg July 2011

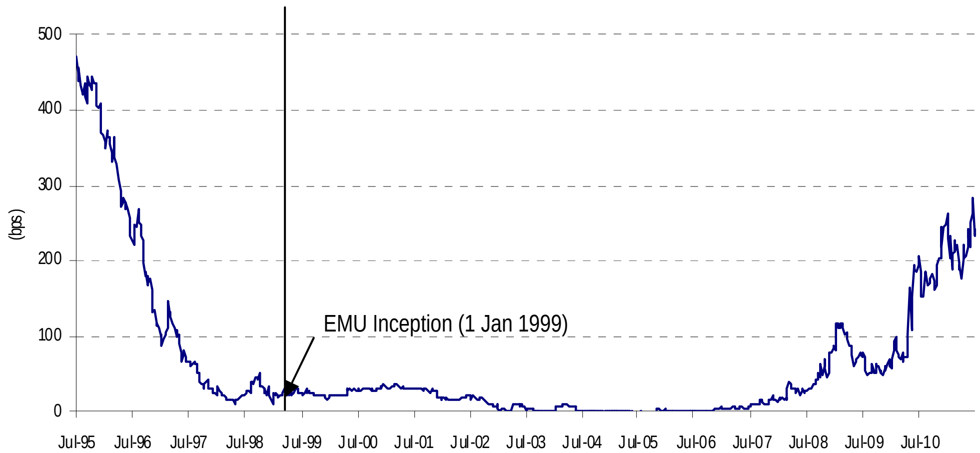
Interest Rates Outlook

Our bearish views on G10 interest rates were largely predicated on an expectation that strong growth and rising inflationary pressures would prompt a shift towards more hawkish central bank rhetoric. This expectation was confounded by both downside growth surprises and stabilized inflation expectations as commodity prices came under downward pressure. Our "rate normalization" theme did not play out in the second quarter, but this does not mean that it will not re-emerge as a market driver should the right macroeconomic conditions occur. However, we are less optimistic that this scenario will play out in the coming quarter, or even over the rest of the year. Both the US Federal Reserve and the Bank of England (BOE) seem to have implicitly accepted a worse trade-off between growth and inflation without feeling pressured to take policy action. To some extent, this is a logical response when inflation overshoots are perceived to be temporary and caused by factors outside of central bank control, as long as inflation expectations remain well anchored. This implies that central banks may continue to keep policy rates easier than market participants anticipate, as long as inflation expectations remain compatible with long-term targets. If this is the case, yields are likely to rise slowly and may not rise more quickly than implied forwards suggest, given historically steep yield curves. Carry and roll-down strategies remain attractive. Conversely, delivered inflation is likely to be higher than predicted, and inflation expectations are likely to drift higher over time until a policy response is provoked. As a structurally bearish view on interest rates requires validation in the form of higher inflation expectations, being structurally long inflation break-evens may offer better risk-reward than being structurally short duration. This does not preclude opportunities for tactically underweighting duration should positioning and sentiment move to a positive extreme and near-term economic pessimism becomes excessive. Yields have moved up sharply in the first half of July. However, we are not convinced that this marks a turning point. Although we expect that global growth data will pick up during the third quarter, this may not be apparent for several more weeks. Furthermore, the Greek debt crisis has been eased but not resolved, and negotiations over extending the US debt ceiling may yet degenerate into a dangerous game of brinkmanship. We will look for opportunities in the coming weeks to reopen tactical short positions in G4 markets.

We prefer to concentrate more structural underweight positions in the short ends of the Canadian and Australian government bond markets, as our sense is that monetary tightening risks are underpriced given relatively robust growth prospects. Similarly, long-dated Japanese government bonds (JGBs) are likely to underperform in an environment of rebounding global and Japanese growth, while rising debt concerns would likely prevent JGBs from enjoying a flight-to-quality rally in the event of continued global growth disappointments.

We continue to believe in a "muddle-through" scenario for European sovereign debt. Uncertainty and event risk remain high, and we have adopted a relative value approach with a modest positive bias. We consider that the risks of a restructuring event in both Ireland and Portugal are currently very low; both countries have recently elected new governments committed to fiscal austerity, both have EU/EFSF/IMF liquidity facilities in place and do not need to return to the markets until 2013, and both are making progress on their current fiscal consolidation plans. We have used recent weakness in spreads to add to our medium-term positive position in Spain. We believe that Spanish risks are mispriced; Spain has below-average debt levels and has enjoyed above-average, long-term growth. The yield spreads on Spanish government bonds have returned to levels last seen in 1996, a time in which Spanish accession to the Economic and Monetary Union (EMU) was by no means assured. We are significantly underweight both Italian and French government bonds. We do not think that Italian BTP pricing adequately reflects Italy's weak growth prospects, high debt levels, and risks of political instability. France has some of the weakest fundamentals among its AAA-rated peers, and the country risks losing its coveted top credit rating over the medium-to-long term.

10-year yield spread of Spain vs. Germany 7/7/1995 – 7/5/11



Source: Bloomberg July 2011

Yield curve opportunities remain rather unpromising. We continue to believe that structural yield curve flattening requires a shift towards imminent central bank tightening and has been further delayed. In the meantime, historically steep yield curves are likely to remain steep. We continue to have a positive bias towards breakevens, and we are overweight inflation-linked securities in global portfolios. However, current positioning is quite light, as we believe that recent soft growth, the end of the US Federal Reserve's second round of Quantitative Easing (QE2), lower commodity prices, and inflation seasonality may lead to a more range-trading environment in the third quarter. We remain overweight short-dated breakevens in the UK and Australia and are looking to add inflation-swap receiver positions in Sweden.

Corporate Credit: Investment Grade Remains Attractive

As previously highlighted, the slow, underlying move towards lower macroeconomic uncertainty and lower market volatility is fundamentally supportive for risk assets. We remain positively biased towards credit markets.

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, although corporate attitudes towards both 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 agency upgrades, which now outpace downgrades. Demand for incremental yield without negative headline risk remains strong. We maintain an overweight stance towards investment grade corporates, particularly in the United States, and we hold selected overweight positions in European corporates and covered bonds. Our bias over the third quarter will be to add to these positions as opportunities arise and risk appetites become firm.

Source: Barcap July 2011

Our short-term caution on high yield at the end of the second quarter has been vindicated. High yield has underperformed, particularly from May onwards. We have used these setbacks to rebuild modest long positions and are looking for further opportunities in the coming months to reinforce our long-term positive stance towards high yield securities.

Structured Securities: MBS is Strong in Alpha

We are neutral on agency mortgage-backed securities (MBS), seeing fundamental valuations as fair. Despite fair valuations, the mortgage sector continues to be a strong source of alpha opportunities at the security-specific and sector levels. Prepayment speeds continue to undershoot expectations due to a combination of seasonal factors, stringent underwriting standards, declining or stagnant housing prices, and a moribund level of transactions. Our up-in-coupon bias and emphasis on particular geographies and loan characteristics continue to perform well, allowing us to add value in the mortgage sector of our portfolios.

CMBS have suffered during the last quarter's "risk-off" move, a trend that was exacerbated by technical selling related to the liquidation of the Federal Reserve's Maiden Lane holdings. Junior CMBS tranches underperformed sharply. We reduced our structural overweight CMBS positions early in the second quarter, locking in healthy profits and nimbly avoiding the subsequent sell-off. We remain constructive on CMBS. Strong investor demand, limited new supply, improving collateral performance and relatively generous valuations should soon help to stabilize spreads at very attractive levels. However, positioning and sentiment remain poor, and we would rather re-enter on clear signs of stabilization than attempt to "catch a falling knife."

Emerging Market Debt: Poised to Rally

The expected second quarter rally in EM debt was interrupted as slowing global growth and renewed concerns over EU sovereign debt, misplaced worries over a hard landing in China, and fears of the end of QE2 pressuring credit and equity markets led to a general underperformance of risk assets in May and June. We think the risk environment is poised to turn more positive in the coming months. As previously discussed, oil and global food prices have fallen considerably in recent weeks, and will help to temper inflation risks in the second half of the year. We can expect a significant sequential easing of headline inflation. EM growth has eased, but remains at a very comfortable level of 6% or more. The Chinese authorities seem to have successfully engineered the required soft landing, and are confident that inflation rates are peaking. In the developed world, US production seems to have found a base while Japanese economic activity is rebounded strongly after the tsunami disruptions.

We believe that the market is now poised for a rally. Positions are light and somewhat defensive, value has been restored, and the storm clouds of the second quarter are receding. Both sovereign and corporate credit are attractively priced, as are selective local rates, markets and currencies. We favor a carry bias in local debt, financing positions with low yielding G10 and EM currencies. We will be looking for opportunities to raise EM exposure in global portfolios and to raise risk levels in dedicated EM portfolios.

External debt performed well in the second quarter in absolute terms, as "risk-free" yields fell and spreads to US Treasuries widened modestly. We expect spreads to tighten in the third quarter, and we are positive on high-quality, high yield issuers. We are overweight high-beta sovereign issuers, such as Venezuela and Argentina, where strong growth and easing political fears should trigger outperformance. We remain structurally under-invested in Europe, the Middle East and Africa (EMEA), underweighting Turkey, Croatia and Egypt.

EM corporate bonds remain attractively priced versus their developed market counterparts. We favor domestic-oriented companies and basic commodity-related issuers at the expense of financials and utilities. We continue to like high–quality, high yield issuers, and have increased our exposure in recent weeks. Our process emphasizes transparency and attractive yields supported by sustainable growth rates and strong cash flow. This careful approach has helped to keep us out of trouble while capturing yield for portfolios, exemplified by the fact that we successfully avoided an investment in China's Sino-Forest Corporation.

We believe that EM local debt will perform well in the second half of the year, initially from rallying rates as inflation fears recede and—later—through (delayed) currency appreciation. EM currencies are well supported by fundamentals, but we see them range trading against the US dollar in the short term as QE2 ends. We favor a relative value approach for now, overweighting Latin American vs. EMEA currencies. We like higher yielding local markets and steep yield curves against lower yielding markets in which the respective central banks seem to be behind the curve. This means overweighting Mexico, Brazil, Colombia and South Africa, and underweighting Asian local markets, with the exception of Indonesia.

Currencies: Underweight G4 versus Minor G10

Presently, we hold few strong currency views. We are optimistic that the macroeconomic environment in the second half of 2011 will prove more supportive, with global production picking up as the effects of Japan's natural and nuclear disasters wear off and consumption is reinvigorated by lower oil and food prices. Positioning is light but reflects our expectation of a firmer second half; we believe that growth-sensitive and commodity-related currencies will continue to outperform. We favor the Canadian, Australian and New Zealand dollars, as well as the Norwegian krona. We believe that the end of QE2 may also mean a near-term end to US dollar weakness against the euro, Swiss franc, and Japanese yen.

Conclusions: Future Governance Structure is a Concern

Markets remain focused on a multitude of near-term risks—the approval of the second EU/IMF bailout package and details of the required private sector involvement, the risks of a hard landing in China, EM inflation, softer G10 growth, and the risks surrounding the complicated US debt ceiling debate, which seeks to raise the debt limit to avoid a damaging technical default. While not dismissive of these concerns, we have a more positive view on most of these issues. More importantly, serious downside risks to markets usually come from unexpected events and not from issues on which everyone is already focused. Our own concerns are more secular in nature: the possibility of a deteriorating inflation-growth trade off, the difficulty of sustaining multi-year fiscal consolidation programs in democratic societies, the challenge to growth more generally for debt-laden economies, the decreasing room for policy maneuver in the next downturn, the role of governments in economic activity and the changing roles of regulators and supervisors. In short, we are mainly concerned with the future political and economic governance structure and our ability to navigate the storms ahead. We will return to these themes, which are likely to impact our 2012 strategies, in future quarterlies. For now, we are optimistic that near-term concerns will be resolved satisfactorily, and that the rest of 2011 will see a resumption of global growth, a recovery in risk appetite, and better performance for EM and credit markets in an environment of slow, relatively benign rises in government bond yields.

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