

# FFTW QUARTERLY COMMENTARY

Third Quarter 2011

By Guy Williams, Global CIO

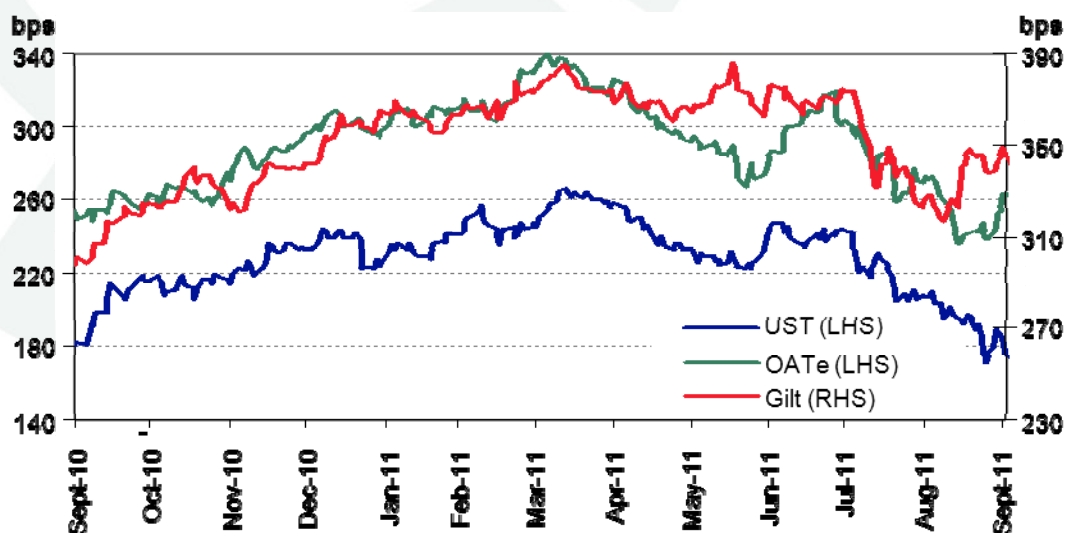
## OUTLOOK OVERVIEW

As 2011 comes to a close and we move into 2012, we expect continued below trend growth rates for the foreseeable future. The risks of a mild recession in Europe are very real. Growth forecasts in the developed world have declined significantly, but still have room to fall further. Commodity prices have eased as growth has slowed, and inflation expectations have fallen. This has allowed G4 central banks to resume their "lower for longer" approach to monetary policy, while authorities in developing countries have started to ease rates.

Government bonds remain well underpinned. We do not expect a speedy resolution to the European sovereign debt crisis. Inflation expectations are unlikely to rise quickly in an environment of weak growth and abundant spare capacity.

We would look to take advantage of temporary yield rises to rebuild overweight duration positions, particularly in Europe, while taking advantage of dips in inflation break evens in the US to reset secular overweight positions in inflation-linked securities. The long-term risks to inflation remain tilted to the upside.

French Government Bonds Indexed to EU Harmonised CPI



Source: Bloomberg, October 2011



In September, the Federal Reserve introduced Operation Twist, which we believe is misunderstood and underappreciated. We believe that the Federal Reserve's buying of long-dated Treasuries will lower yields and dampen volatility, thus providing a powerful positive catalyst for high-quality spread product. Agency mortgage-backed securities (MBS) are expected to react first. Emerging markets (EM) fixed income is also expected to rebound relatively early, repeating its 2008-2009 experience. Growth and earnings concerns are likely to hamper high yield, despite attractive valuations.

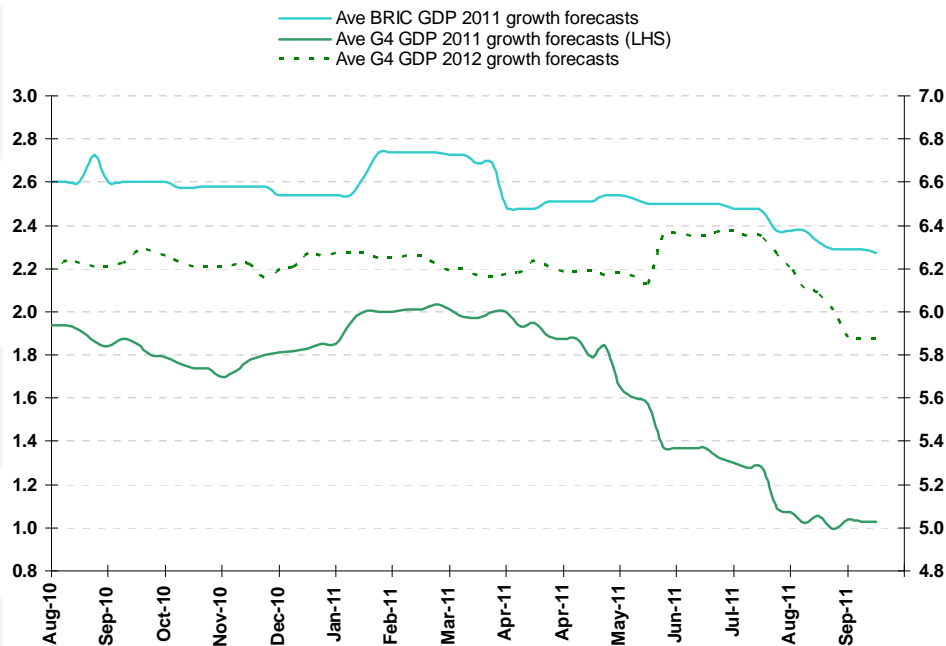
Currency opportunities remain limited in this environment. Growth and policy flexibility are still a differentiating factor. Choppy range-trading is expected to continue among the G4 majors.

Long-term concerns are catching up with global markets. We expect 2012 to be characterised by weaker growth, continued deleveraging and increasing downside vulnerabilities as policy makers run out of options. US fiscal policy is on an unsustainable path, and focus on the lack of progress towards fiscal consolidation in the US may become a recurring theme next year.

## THIRD QUARTER

The third quarter started with concerns about a global slowdown, and soon developed into a crisis of confidence in policy makers' ability to deliver any growth. Indecision and policy mistakes in the face of an intensifying sovereign debt crisis were compounded by the negative feedback loop from a fragile and under capitalised European banking system. By the end of the quarter, slower growth concerns had been supplanted by recession fears in the developed world, and expectations of a hard landing in China. The ensuing flight-to-quality rally saw government bond yields fall to new historic lows in the US, UK and Germany, while risk assets underperformed sharply.

Bloomberg Growth Forecasts – BRICs Versus G4 Countries (% Growth)

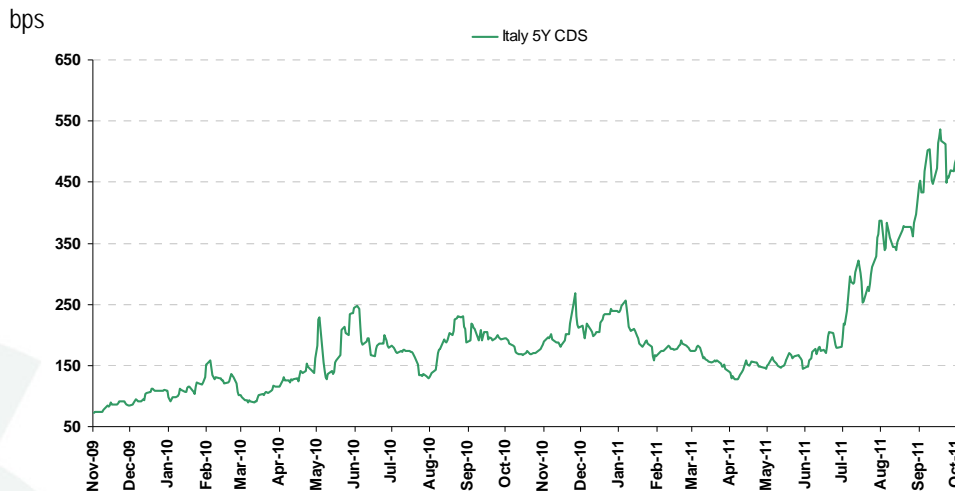


Source: Bloomberg, October 2011

The beginning of the third quarter was dominated by consistent downside surprises in economic data, particularly in peripheral European countries. Markets now clearly understand that credible fiscal consolidation in Europe will not be achievable without growth. Italian government bonds soon came under severe pressure, thanks to Italy's high debt levels and low long-term growth rates. Italy is widely seen as both "too big to fail" and also "too big to bail". The European Union (EU) agreement to expand the size and scope of the European Financial Stability Facility (EFSF) provided limited support in late July, even before weaker

growth data, delays in ratification of the new measures, policy disagreements, indecision and contagion to the banking sector compounded the pressures on EU sovereign debt. As spreads moved wider, the European Central Bank (ECB) reluctantly resumed Securities Market Program (SMP) purchases, this time focused on Italian government bonds. These measures helped to cap yields and provide some stability, but did little to reverse negative sentiment.

### Italy – Too Big To Fail, Too Big To Bail

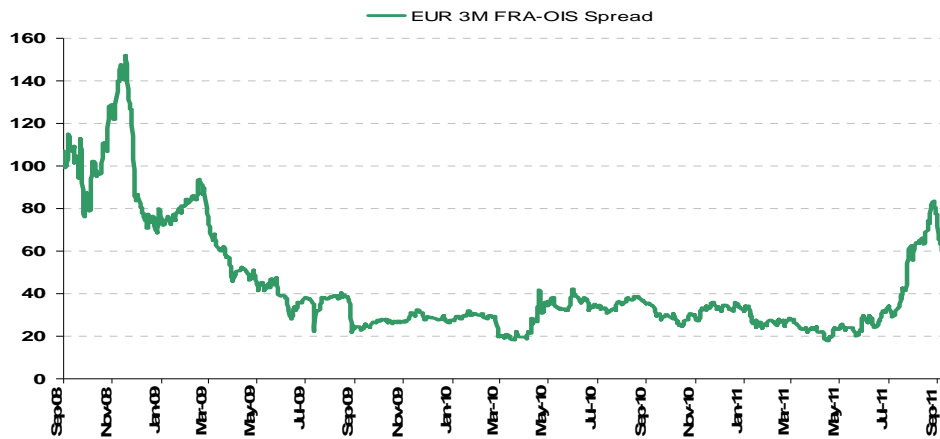


Source: Bloomberg, October 2011

Meanwhile, business and consumer confidence in the US was adversely affected by the unseemly squabbles over lifting the debt ceiling. Even though the ignominy of a technical default was saved by a last minute deal between Republicans and Democrats, the damage had already been done. Painful fiscal consolidation has been postponed, but cannot be avoided altogether, and this fact is weighing on animal spirits. The principle of Ricardian Equivalence seems to be at work. The Federal Reserve reacted quickly to the deteriorating growth outlook, by surprising markets at the August Federal Open Market Committee (FOMC) meeting with its commitment to keep rates near zero for another two years should the economic environment warrant it. The threat of rate normalisation has been entirely replaced by a "lower for longer" approach to monetary policy. Declining confidence and weak economic data triggered significant downward revisions to market growth forecasts. This process had become sufficiently advanced by September therefore, lessening downside economic surprises. The Federal Reserve eased rates further in September announcing Operation Twist, in which short-dated Treasuries are to be sold and the proceeds reinvested at the long-end of the curve. The yield curve flattened sharply on the announcement.

However, in Europe good news never materialized. The sovereign debt crisis continued to intensify in September, equities fell sharply, particularly bank stocks, and economic data consistently disappointed. Signs of tension in European money markets started to rise towards third quarter 2008 levels. The ECB lowered its 2012 growth forecasts, but failed to even signal an easing bias, stubbornly continuing to characterise monetary policy as "accommodative", a surreal assessment in the midst of an obvious credit crunch. Risk assets reacted very badly to perceived policy failures in Europe. Investment grade and high yield corporate bond spreads widened sharply to levels last seen in early 2009. Bank paper widened to the cheapest levels ever experienced.

Bank Contagion – Spread Between Euro Forward Rate Agreements and Overnight Index Swap Rate (in bps)



Source: Bloomberg, October 2011

Whilst events in the developed world have been characterised by a crisis of confidence in European and US policy making, the outlook for emerging countries has been more promising. Lower debt levels and higher policy rates in the developing world mean that the authorities have the tools at their disposal to deal with economic shocks. Slower growth and lower inflation expectations have already triggered a number of rate cuts.

## FOURTH QUARTER VIEWS

We believe that the process of downward revisions to growth forecasts remains incomplete. These concerns are strongest in Europe. We believe that the sharp tightening in financial conditions, unless quickly alleviated, is already sufficient to trigger a mild recession in the first half of next year. This is feared, but not yet fully discounted, by market participants.

European risk assets are cheap, but valuation means little in the absence of positive catalysts to unlock that value. In our view, a sustained improvement in sentiment requires putting in place ring fencing measures, including a credible bank recapitalisation plan, before an orderly, but hard restructuring of Greek debt. This must be accompanied by credible progress towards agreeing to a blueprint for a new version of the European Monetary Union (EMU), additional structural reform measures, lower ECB repo rates and a clear commitment to keep rates "lower for longer". Unity and clarity of vision from EU policy makers may be more important than exactly what that vision is.

US growth appears to be stabilising at below-trend, but non-recessionary levels, thanks to the Federal Reserve's proactive approach to monetary policy and the related broad-based decline in borrowing rates for investment grade issuers. However, retail spending has been supported by equity markets so it is crucial that recent weakness does not persist. Furthermore, should the bi-partisan talks to agree on back-loaded spending cuts fail, as seems likely on current showing, the imposition of automatic spending cuts next year may weaken the growth outlook further.

We continue to be hopeful that a soft landing can be achieved in developing economies, thanks to the continuing strength of domestic demand and the flexibility enjoyed by policymakers in terms of the range of easing options available to them.

### Interest Rates

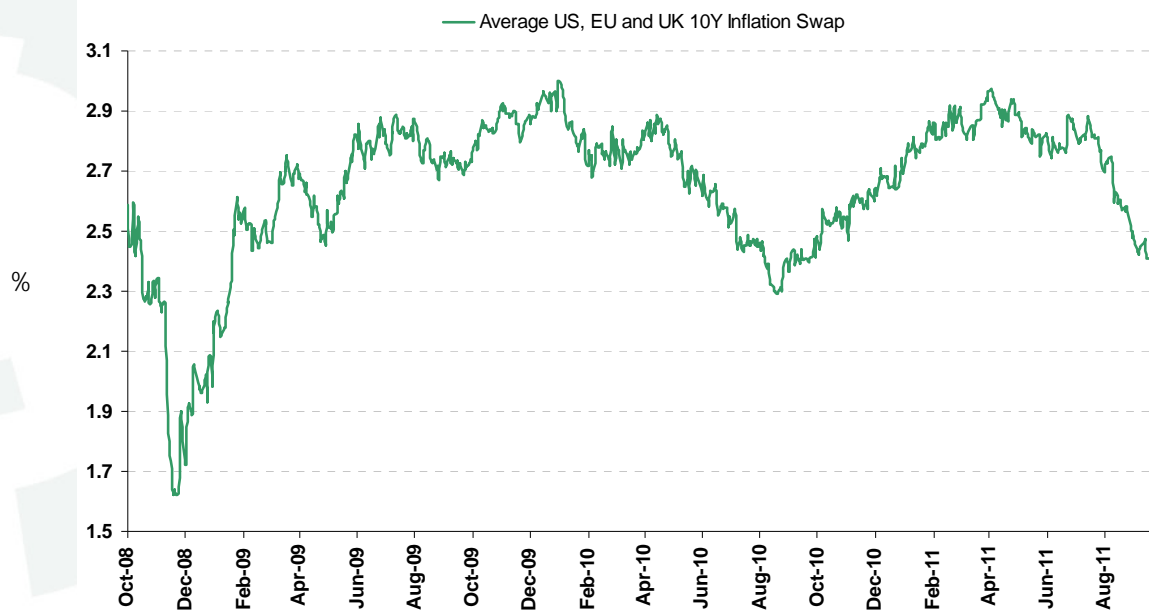
Yields may be historically low in G4 markets, but there is, as yet, little evidence that they have yet bottomed. Downside risks to economic growth remain, and we expect further downward revisions to growth forecasts. Although government bond markets have been under pressure in recent days on optimism that EU policymakers are on the verge of an important breakthrough, we

are sceptical of "magic wand" solutions. If easy solutions to Europe's predicament existed, policy makers would have found them long ago. Although the ratification of EFSF 2 is an important step, hopes for a speedy and decisive recapitalisation of European banks are likely to be frustrated. We believe that further disappointments are likely to occur.

We plan to use a further short-term rise in yields on the current reversal of the flight-to-quality rally to rebuild long duration positions. Given the risks that we still perceive, we are more likely to overweight duration in Europe, whilst exercising more caution towards US Treasuries. Long-dated Japanese government bonds (JGBs) remain unattractive. Japan's excessive debt levels make it hard for JGBs to participate in flight-to-quality rallies, whilst signs of economic health weigh on bond prices.

Now that central banks, with the notable exception of the ECB, have resumed the "lower for longer" approach that characterised 2009 and 2010, movements in long yields are likely to be driven by changes in inflation expectations rather than changes in expected monetary policy. Correctly anticipating changes in break even inflation rates will be key to duration positioning in the coming months. Specifically, a significant rise in US Treasury yields would need to be led by a sustained rise in inflation expectations. This is unlikely to happen in the short term given below trend growth rates and abundant spare capacity. We would prefer to look to build long break even inflation positions before building duration underweights. We have recently closed out tactical break even short positions and started to reset break even long positions. We plan to use periods of weakness in the fourth quarter to build more significant long positions in break evens. Long-term inflation risks are tilted to the upside, in our view, and the upcoming quarter may provide an attractive reentry point for this secular theme. Given Operation Twist, which we expect will be effective in lowering yields, we are in less of a hurry to rebuild structural underweight duration positions.

Developed Market Inflation Expectations – US, UK and EU 10 Year Inflation Swaps



Source: Bloomberg, October 2011

The essential difference between quantitative easing (QE) and Operation Twist is that the latter changes the composition, but not the size of the Federal Reserve's balance sheet. As such, the direct impact on inflation expectations, the dollar and commodity prices is minimal, as the Federal Reserve is not perceived to be printing money. The clearest impact of QE fell on commodity prices, equities, volatility and investment grade spreads. Given that credit multipliers are weak, easier financial conditions were largely offset by higher oil prices, rendering QE relatively ineffective in boosting US growth. To the extent that QE was effective at all, it worked largely through raising equity prices and thus boosting consumer spending via the wealth effect.

We believe that the efficiency of Operation Twist is under-rated by markets. By not directly raising inflation expectations or commodity prices, the overlooked negative feedback loops of QE are avoided. Moreover, Operation Twist will act to both lower long-term bond yields, and reduce volatility, ceteris paribus. The Federal Reserve is already attempting to pin short yields through "lower for longer" policies; the resulting combination should provide a powerful catalyst towards lower Treasury volatility.

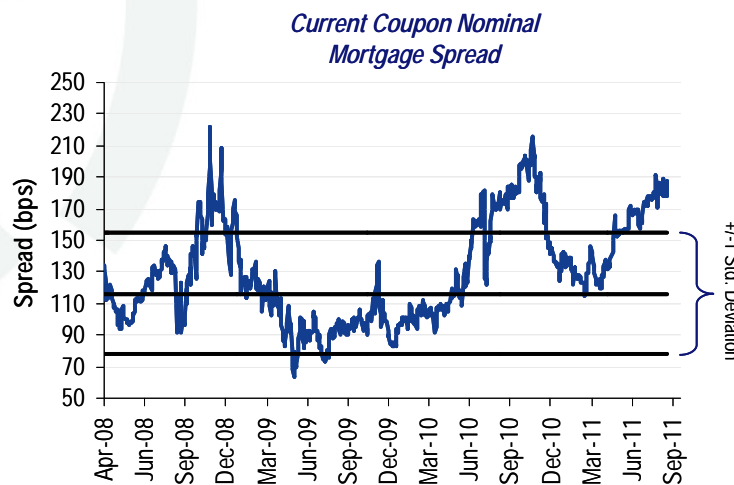
### Sector Rotation: MBS Expected to Rebound

Lower and more stable Treasury yields will gradually impact other asset classes, bringing down volatility across the board. Much of the pain in credit markets in the third quarter was linked to a sharp rise in fixed income volatilities as markets struggled with the growing realisation of the increasing macroeconomic vulnerabilities in this post-crash world. The ongoing need for deleveraging will suppress long-term growth rates while downside vulnerabilities are magnified by the diminishing availability of policy options. The deteriorating mix between growth and inflation, already evident in the US and UK, poses further risks that macroeconomic policies may become inherently more unpredictable. This structural increase in uncertainty warrants an underlying increase in asset volatility. The actual rise in volatility witnessed in the third quarter was an excessive reaction to these longer-term concerns.

We believe that Operation Twist has provided a significant, and much over looked, positive catalyst. Lower, and more stable Treasury yields will gradually impact other asset classes, bringing down volatility across the board. This will be a very welcome development after the disruptive volatility spikes that have so characterised the past few months.

Lower volatility will have an immediately positive impact on high quality spreads. MBS have already reacted positively to the Federal Reserve's announcement that maturing agency and agency MBS will be reinvested in agency mortgages. However, the positive impact of an additional USD 200 billion of demand may be outweighed by the effects of lower interest rate volatility, when it materialises.

MBS have underperformed Treasuries so far this year, thanks to wider swap spreads and an increase in prepayment speeds as Treasury yields tumbled during the third quarter. In this yield hungry world, we believe that the asset classes of choice are those which offer income advantage, high credit quality and limited incremental risk versus governments. MBS, both agency and non-agency, fit the bill exactly. We are looking for opportunities to significantly add to our mortgage holdings in multi-sector portfolios.



Source: Bloomberg, Citigroup, September 2011

We continue to see strong alpha opportunities in the mortgage sector. Our move up-in-coupon bias (an example of this is a move from 5% coupons to 3.5% coupons), and careful emphasis on specific geographies and loan characteristics, has allowed us to successfully identify specific pools with lower prepayments, thus capturing yield advantage for our clients.

We have spoken often in previous quarterlies about the strength of corporate balance sheets and cash flows. These advantages are well known, and widely understood. Corporate bonds, both investment grade and particularly high yield, have reacted negatively to slower growth, higher volatility, and falling equity prices. Valuations are now cheap. Although the expected decline

in volatility will be supportive, we remain somewhat cautious given that recession risks remain real, particularly in Europe. Although growth forecasts have been revised downward, the same is less true for corporate earnings forecasts. Given our view that growth forecasts may still be revised down further, we would like to evaluate the impact of any earnings disappointments on the pricing of corporate securities before sounding the "all clear". We remain somewhat cautious on corporate bonds, and prefer investment grade issuers to high yield securities.

### Emerging Markets

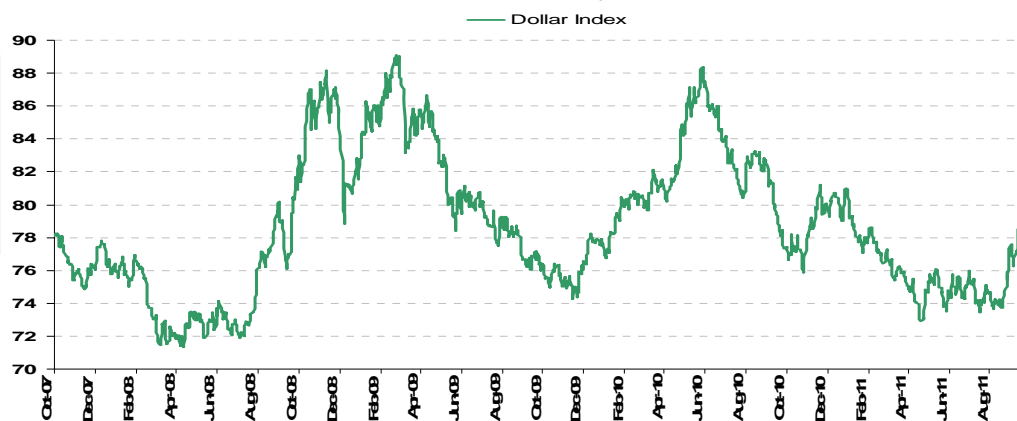
Value has been created across the board in EM assets. Sovereign external debt (debt issued by emerging market governments in US dollars or euros) spreads are 170 basis points wider than at the start of the summer. Currency values have fallen between 6% to 16%, and sovereign local debt (debt issued by emerging market governments in local currency) rates have decreased more than 50 basis points (although the environment is turning favourable for rate cuts). Fundamentals are solid and continue to improve, with ratings upgrades (for example, Turkish sovereign debt issued in local currency received an upgrade to investment grade), an improved inflation outlook, faster growth than developed countries, and increasing policy flexibility. The last point is the strongest advantage of EM countries, with policy options both on the monetary and fiscal side. Central banks have ammunition to cut rates and use currency reserves in order to support growth.

Value needs a catalyst to transform positive fundamentals into strong absolute returns. Europe remains the biggest risk for emerging markets. Ring fencing measures as they concern European sovereigns and banks continue to be implemented. The Federal Reserve has committed to keeping rates at zero for two years, and the ECB is expected to cut rates by the end of the year. In a low rate environment, EM fixed income assets look attractive. We believe that sovereign external debt will be the first segment of EM debt to benefit from an improved market environment, along with sovereign local debt, followed by higher-quality corporate debt. High yield corporate debt will need more time to recover. EM currencies have fallen more than expected. They will recoup their losses, but an improved growth environment is required to quickly recoup all losses. Zero-rate policies in the developed world and the growth differential between developed and emerging markets keep the long-term trajectory bullish for EM currencies. Sovereign external debt is our preferred asset class in this environment. We do not often get excited about sovereign external debt because it is a defensive asset class and out of fashion compared to sovereign local debt. However, the premium has been built to such an extent that it cannot be ignored. Spreads are at the widest they have been for the last two years, rising from 250 basis points at the beginning of the summer to 420 basis points, which we see as a substantial premium over a 10-year Treasury note yielding 2%. This is significant for an investment grade asset that does not need to offer that much.

### Currencies

Our currency positioning and risk levels are limited. Secular dollar weakness has been on hold since the middle of the second quarter, and the US unit has enjoyed a counter-cyclical rebound on risk aversion inflows. Should the risk environment stabilise during the fourth quarter, we would expect the dollar to resume its decline. We are cautiously underweight the US dollar, favouring Asian currencies (led by the Singapore dollar), as well as faster growing and commodity related G10 currencies, such as the Canadian and Australian dollars.

US Dollar Index – Value of US Dollar Relative To Other Major Developed Market Currencies



Source: Bloomberg, October 2011

## LONG TERM

For most of the past two years our approach has emphasised shorter-term, cyclical positives rather than the longer-term, secular negatives facing markets. These long-term concerns have now come back to haunt the markets. We have entered an environment of shorter cycles, with shallower upturns and increased downside vulnerabilities given the shortage of effective tools available to policy makers in developed markets. The best of growth in this cycle is now clearly behind us. With the benefit of hindsight, the third quarter of 2011 may well be viewed as an inflection point in this shallow post-crash recovery, in which market attention on the realities of lower long-term growth, ongoing deleveraging, excess government debt and diminished policy flexibility returned. We believe that the new environment will continue to favour EM fixed income over developed fixed income, and that fixed income assets backed by strong balance sheets and underlying cash flows will remain in strong demand.



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