



FFTW QUARTERLY COMMENTARY

Fourth Quarter 2011
By Guy Williams, Global CIO

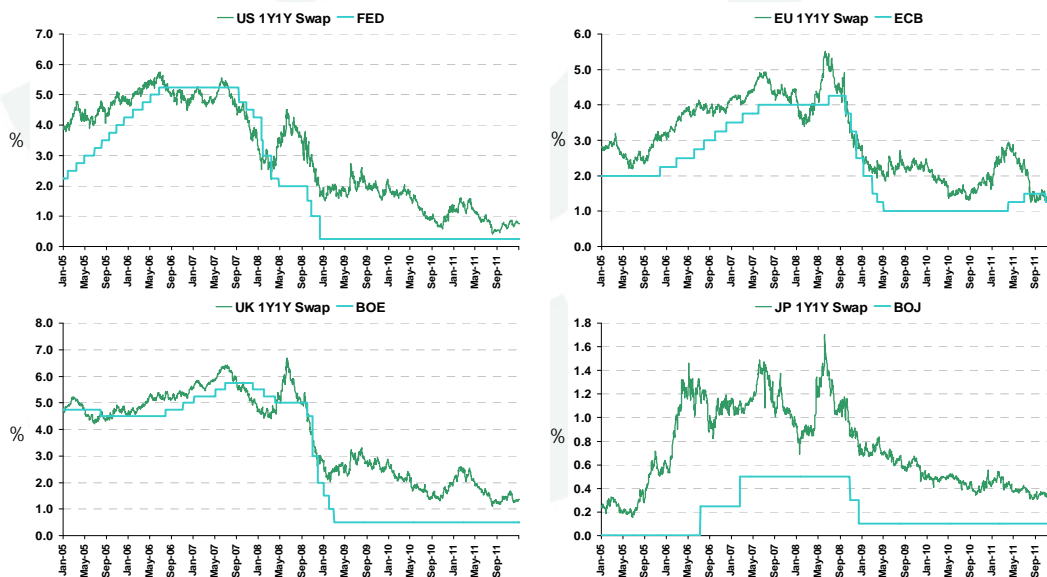
OUTLOOK OVERVIEW

Global growth has slowed, and investors have adapted to the new, bleaker environment: consensus growth expectations have fallen sharply over the past six months, and incoming economic data—although often weak—is failing to generate much disappointment.

Developing markets have engineered a soft landing, and the US economy is proving more resilient than expected; however, underlying demand is weak. US growth is likely to remain slow in 2012. The euro area is in recession, and a speedy or credible solution to Europe's sovereign debt crisis is not in sight.

Global government bond yields are likely to remain low in 2012, even if further sustained yield declines are not expected. We expect additional European Central Bank (ECB) repo rate cuts and a continuation of the "lower-for-longer" theme in the G4 countries.

"Lower for Longer"



Source: Bloomberg, January 2012

European Union (EU) break-up risk is a new and sinister theme. Anticipating changes in other investors' perception of these break-up risks will be the key to investing successfully in Europe. We are concerned that fears will intensify in the first quarter through the first half of 2012, driving sovereign spreads wider.

Political risk is high in 2012: the US elections could mark an important turning point, while a potential Socialist victory in France could intensify concerns over the viability of the European project (i.e., euros). Tensions between the United States and Iran may raise oil prices, triggering a slowdown.

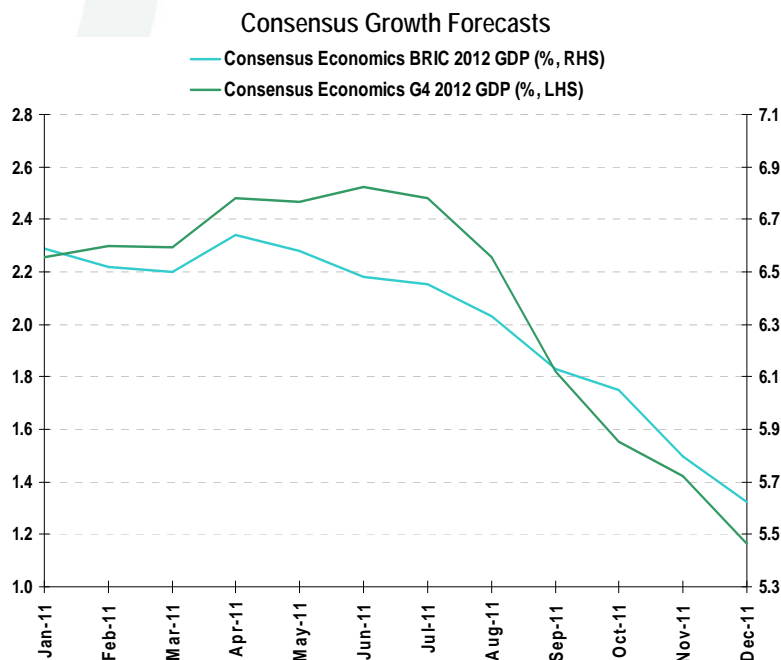
Accommodative central banks have had considerable success in stabilizing yields at low levels across the curves, contributing to a marked decline in volatility and helping to promote a recovery in investor risk appetites. High-quality spread products have reacted positively. Corporate balance sheets, earnings and free cash flow remain in good shape. These well-known positives are partially offset by an adverse regulatory environment. Dodd-Frank, the Volcker Rule and related European initiatives are negatively impacting market liquidity. These new regulations have not been fully implemented, and their implications are not yet fully understood. The attendant re-pricing of credit sectors is incomplete and poses a risk for the success of our strategies this year.

Emerging Market Debt (EMD), particularly Advanced (i.e., investment grade) remains the asset class of choice for flexible global portfolios. There are some pockets of significant value in the structured securities sector, such as commercial mortgage-backed securities (CMBS) and reverse mortgages. We have a more cautious approach to issue-selection risk in mortgages this year, and are scaling back our long-held, up-in-coupon bias on increasing prepayment risks. The relative resilience of the US economy argues for a continued underweighting of European corporate credit versus US issuers.

We are structurally short the euro, which stands to lose out in both an environment of increased EU concerns fanned by political discord, and through ECB attempts to combat these concerns through monetary easing, either conventional or unconventional in nature.

FOURTH QUARTER 2011

At the beginning of the fourth quarter investors were still shell-shocked after the abrupt global slowdown, a collapse in confidence in developed-market policy makers and the extreme market turbulence that had so characterized the previous quarter. Volatility was elevated. The recently announced “Operation Twist” in the United States was poorly received by the market, and its potentially positive impact was misunderstood and underappreciated. Economic data weakened noticeably, the euro area appeared to be entering a recession amid signs of a bank-deleveraging-related credit crunch, and investors were vying with each other to competitively lower growth forecasts for 2012.

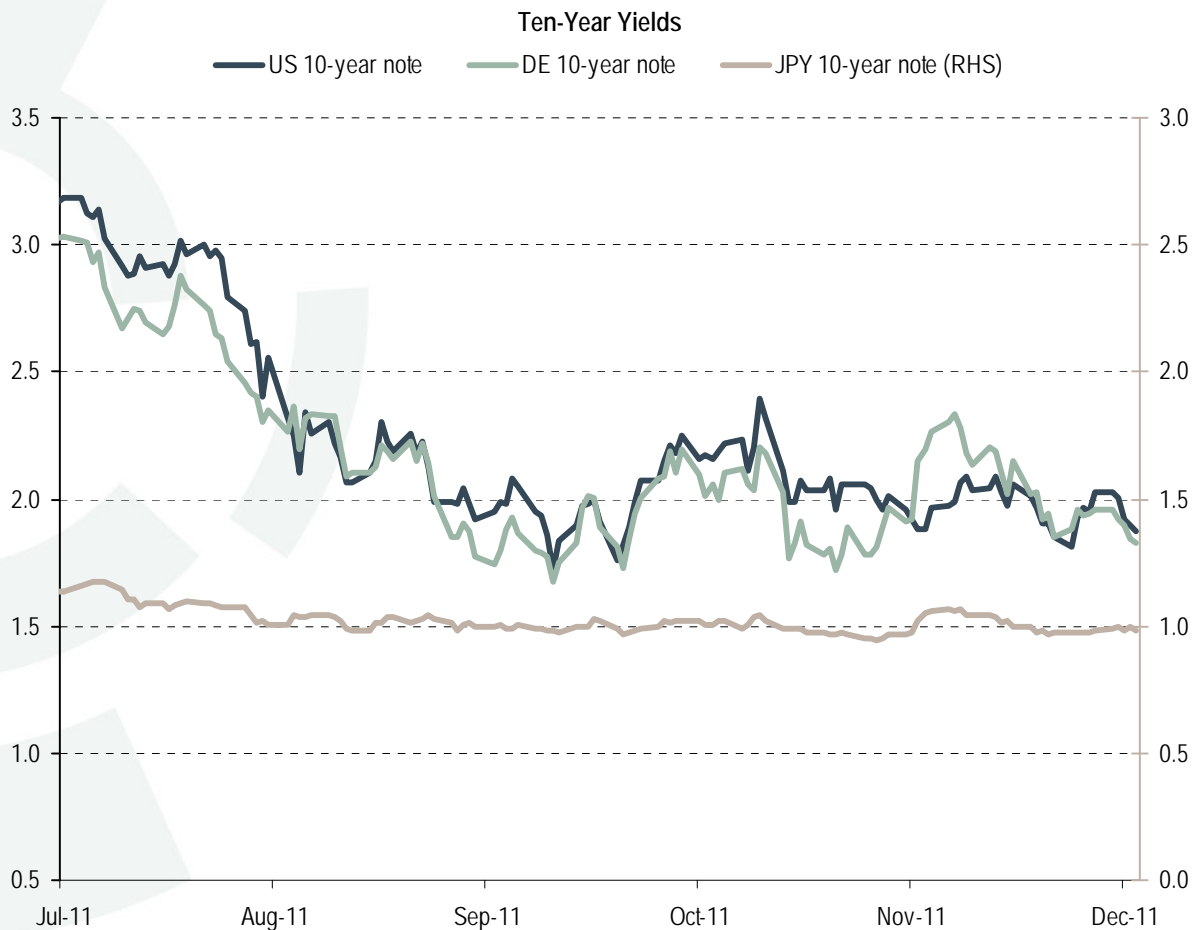


Source: Datastream, January 2012

As the quarter unfolded, evidence mounted that the euro area had, indeed, entered a recession. Bank deleveraging weighed on European markets. October's much-heralded EU Summit failed to deliver a credible solution to Europe's debt problems. An intensifying war of words between France and Germany on one side and Greece on the other led to the first open discussion of EU exit among policy makers. This injected a new and highly unwelcome element into the proceedings—the specter, however remote, of an EU break-up. Euro area sovereign debt spreads came under intense pressure during late October and November. Yields on Italian government bonds rose to around 7.5%, and the spread between OATs and Bunds widened to levels last seen in 1990. Even Dutch government bonds were negatively affected.

Investor gloom was further fanned by slowing growth in the developing world, particularly concerns about the Chinese property sector and related fears of a hard landing in China. Consensus growth expectations for 2012 continued to fall over most of the quarter. However, investors quickly adapted to the new reality. Incoming US economic data, although far from strong, began to register mildly positive surprises versus downwardly revised expectations. A similar pattern was soon seen in much of the rest of the world. The ECB reversed its earlier tightening moves and furthermore injected considerable liquidity into the system through swap facilities and the introduction of the three-year Long Term Refinancing Operation (LTRO) in December. As the year drew to a close, even European data was failing to shock, while the relative resilience of the US economy, thanks to a significant easing of financial conditions over 2011, was becoming apparent to all.

Capital preservation remained the dominant investor mode during the fourth quarter. However, despite several waves of flight-to-quality buying, government bond yields in the United States, Germany and Japan were unable to break below their September crisis lows. Volatility measures eased as developed market yields remained trapped at low levels.



As often highlighted, lower volatility is a powerful but quietly positive catalyst for credit. High-quality spread sectors stabilized early on in the quarter, with both mortgages and CMBS registering relative gains. EMD, both local and hard currency, soon began to rally. As confidence grew that the worst had been discounted, corporate bond spreads, including high yield, began to tighten. Credit sectors generally performed reasonably well over the period. Only euro area sovereign debt and European bank capital continued to languish.

The slow counter-trend rally in the US dollar continued, fueled by US economic resilience, and by safe-haven inflows. The euro came under strong downward pressure from late October onwards; investors realized an effective solution to Europe's sovereign debt problems would involve a highly accommodative ECB, meaning that both the crisis, and its possible resolution, would entail a weaker euro.

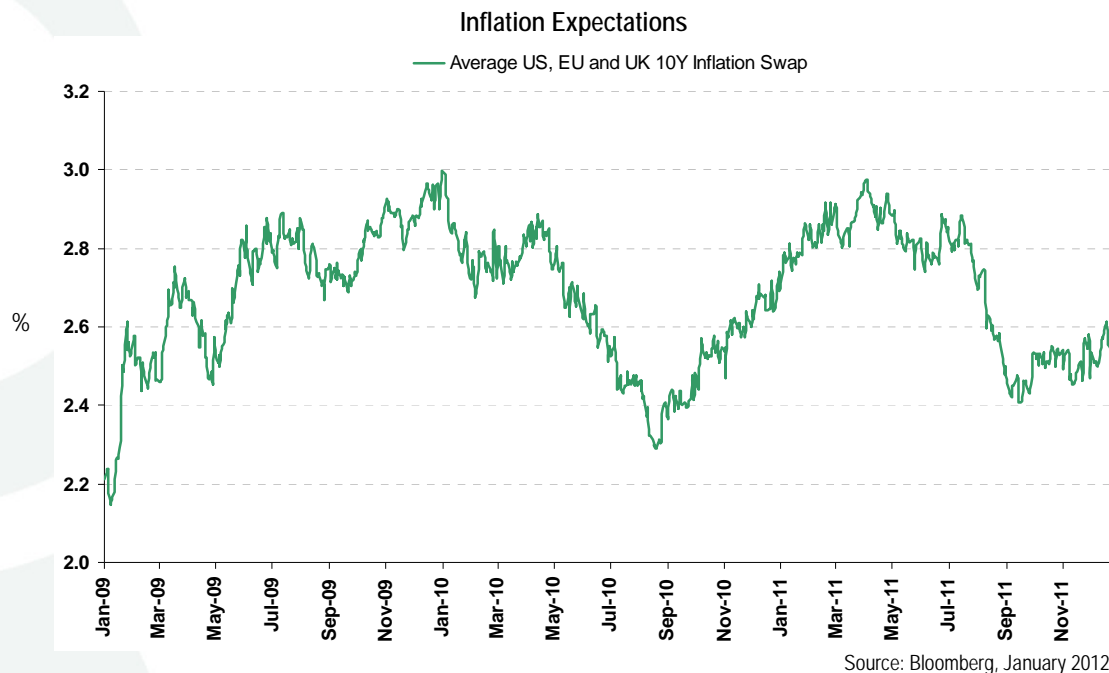
2012 FIRST QUARTER VIEWS

We believe that the process of downward revisions to 2012 growth forecasts is now more or less complete. Although the scope for disappointment remains, not only for the euro area and China but also for the United States, disappointment rather than shock is the operative word. We do not expect a repeat of the market trauma of 2011, when expectations of above-trend growth quickly turned to fears of a double-dip recession. We expect growth to be below consensus expectations in 2012 but not to shock.

Interest Rates

Central banks have signaled the continuation, or resumption, of "lower-for-longer" monetary policies. We do not expect any rate increases in G4 countries this year. Indeed, we think that the ECB will cut its repo rate to 0.50%, and possibly lower, over the course of 2012.

Headline and core inflation rates are likely to ease. Inflation expectations, however, are already ahead of the game and have little room to fall further in the United States and the United Kingdom. Given the experimentalism of the US Federal Reserve and the Bank of England's approach to monetary policy, as demonstrated by their willingness to embrace unconventional measures such as quantitative easing (QE), we believe that the longer-term risks for inflation expectations are tilted to the upside.



By contrast, both inflation and inflation expectations have room to fall further in the euro area. A sharp decline in expected inflation may yet push the ECB towards more explicit forms of QE, although this is a story for the second half of 2012 rather than now.

An environment of weak growth, contained inflation, near-0% short rates and central bank purchases of longer-dated bonds is clearly supportive of high-quality fixed income markets. We expect government bond yields to remain range-bound at low levels over most of this year. New marginal yield lows are still possible should euro area debt fears return in force over the next quarter. However, we do not think that the US 10-year Treasury yield can be sustained below 1.75% for long. We see better prospects

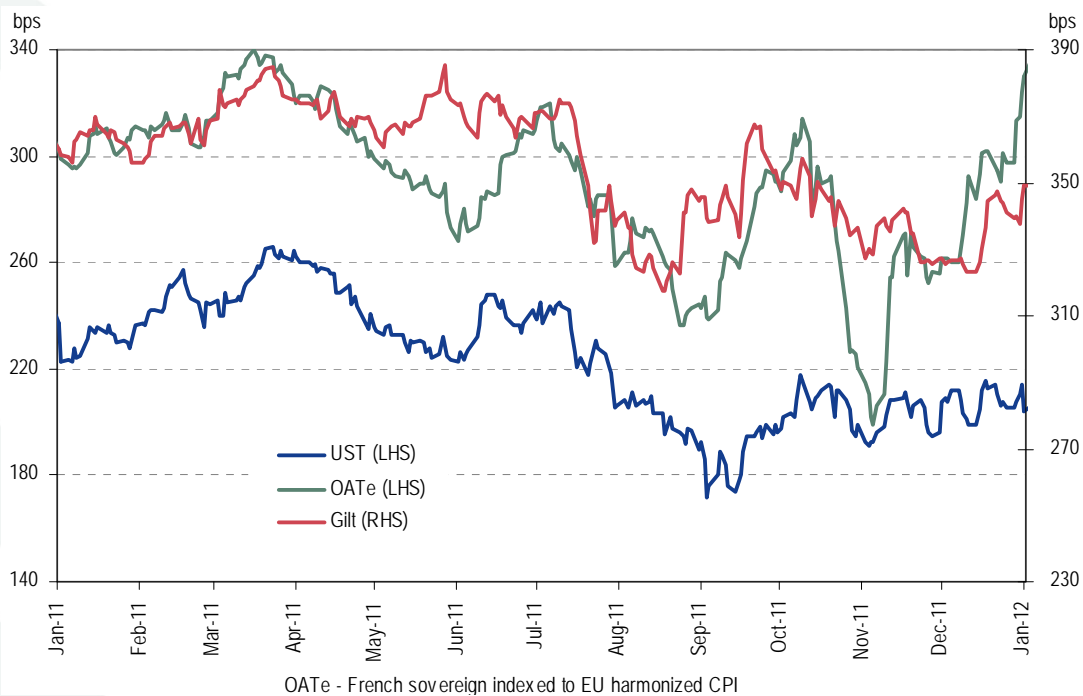
for AAA euro area government bonds than US Treasuries, given the relative weakness of the euro area economy and greater prospects for monetary easing and declines in inflation expectations.

In our view, it is still too early to position for a sustained rise in US Treasury yields. Economic growth, although relatively resilient, is far from strong. Underlying domestic demand remains weak, and a recent firming of final demand has been driven by declining consumer savings rates—a phenomenon that seems unlikely to prove sustainable given structural pressures for household balance sheet deleveraging. Concerns about upcoming fiscal tightening in 2013 could emerge as the election approaches, contributing to double-dip fears.

We think early warning signals of higher yields are likely to come through rising inflation expectations. Given our long-term views that inflation risks are somewhat tilted to the upside, and our shorter term concerns that euro area woes may resurface soon, we prefer to look for opportunities to establish structural longs in inflation breakevens in the United States and the United Kingdom rather than underweighting nominal durations. Similarly, we see prospects for the long end of yield curves—particularly the spreads between 30 years and the belly of the curve—to steepen from current levels.

By contrast, we like to underweight breakevens in Europe and have a bias to be long duration in core countries. We remain cautious on peripheral Europe. We are unimpressed by the policy makers' attempts to find a credible solution to euro sovereign debt problems. We are also concerned by signs of disunity among EU policy makers, by the weight of supply, the threat of credit rating downgrades, elections in France and Greece, and the uncertain prospects for a satisfactory conclusion to current Greek private-sector involvement (PSI) discussions. The crisis has been marked by unexpected policy developments and even more unexpected market reactions to these initiatives. Now that the genie of EU break-up risk is out of the bottle, it may prove hard to put back in. Political risk is likely to remain high this year. Despite recent market optimism over the LTRO, we think sovereign debt concerns are likely to resurface soon.

Break-Even Inflation



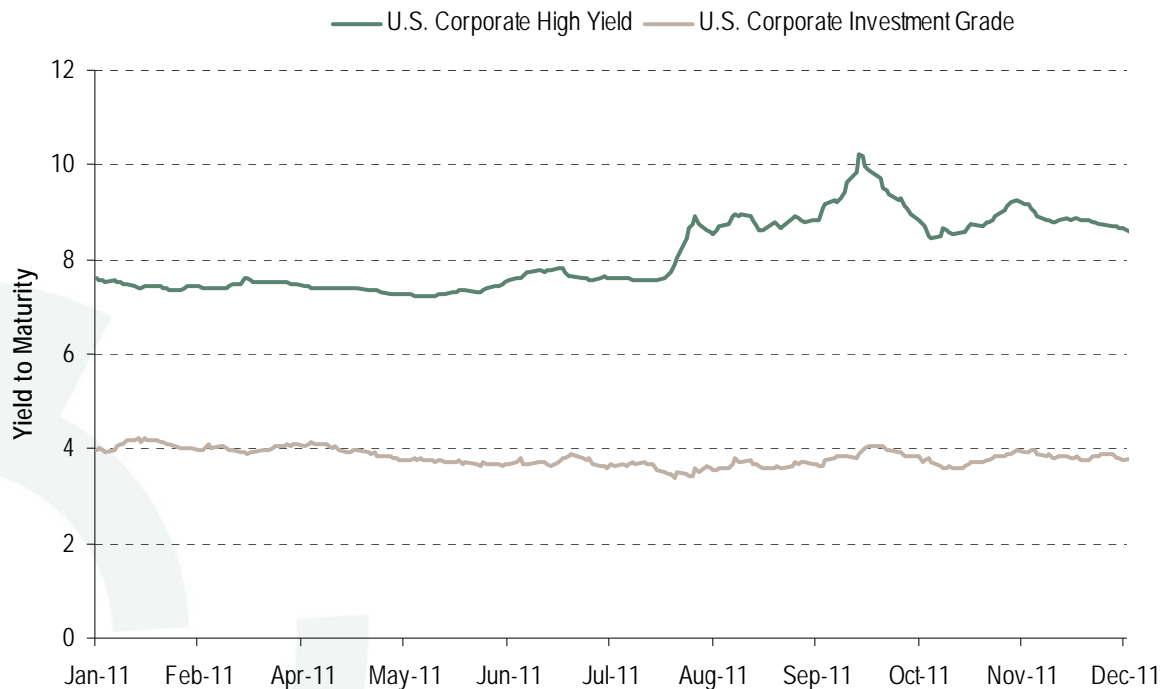
Source: Bloomberg, January 2012

Sector Rotation

Volatility eased significantly during the fourth quarter of 2011, spurring a stabilization and a partial recovery in credit markets despite weakening growth and clear evidence of a recession in the euro area. Volatility movements are being driven by the interplay between the medium-term impact of central bank yield suppression and shorter-term dynamics emanating from perceived political (largely euro area) and geopolitical risk. Our best guess is that shorter-term forces will win out this quarter and that volatility will rise from current levels. If we are right, the current rally in risk assets will not be sustained, and better entry points for credit will present themselves in coming months.

Risk appetite is likely to remain the dominant driver in sector-rotation decisions. We are broadly neutral on the corporate sector. Valuation is reasonable-to-cheap, balance sheets are sound, and both earnings and free cash flow are very healthy. However, earnings are starting to disappoint somewhat, defaults are projected to rise and liquidity is being undermined by regulatory initiatives such as the Volcker Rule and Dodd-Frank. The impact of these measures is not fully understood, nor fully discounted in market pricing. We think that investment-grade and high-yield corporates are attractive on a longer-term basis, but primarily for their yield advantage rather than their potential to tighten meaningfully this year from current levels. We would prefer to wait for periods of risk aversion and wider spreads before starting to rebuild exposures. We are overweight US corporate issuers against European issuers.

U.S. Corporate Bond Yields



Source: Barclays Capital, January 2012

Structured Securities

As in 2011, we are more upbeat on sectors of the securitized market. We like CMBS and GNMA reverse mortgages. We are neutral on agency MBS, with a bias to buy on dips. Although not our central case, renewed QE in the United States is quite possible this year and would likely be focused on current coupon MBS rather than Treasuries. Within the agency mortgage sector, we are starting to scale back our long-held, up-in-coupon approach. Risks of more effective attempts to help refinancing are growing, while the potential returns of up-in-coupon strategies have been trimmed as prepayment models have been adjusted to reflect the post-crash reality of slower prepayments and a more difficult mortgage-refinancing environment. We are starting to reposition portfolios towards current and lower-coupon agency MBS in order to avert prepayment risks, and also in order to benefit from likely Federal Reserve purchases should QE3 materialize. Post-HARP (Housing Assistance and Refinancing Program) mortgage pools also offer lower prepayment risks. Flexible investors may still be able to take advantage of selective pockets of value in non-agency mortgage securities, and in mortgage derivatives such as inverse interest only (IOs) mortgage-backed securities.

Emerging Markets

As previously mentioned, emerging markets, particularly Advanced EMD, remains our credit sector of choice for flexible global bond portfolios. We prefer countries and regions that stand to benefit from relative US resilience and that are not overly exposed to tail risks from the euro area crisis. This means overweighting Latin America at the expense of Eastern European bonds and currencies. We think that a soft landing is more or less discounted now in local markets and that rates have limited potential to rally further. We are positioned in the short and medium dates as a result, looking to earn and preserve carry rather than

capturing capital gains. While the US dollar retains its safe-haven status, we prefer to finance EM currency positions through the euro.

Currencies

We are structurally underweight the euro in global portfolios. The euro appears to be vulnerable both to an intensification of European sovereign debt concerns and to attempts to calm market nerves through greater ECB policy accommodation. As we believe that the former is likely in the shorter term, and the latter in the longer term, the path of least resistance for the euro appears to be downwards.

As in our EM portfolios, we favor growth currencies that are more closely linked to the United States. Our favored currency is the Canadian dollar, followed by the Mexican peso. We are neutral on UK sterling and Scandinavian currencies, and somewhat bearish on the Swiss franc.

LONG TERM VIEWS

The key risks in 2012 seem mainly to be political or geopolitical in nature. The US elections later this year have the potential to profoundly impact not only the United States but also the global economy and financial markets in the years to come. The euro sovereign debt crisis remains seemingly unresolved. Political unity among the 17 euro area nations, let alone the EU 27, has proved hard to forge. The outcome of this May's French elections could further undermine the critical Franco-German relationship, with potentially far-reaching consequences. Tensions between Iran and the United States are brewing, and the risk of an unexpected significant terror event lurks in the background. Regulatory initiatives are weighing on liquidity, thereby amplifying market reactions to unexpected developments. We expect risk appetite to remain a key driver for global fixed income markets in 2012, and there are plenty of event risks on the horizon to keep markets in the volatile and now-familiar cycle of sequential optimism and despair.

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