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WEEKLY COMMENTARY:
Mario Draghi's Verbal Intervention

Major Developments:

Monday, July 23:

- Eurozone Advance Consumer Confidence Indicator decreased to -21.6 for July.

Tuesday, July 24:

- Eurozone Advance Composite PMI Output remained at 46.4 for July.
- US FHFA House Price Index growth remained 0.8% m.o.m. for May.

Wednesday, July 25:

- UK Advance Second Quarter GDP decreased to -0.8% y.o.y.
- Germany IFO Business Climate Survey decreased to 103.3 for July.
- US New Home Sales growth decreased to -8.4% m.o.m. for June.

Thursday, July 26:

- US Durable Goods Orders growth increased to 1.6% m.o.m. for June.
- Japan CPI decreased to -0.2% y.o.y. for June.

Friday, July 27:

- Germany CPI remained at 1.7% y.o.y. for July.
- US University of Michigan Consumer Confidence remained at 72.3 for July.
- US Second Quarter GDP decreased to 1.5% q.o.q. annualized.

Last week, we cautioned against fatigue with the Eurozone playing the same record over and over again. This week, the tune changed. At a conference in London, European Central Bank (ECB) President Mario Draghi gave what seemed to be a remarkably forceful speech. While his performance in the Q&A after past ECB meetings had already demonstrated a willingness to be quite direct, the speech he gave at the Global Investment Conference on July 26 was still much more strident than anyone was expecting. Two comments in particular fired the imagination:

"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough," and;

"To the extent that the size of these sovereign premia hampers the functioning of the monetary policy transmission channel, they come within our mandate."

The conclusion seems clear. "[W]hatever it takes" is a phrase without ambiguity. Additionally, wide spreads—that is, high yields in the periphery—are a legitimate target for ECB intervention under the guise of ensuring that the current 0.75% repo rate is properly transmitted to the affected economies. It follows then, that Draghi has communicated that the ECB will not stand on the sidelines dogmatically allowing the Eurozone to unravel, and consign itself with it to oblivion. This has long been FFTW's belief, but it is worth restating due to the number of people who have taken a very literal approach to the Treaties.

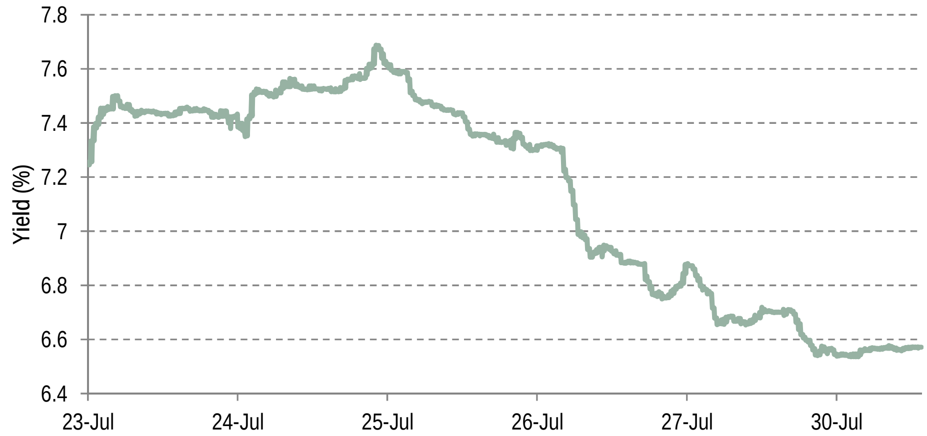
In response, spreads have tightened very sharply. The Chart of the Week, for the second time in a row, shows 10-year Spanish yields, which have rallied by 85 basis points over the week to Friday July 27, to 6.66%. The move is even more pronounced at the front end, where the rally has been in excess of 160 basis points.

What makes this even more remarkable is that at the time of this writing, rumors are circulating that Spain will enter a program with the International Monetary Fund (IMF) and the European Union (EU), which has been vociferously denied by Spain's Deputy Prime-Minister, Soraya Saenz de Santamaria. The way to square the circle, of course, is that some support is much better than no support.

However, we should caution against being carried away by exuberance. What did Draghi really tell us that we did not already know? He told us that the ECB can be much more creative in the implementation of its core monetary policy function than some had presumed. Yet the ECB invented both the SMP (Securities Market Programme)—by which it bought bonds of peripheral issuers, and also the Long-Term Refinancing Operation (LTRO) and its successor, by which the feedback mechanism between banks and sovereign issuers was, if not broken, then at least significantly weakened. Most recently, the ECB cut the rate it pays on reserves to 0%. Despite some perceptions, the ECB has form with doing "whatever it takes." It must follow though, that behind the very direct language, Draghi was reiterating what we already knew and not announcing anything truly novel.

What was also not new were the other aspects of his speech, which focused at some considerable length on the importance of combating debts and deficits. It was made very clear that Draghi regards progress in this sphere as essential. The ECB is not going to reward back-sliding. However, this raises a significant issue. If yields are where they are not due to liquidity or fundamental break-up fears—because the ECB can and has addressed both of these—then that leaves the reason for a risk premium as solvency. There are fewer quick fixes for that.

Chart of the Week: Spanish 10-Year Borrowing Costs 7/23/2012 – 7/27/2012



Data Source: Bloomberg

Next Week:

Monday, July 30:

- Eurozone Final Consumer Confidence Indicator is expected to remain at -21.6 for July.
- US Dallas Federal Reserve Manufacturing Survey is expected to decrease to 2.0 for July.

Tuesday, July 31:

- Germany Retail Sales growth is expected to increase to 0.5% m.o.m. for June.
- Eurozone Unemployment Rate is expected to increase to 11.2% for June.
- US Personal Income & Spending growth are expected to increase to 0.4% and 0.1%, respectively, m.o.m. for June.
- US Conference Board Consumer Confidence is expected to decrease to 61.5 for July.

Wednesday, August 1:

- Eurozone Final PMI Manufacturing Survey is expected to remain at 44.1 for July.
- US ISM Manufcaturing Survey is expected to increase to 50.2 for July.

Thursday, August 2:

- UK PMI Construction is expected to increase to 48.7 for July.
- US Factory Orders growth is expected to decrease to 0.5% m.o.m. for June.

Friday, August 3:

- US Unemployment Rate is expected to remain at 8.2% for July.

Source: Bloomberg

Central Bank Watch:

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on Sept. 2012 Interest Rate Futures Contract	Next Meeting
Fed	-75 bps	December 16, 2008	0% - 0.25%	0.14%	August 1
ECB	-25 bps	July 5, 2012	0.75%	0.06%	August 2
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.30%	August 9
BoE	-50 bps	March 5, 2009	0.50%	0.61%	August 2

Source: Bloomberg

Market Review: Sovereign Bond Markets

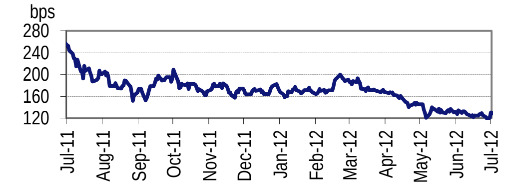
United States

US Treasuries rallied in the earlier part of the week following concerns about additional funding required by regional governments in Spain as well as the visit to Greece by representatives of its international creditors to access its progress in reining in its budget deficit. The 10-year yield rallied to an all-time low of 1.38% as Eurozone peripheral spreads widened significantly. However, Treasuries quickly gave back the gains on Thursday and Friday after Mario Draghi's comments at a speech in London emphasized that policy-makers will be ready to take additional steps in case liquidity risks flare up in EU sovereign debt markets.

In economic data this week, the theme of better-than-expected US housing data and deteriorating manufacturing data continued to dominate. The Richmond Federal Reserve's Manufacturing Survey for June came in at a much lower-than-expected -17, with significant declines in new order volume, order backlog, and capacity utilization. In housing data, the house price index climbed 0.8% m.o.m. for May versus growth expectations of 0.4%, m.o.m. New home sales however disappointed, with the number for June coming in at 350,000 annualized units versus expectations of 372,000. Durable goods orders for the month of June grew 1.6%, much higher than the expected 0.3%, though the higher number was primarily due to surplus defense-related orders. The initial jobless claims number for the week came in at a much lower 353,000, bringing the four-week moving average to 367,000.

2- to 10-Year Treasury Yield Spread

US		Change in Level (bp)		
	Current	1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.10	2	2	9
2 Yr	0.24	4	-6	0
5 Yr	0.65	8	-7	-18
10 Yr	1.55	9	-10	-33
30 Yr	2.63	8	-13	-27
2 - Fed	-0.01	4	-6	0
5 - 2	0.41	4	0	-18
10 - 5	0.89	1	-3	-15
30 - 10	1.08	-1	-3	6



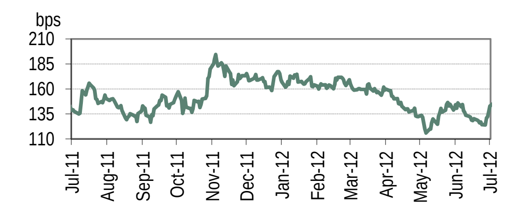
Source: Bloomberg

Europe & Japan

In Europe, the latest figures on economic sentiment came in at low levels; the Eurozone Advance Composite PMI Output stayed at the same level as at the end of June (46.4), but the Germany IFO Business Climate Survey decreased by more than the consensus, from 105.2 in June to 103.3 in July. Manufacturing data was also noticeably weaker; the Eurozone Manufacturing PMI fell to 44.1, its weakest point since June 2009. Italian and Spanish bonds underperformed early this week as a result, but messages from Draghi, and ECB Council Members Christian Noyer and Ewald Nowotny, toward the end of the week helped to improve market sentiment. Peripheral bonds closed the week slightly higher; the yield on 10-year Italian and Spanish bonds were down by 21 and 52 basis points, respectively, on the week; while the yield on the two-year German Bunds closed the week at -0.03%, five-basis points higher than at last Friday's close.

2- to 10-Year Bund Yield Spread

Europe		Change in Level (bp)		
	Current	1wk	MTD	YTD
ECB	0.75	0	-25	-25
1 Yr	-0.01	4	-9	6
2 Yr	-0.03	5	-15	-17
5 Yr	0.42	18	-19	-34
10 Yr	1.40	23	-19	-43
30 Yr	2.27	20	-6	-10
2 - ECB	-0.78	5	10	8
5 - 2	0.45	13	-4	-17
10 - 5	0.98	5	1	-9
30 - 10	0.87	-3	12	33

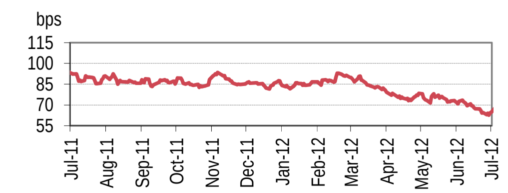


Source: Bloomberg

In the UK, Gilts sold off as European leaders outlined the need to preserve the single-currency bloc. Ten-year Gilt yields rose five basis points to 1.54% over the week. In terms of economic data, second-quarter GDP figures came out lower than expected, at -0.8% y.o.y. versus an expected -0.3%. This means that the economy has been contracting for three quarters in a row now.

2- to 10-Year JGB Yield Spread

Japan		Change in Level (bp)		
	Current	1wk	MTD	YTD
BOJ	0.10	0	0	0
1 Yr	0.10	0	0	-2
2 Yr	0.10	0	-1	-3
5 Yr	0.19	0	-3	-16
10 Yr	0.75	0	-9	-24
20 Yr	1.56	1	-11	-19
30 Yr	1.81	3	-10	-12
2 - BOJ	0.00	0	-1	-3
5 - 2	0.09	0	-2	-13
10 - 5	0.56	0	-6	-8
30 - 10	1.06	2	-1	13



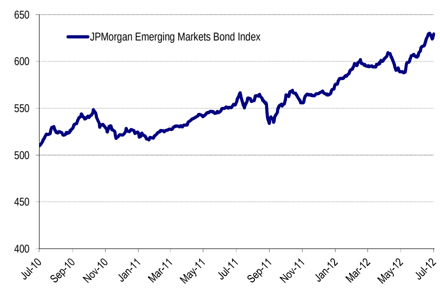
Source: Bloomberg

In Japan, CPI figures for June came out last week, and the decrease was more than expected, falling to -0.2% y.o.y. versus an expected drop to 0.0% y.o.y. The Bank of Japan Governor Masaaki Shirakawa indicated that the Central Bank will continue to pursue "powerful monetary easing" until its inflation target of 1.0% is achieved.

Market Review: Emerging Markets

There was a pause in the recent rally in emerging markets (EM) debt, and the JP Morgan Emerging Markets Bond Index Global Diversified (JP Morgan EMBIGD) lost 0.1% over the week. Spreads tightened seven basis points. EM currency performance was mixed over the week with European and African currencies outperforming (i.e., Hungarian forint, Polish zloty, Czech koruna, and South African rand). Latin American currencies (Colombian peso and Argentine peso) were the laggards. The Eurozone was again the focus this week, with 10-year Spanish government-bond yields reaching new highs. Core Eurozone yields also rose after Moody's put the Aaa ratings of Germany and the Netherlands on a negative outlook.

JP Morgan Emerging Markets Bond Index Global



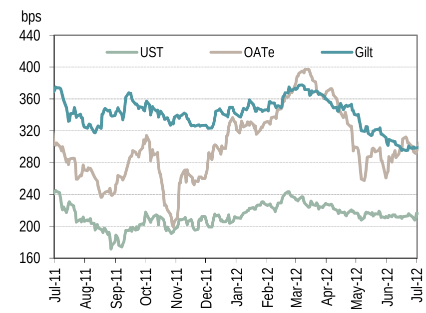
Source: Bloomberg

Market Review: Global Inflation-Linked Bonds

In the Eurozone inflation-linked bond (ILB) market, Italy's impending falling out of most of the widely followed ILB indices remains the focus. Italy cancelled its monthly ILB issuance for July, and the Bank of Italy also held an exchange auction of nominal bond BTP 2017 against the buy back of ILB BTPei 2017, 2019, 2023, and 2035. The exchange operation went well, with a total of €1.3 billion of ILBs being bought from the market. While BTPei initially outperformed nominals early in the week, Draghi's verbal commitment in doing "whatever it takes" to preserve the euro sparked a meaningful rally in peripheral government bonds. Italian ILBs failed to keep up with the strengthening Italian nominal market, resulting in a narrowing of breakeven inflation (BEI) spreads.

On the other hand, Draghi's comments also triggered a sharp sell-off in the safe-haven government bond markets (including US Treasuries, UK Gilts, and German Bunds) and a rally in risky assets on Thursday and Friday. US BEI, helped by the risk-on sentiment, rebounded strongly after being under pressure during the first three days of the week.

GILBs - 10-Year Breakeven Spreads



OATe - French sovereign indexed to EU harmonized CPI

Source: Bloomberg

UK BEI, however, closed the week lower across the curve despite a very successful UKTI 2044 syndication. The £4 billion issuance of the new 30-year UK ILB was oversubscribed with a book of £10 billion demand, and the follow-through price action was strong. A surprisingly weak second-quarter GDP report and thin trading volumes ahead of the Olympic Games were perhaps reasons why BEI failed to benefit from the risk-on sentiment late in the week.

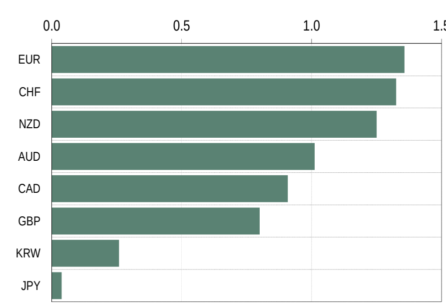
Market Review: Currency Markets

G10

For the week, better risk sentiment has led to outperformance in risky assets. Cyclical currencies, EM currencies, and the euro were the outperformers, while the safe-haven currencies, the US dollar, and the Japanese yen underperformed. The euro ended the week 1.2% higher, while the Australian dollar and New Zealand dollar also rallied almost 1%.

Markets have welcomed statements by Nowotny, who was in favor of granting the European Stability Mechanism (ESM) a banking license. The positive remarks were later followed by Draghi, who pledged to do whatever is needed to preserve the euro, including rate cuts, bond purchases, and renewal of LTRO. With the upcoming ECB meeting, Draghi's comments have heightened market expectations that the ECB is likely to restart the SMP or another LTRO. Meanwhile, the Federal Reserve may also set the stage for quantitative easing (QE3) at next week's meeting in light of weaker US data.

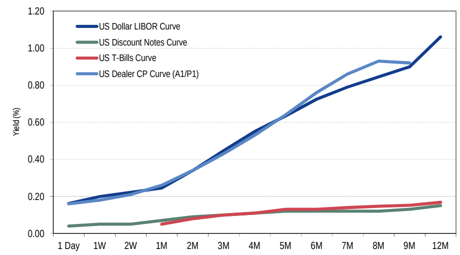
US Dollar's WTD Performance Against Other Majors



Source: Bloomberg, performance in percentage points (%)

Market Review: Money Markets

Money Market Yield Curves



Source: Bloomberg

Early in the week, market concerns that Spain might require a bailout along with resurgent fears of a Greek default were placated by ECB President Draghi stating that the, "ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." Euro deposit rates have already been lowered to 0%, and many euro-denominated money market funds are closed to new investment. Against this backdrop and with softer US repo funding levels, short-term investors' appetite for highly-rated bank paper in favored jurisdictions resumed, as investors were encouraged to spend further out the curve to pick up some yield. Sizeable trading occurred in three-month paper for Japanese, Scandinavian, and UK banks—while Australian and Canadian banks were able to issue six-month to one-year maturities in floating-rate notes. However, we would expect month-end activity to remain muted ahead of major central bank announcements on Wednesday and Thursday, with the hope that these decisions will provide clarity for policies for the next several months.

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

Both US and European corporate bonds marginally outperformed government bonds this week. Draghi and other European policymakers signaled their willingness to deliver strong enough actions this week, to once again drive credit investors to cover shorts ahead of next week's ECB meeting. The US Federal Reserve also has their Federal Open Market Committee (FOMC) meeting next week, and expectations for additional action from the Federal Reserve have been pulled forward. Strong demand for US dollar-denominated corporate bonds continued; issuance slowed, but is expected to pick up this week. US high-grade bond inflows remained strong at US$1.13 billion (the third US$1 billion-plus week consecutively). High-yield bond inflows increased to US$2 billion from US$724 million last week. US corporate bonds outperformed Treasuries by 0.07% for the period and closed the week at 182 basis points (one basis point tighter). European corporate bonds outperformed government bonds by 0.07% and ended the week at 232 basis points (one basis point tighter).

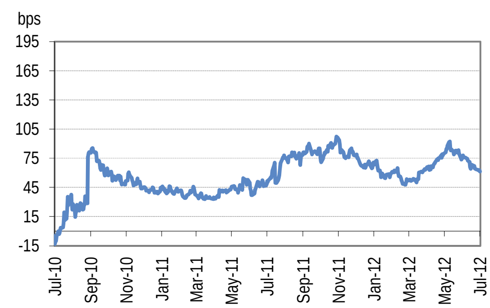
Investment-Grade Corporate Bond Index OAS

Source: Barclays Capital

Mortgage-Backed Securities

The mortgage sector outperformed duration-matched Treasuries by 16 basis points last week. More than 50% of the market expects QE3 to occur before the September Federal Reserve meeting. Oscillating European news has kept sector performance contained. This past week, DYNEX Capital, Inc. announced US$50 million of preferred stock issuance, signaling a growing REIT market. We are positive on structured products, including MBS, CMBS, and non-agency RMBS.

Agency MBS Current-Coupon Fixed-Rate OAS

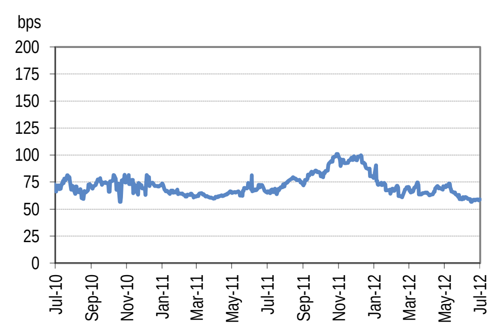


Source: Barclays Capital

Asset-Backed Securities

Stronger w.o.w. primary and secondary demand outpaced supply in the ABS market. This week US$2.6 billion of ABS securities priced, with about US$1.7 billion coming from autos and student loans. Spreads were relatively unchanged this week.

Barclays Capital ABS Index OAS



Source: Barclays Capital

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