MARCH 29, 2013
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WEEKLY COMMENTARY:

Lessons Learned

Major Developments:

Monday, March 25:

- US Dallas Federal Reserve Manufacturing Activity Index beat expectations and came in at 7.4 for March.

Tuesday, March 26:

- French Consumer Confidence Index unexpectedly fell to 84 for March.
- US Durable Goods Orders growth surged to 5.7% m.o.m. from -5.2% m.o.m. previously.
- US Consumer Confidence Index decreased more than expected from 69.6 to 59.7 for March.

Wednesday, March 27:

- UK GDP growth was -0.3% q.o.q. and 0.2% y.o.y., respectively, for fourth quarter of 2012.

Thursday, March 28:

- The unemployment rate (s.a.) in Germany remained at 6.9% for March.
- US GDP growth marginally missed expectations and was finalized at 0.4% (annualized) q.o.q. for fourth quarter of 2012.

Friday, March 29:

- Industrial Production growth in Japan deteriorated beyond expectations and fell to -11% y.o.y.

Source: Bloomberg, as at end March 29, 2013

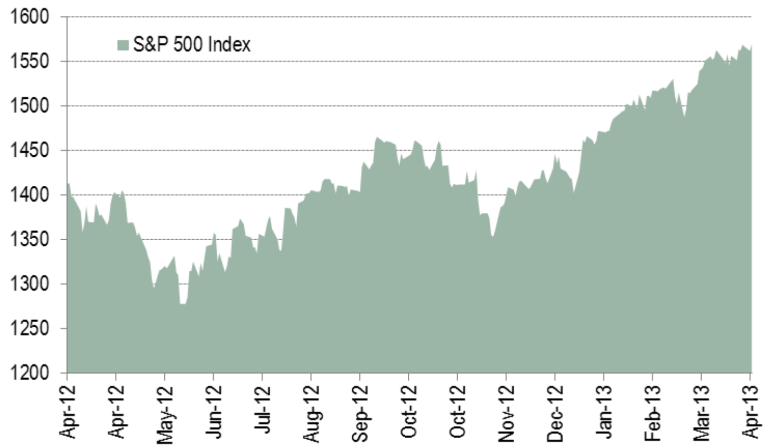
Cyprus will stand as an object lesson in a number of respects. Banks by definition are leveraged, and allowing the financial sector to reach such a size that bailouts would dwarf the size of the national economy is problematic, as Iceland, Ireland, and even the UK demonstrated in 2008. However, doing so when you do not have control over the currency is doubly problematic, and suggests that as a model for economic growth, it may leave something to be desired.

Second, the necessity to guarantee deposits has been something understood by financiers for centuries, and this was formalized in the United States with the creation of the FDIC in 1933. Weaknesses in this guarantee were recognized in the UK in 2007 when it experienced its first modern bank run. There is a role for moral hazard, but historic experience tells us that the cancer of lack of confidence in a deposit-taking institution can spread very quickly and out of all proportion to any instructive benefits to allow the institution to fail. Nonetheless, the Cypriot government decided initially on confiscatory bail-ins. It has, of course, retreated from this position and after a bank holiday of almost two weeks, deposits below €100,000 will be protected, but with haircuts applying to larger balances, up to 60%. The problem, unfortunately, is that the proverbial genie is out of the bottle: depositors in Cypriot banks know full well now that the principle that their deposits are safe has been violated. While the government has rowed back, the perception exists that those deposits now exist at the sufferance of a pen stroke, and it follows that severe capital controls have had to be put in place. It is a myth that capital controls were prohibited under the European Union's (EU's) Maastricht Treaty: they are permitted for six months in appropriate circumstances, and Reuters ran stories in July 2012 stating that capital controls across the Eurozone had been discussed in the event of a disorderly Greek exit. Nonetheless, with limits including the taking of more than €1,000 in cash from the country, it is true to observe that in a real sense a euro in Cyprus is not worth the same as euro elsewhere. A precedent has been set, and it should be a least somewhat unnerving to depositors to know that the rules are flexible, and may not apply to them at precisely the moment at which they would be expected.

The third thing we learned was that telling the truth can be unwise, even if the person doing the telling is surprising no one. Dutch Finance Minister Jeroen Dijsselbloem in his role as Head of the Eurogroup of European Finance Ministers spooked markets last week by stating that the Cyprus bail-in would serve as a model for future crises. We can guess what he meant to imply perhaps: the time for unconditional bailouts was over. In its own way this would be good news, because it must also imply a probably correct view that systemic risk was much less significant than it has been, and would no longer outweigh moral hazard concerns as if by right. One can see from where Mr. Dijsselbloem was coming. Indeed, many now believe that unconditional guarantee of Ireland's banks, and in particular senior bondholders with no cap, was a significant policy error. However, to suggest that a confiscatory tax triggering a nationwide bank run in order to protect other deposits that many believe to have benefitted from a light-touch regulatory regime, only then for a complete political volte-face and a finance minister's resignation was the model for the future handling of crises, was perhaps asking too much.

Yet, European citizens are perhaps oddly unmoved. There is little evidence of systematic deposit flight from European banks. Indeed, the Bank of Spain released data showing that for the 12 months ending in February 2013, while deposits shrank by slightly less than 6%, household deposits—that is, the deposits by exactly the people who would line up at ATMs—grew by 2.5%; the net was a non-resident deposit flight, which was much more significant. That is highly relevant for banks' capitalization, but much less so for systemic risk. Indeed, with this, and Italy's continuing efforts to gain a government, the S&P 500 has made new highs. Bond markets are back to their highs too, however. Something will have to give.

Chart of the Week: S&P 500 4/2/2012 – 4/4/2013



Data Source: Bloomberg, as at end April 4 , 2013

Next Week:

Monday, April 1:

- US ISM Manufacturing Index is expected to fall to 54.0 for March.

Tuesday, April 2:

- UK PMI Manufacturing Index is expected to increase to 48.7 from 47.9 previously.
- Eurozone Unemployment Rate is expected to increase to 12% from 11.9% previously.

Wednesday, April 3:

- Eurozone CPI growth estimate for March is expected to decline to 1.6% y.o.y from 1.8% y.o.y.
- US ADP Employment Change for March is expected to be 200,000.
- US ISM Non-Manufacturing Composite Index is expected to fall to 55.6 from 56 for March.

Thursday, April 4:

- The Bank of Japan (BoJ) is expected to keep its policy rate at 0%-0.1%.
- The Bank of England (BoE) is expected to keep its policy rate at 0.5%.
- The European Central Bank (ECB) is expected to keep its policy rate at 0.75%.

Friday, April 5:

- Eurozone Retail Sales growth is expected to decline from -1.2% y.o.y. to -1.3% y.o.y.
- US Unemployment Rate is expected to remain at 7.7% for March.

Source: Bloomberg, as at end March 29, 2013

Central Bank Watch:

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on Jun. 2013 Interest Rate Futures Contract	Next Meeting
Fed	-75 bps	December 16, 2008	0% - 0.25%	0.14%	May 1
ECB	-25 bps	July 5, 2012	0.75%	0.08%	April 4
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.21%	April 4
BoE	-50 bps	March 5, 2009	0.50%	0.52%	April 4

Source: Bloomberg, as at end March 29, 2013

Market Review: Sovereign Bond Markets

United States

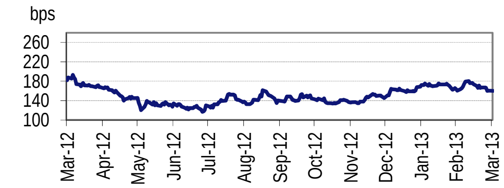
The banking crisis in Cyprus continued to dominate headlines this week as investors fled to the safety of Treasuries following concerns about potential contagion effects on weak peripheral banks in the Eurozone. Also, news about the lack of progress in breaking the political deadlock in Italy provided further disconcert to the risk-off sentiment. The yield on the current 10-year Treasury note ended the week at 1.85%, eight basis points lower than the close of the previous week.

In economic data, durable goods orders for the month of February climbed higher than forecast, propelled mainly by increased orders for automobiles and commercial aircraft. On the housing front, new home sales fell 4.6% m.o.m. while pending home sales fell 0.4% m.o.m, possibly due to seasonal effects. Consumer confidence, however, disappointed, coming in lower at 59.7 versus expectations of 67.5. Initial jobless claims for the week nudged higher to 357,000, compared to 336,000 from the previous week.

Source: Bloomberg

2- to 10-Year Treasury Yield Spread

US		Change in Level (bp)		
	Current	1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.07	1	-3	3
2 Yr	0.24	-1	1	-1
5 Yr	0.77	-3	0	4
10 Yr	1.85	-8	-3	9
30 Yr	3.10	-4	2	15
2 - Fed	-0.01	-1	1	-1
5 - 2	0.52	-2	-1	5
10 - 5	1.09	-5	-3	5
30 - 10	1.25	3	4	6



Source: Bloomberg, as at end March 29, 2013

Europe & Japan

Cyprus agreed to a new bailout deal with the Troika last weekend. As the initial proposal to impose a levy on all depositors was overwhelmingly rejected by the Cypriot parliament, the EU and International Monetary Fund (IMF) continued to insist that Cyprus had to contribute to its own banking rescue. In the new deal, Cyprus will force creditors of the two weakest banks to take losses in ascending order of seniority: shareholders, junior bondholders, senior bondholders, uninsured depositors. However, all insured depositors with accounts below €100,000 will be fully protected. European fixed-income markets remained nervous with 10-year German bonds rallying another nine basis points to 1.29%, however, particularly following Dijsselbloem's remarks that the Cyprus resolution would serve as a template for future bailout agreements. The banks in Cyprus reopened on Thursday without incident, as capital controls curbed all major transactions. Contagion has been limited, although government bond yields in Slovenia did spike more than 1% over the week on the back of speculation that Slovenia will be next in line to request a bank bailout as early as June.

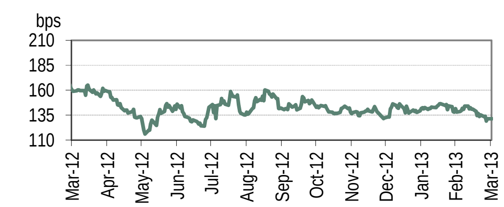
As for Italian politics, President Giorgio Napolitano created the panel of 10 experts last week after the Head of the center-left Democratic Party, Pier Luigi Bersani failed to form a governing coalition with wide support in parliament. This group of experts will try to come up with an agenda of electoral and economic reforms. The members of the panel are senior political figures of the respective political parties and the Bank of Italy official. The risk of early elections in Italy remain elevated.

Next week the ECB will hold its monthly press conference. A dovish tone is expected. The European PMIs in March fell in the Eurozone as a whole and remained in recessionary territory for a number of countries. Inflationary pressures are abating as well with CPI expected to drop toward 1.5% in the next few months.

Source: Bloomberg

2- to 10-Year Bund Yield Spread

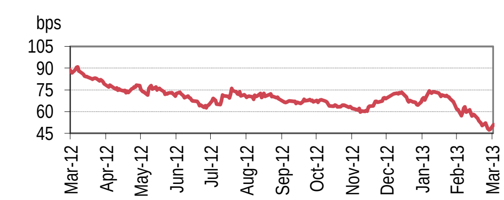
Europe		Change in Level (bp)		
	Current	1wk	MTD	YTD
ECB	0.75	0	0	0
1 Yr	0.02	-2	0	-11
2 Yr	-0.02	-5	-6	-1
5 Yr	0.31	-7	-12	2
10 Yr	1.29	-9	-17	-3
30 Yr	2.22	-3	-10	4
2 - ECB	-0.77	-5	-6	-1
5 - 2	0.34	-2	-6	2
10 - 5	0.98	-2	-4	-4
30 - 10	0.93	6	7	7



Source: Bloomberg, as at end March 29, 2013

2- to 10-Year JGB Yield Spread

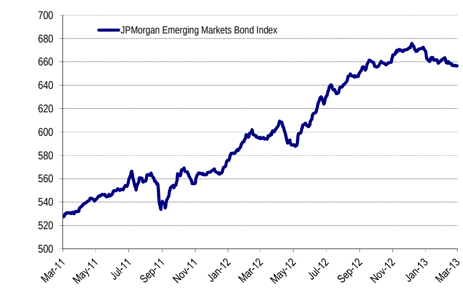
Japan		Change in Level (bp)		
	Current	1wk	MTD	YTD
BOJ	0.10	0	0	0
1 Yr	0.07	3	2	-3
2 Yr	0.08	1	2	-2
5 Yr	0.14	2	1	-5
10 Yr	0.55	-1	-11	-24
20 Yr	1.41	-11	-24	-34
30 Yr	1.55	-11	-29	-42
2 - BOJ	-0.03	1	2	-2
5 - 2	0.06	0	-1	-3
10 - 5	0.42	-3	-13	-19
30 - 10	0.99	-9	-18	-18



Source: Bloomberg, as at end March 29, 2013

Market Review: Emerging Markets (EM)

JP Morgan Emerging Markets Bond Index Global



Source: Bloomberg, as at end of March 29, 2013

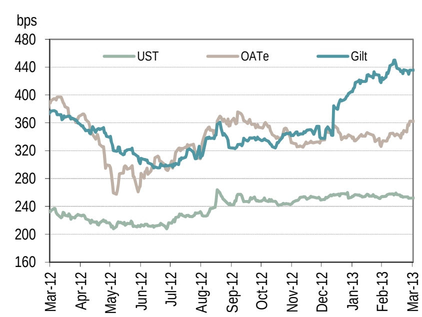
The end of the month provided some respite for local EM debt, with each region posting positive returns in US-dollar terms, with the exception of Eastern Europe. Developed-market macro data for the first quarter is still showing a wide divergence between the recovery in the US and the struggling Eurozone. In the former, construction numbers have exceeded expectations, somewhat offsetting weaker PMI data, and employment has remained firm. Overall, the US economy probably grew in excess of 3% q.o.q. for the first three months of the year.

In local markets, the South African rand outperformed for the week, rising 2.44% (versus the US dollar) after a sharp fall over the first three weeks of March. The South African rand finished the month more than 2% weaker, but a late rally in bonds blunted the impact. The country is facing significant economic and political challenges, but with the currency at levels above R9/US$, valuations are fully pricing in the negatives. Elsewhere, the Mexican peso finished the month strongly, capping off a rise of almost 5% (versus the US dollar) over the course of the month. The currency has been supported by strong fundamentals and the reform agenda, but also by hot money flows from US investors, mirroring the rise in equities. Our long-term view of Mexico is still very favorable, but the speed of the rally combined with the high percentage of ownership of the local bond market by foreigners, has increased the country's vulnerability to a correction in the shorter term.

Source: Bloomberg, Barclays Research

Market Review: Global Inflation-Linked Bonds (GILBs)

GILBs - 10-Year Breakeven Spreads



OATe - French sovereign indexed to EU harmonized CPI

Source: Bloomberg, as at end of March 29, 2013

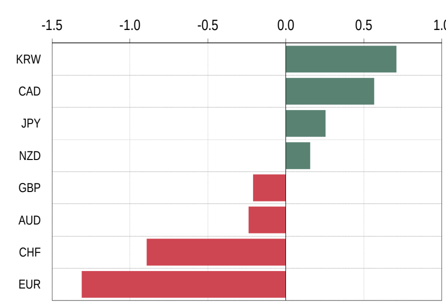
ILB markets were relatively quiet during the Easter-holiday-shortened week. US TIPS breakeven inflation (BEI) spreads were largely unchanged, while Eurozone BEI spreads widened optically to offset the negative inflation carry. The UK market was an exception—BEI spreads rallied aggressively on Thursday upon the announcement of the Debt Management Office's (DMO) issuance schedule for the coming quarter. The DMO will be reopening the 10-year, 15-year, and 30-year ILBs via auctions in the coming quarter, while the highly anticipated new 50- to 60-year syndication will be in conventional format. The lack of ultra-long ILB supply helped long-dated BEI spreads to outperform on the curve on Thursday. Over the week, UK BEI spreads widened 5-to-10 basis points across the curve.

Source: Bloomberg

Market Review: Currency Markets

G10

US Dollar's WTD Performance Against Other Majors



Source: Bloomberg, performance in percentage points (%), as at end March 29, 2013

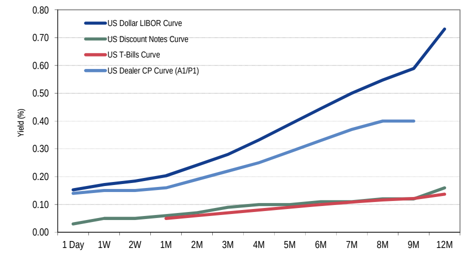
For the week, the euro along with other European currencies came under pressure as headlines in Cyprus continued to dominate currency market moves. The euro ended the week as the worst performer among the G10 currencies, falling 1.3% against the US dollar and 1.6% against the Japanese yen. Although the worst-case scenario has been avoided in Cyprus, the vulnerability of the Eurozone banking sector has now been exposed, while Italian political uncertainty lingered on and the growth outlook remained sluggish. Meanwhile, Japanese yen weakness has moderated, driven by flows related to Japanese fiscal year-end and views that the upcoming BoJ meeting is unlikely to deliver any surprises. Outside of G3 currencies, the Mexican peso and Canadian dollar have benefited from the strong US cyclical data, and the lack of contagion risks from Cyprus. EM currencies have regained some ground this week after US stocks hit an all-time high as risky assets remained resilient.

Source: Bloomberg

Market Review: Money Markets

With economic data released so far, it appears that first-quarter 2013 US GDP growth could exceed 3.0%, pulling out of the fourth-quarter doldrums caused by Hurricane Sandy on the East Coast and declines in government and consumer spending. In Europe, the Cyprus crisis appears to be under control with an aggressive bailout deal, but unfortunately, this reminds us of the continued unresolved issues in Europe, increasing concerns that the European markets may have gotten ahead of themselves. Going into quarter-end and given the holiday-shortened week, volume was light for money markets with investors content to focus on slightly higher overnight repo rates, filling in short dates with commercial paper and selectively extending maturities in Canadian and Nordic banks.

Money Market Yield Curves



Source: Bloomberg, as at end March 29, 2013

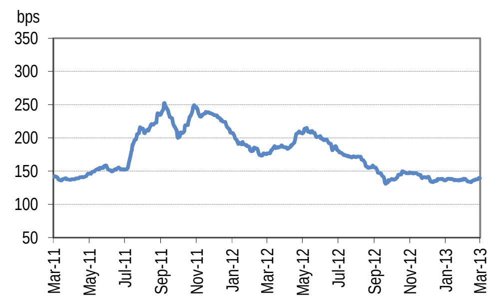
Sources: *Wall Street Journal*, Federal Reserve, JP Morgan

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

Both US and European corporate bonds underperformed government bonds for the second consecutive week. Cyprus finalized its banking bailout and financials underperformed industrials given the uncertainty created by the forced depositor bail-in. Despite this underperformance, overall index-level volatility remains extremely low, but single-name volatility has increased as a result of negative event risks, primarily driven by leveraged buyout concerns. Overall demand for fixed income remains solid as US Treasuries rallied for the third consecutive week on mixed economic data over the holiday-shortened week (10-year US Treasuries rallied eight basis points to 1.85%). US high-grade bond fund inflows continued at a strong pace with US$1.56 billion, which is the 14th consecutive week of inflows. US high-yield bond fund inflows slowed to US$34 million from last week's US$210 million inflow. US corporate bonds generated -0.14% excess return for the week ending March 28, ending at 139 basis points (one basis point wider). European corporate bonds generated -0.15% excess return for the same period and ended at 156 basis points (five basis points wider).

Investment-Grade Corporate Bond Index OAS

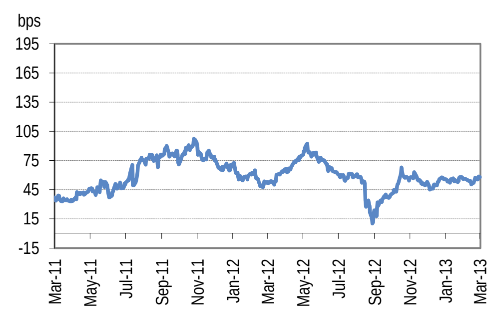


Source: Barclays Capital, as at end March 29, 2013

Mortgage-Backed Securities

The mortgage sector underperformed duration-matched Treasuries by five basis points this week. The Federal Reserve continues to buy MBS in lower coupons. The Federal Reserve's net purchases totaled approximately US$17.1 billion this week, mostly in conventionals. We are positive on structured products, including MBS, CMBS, and non-agency RMBS.

Agency MBS Current-Coupon Fixed-Rate OAS

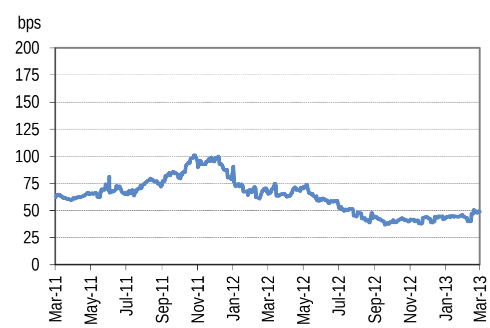


Source: Barclays Capital, as at end March 29, 2013

Asset-Backed Securities

Supply pressure coupled with investors looking vigilantly for higher yields have kept the sector's performance relatively contained. The primary market struck US$453 million of new issuance this week, bringing the year-to-date issuance total to US$45.9 billion compared to US$49.5 billion at this point last year.

Barclays Capital ABS Index OAS



Source: Barclays Capital, as at end March 29, 2013

Sources: Bloomberg, JPMorgan, Morgan Stanley, JP Morgan Securitized Products Weekly

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