AUGUST 24, 2012
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WEEKLY COMMENTARY:

Business as Usual

Major Developments:

Monday, August 20:

- US Chicago Federal Reserve National Activity Index increased to -0.13 for July.

Tuesday, August 21:

- Japan All Industry Activity Index increased 0.2% m.o.m. for June.
- UK Public Sector Net Borrowing decreased by £1.8 billion for July.

Wednesday, August 22:

- US Existing Home Sales growth increased to 2.3% m.o.m. for July.

Thursday, August 23:

- Germany Second Quarter Final GDP remained at 0.3% q.o.q.
- Eurozone Preliminary PMI Manufacturing and Services increased to 45.3 and decreased to 47.5, respectively, for August.
- US New Home Sales growth increased to 3.6% m.o.m. for July.

Friday, August 24:

- UK Second Quarter Preliminary GDP increased to -0.5% q.o.q.
- US Durable Goods Orders growth increased to 4.2% m.o.m. for July.

Source: Bloomberg, as at end August 24, 2012

This week's *Weekly Commentary* comes to readers in what is traditionally one of the quietest periods of the year, falling between the end-of-summer UK and US holidays, but there have been several important themes. We refer to "business as usual," and this is reflected in two perhaps contradictory ways. First, after a lengthy period in which the risk-on / risk-off trade was characterized by very high correlations across asset classes being driven by sentiment surrounding the Eurozone sovereign debt crisis, at least four broad themes are currently playing out, each largely independent of the other. The second way in which the world is carrying on is the continuing grind upward in equity prices perhaps despite those risks.

The themes we are exploring currently are Europe, the US and the upcoming Jackson Hole conference, the continuing disappointments in Chinese PMI data, and to a greater extent, the increase in food prices and the risk that this translates into inflationary pressure.

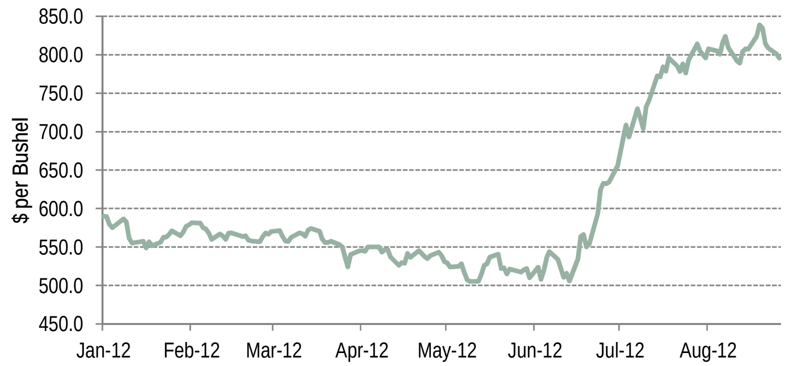
The next date in the diary for Eurozone watchers is September 12, when the German Constitutional Court will rule on the constitutionality of the European Stability Mechanism (ESM) bailout fund, as well as the fiscal compact. A narrow reading of the plaintiffs' complaint does raise some legitimate concerns, such that while it is more likely than not that the ESM and fiscal compact will be approved, this is not guaranteed. Furthermore, the court can set additional limits in how these mechanisms are to be operated. On the same date, the Netherlands has elections, with the Socialists doing well in polls. The party is anti-austerity, and if it has the chance to form a government, this may introduce a new dynamic to the wrangling over bailouts. However, there is really one key player now: German Chancellor Angela Merkel. She is facing tough domestic opposition to bailouts, yet she intervened over the weekend to dampen increasingly public speculation from officials (including Bundesbank President Jens Weidmann who likened ECB bond purchases to taking a drug) and speculation about a Greek exit. When speaking to public channel ARD, "We are in a very decisive phase in combating the euro debt crisis," she said. "My plea is that everyone weigh[s] their words very carefully."

The US election campaign is about to kick off, but market participants' attentions are likely focused on Wyoming rather than Florida, and Federal Reserve Chairman Bernanke's speech on August 31. It looks increasingly likely that the Chairman will use the speech as an opportunity to set the stage for a third round of quantitative easing (QE3), likely through purchases of MBS. We will return to this in next week.

The HSBC China Flash Manufacturing PMI released on August 23 was also unexpectedly weak, at 47.8, down from 49.3 in July. Looking into the data, each component also registered a contraction, except one—"Stocks of Finished Goods" indicated "expansion, at faster rate": that is, inventories of unsold goods are rising. Increasingly, attention is being focused on the leadership transition, to ask why more policy stimulus is not taking place. China is not the only emerging economy to be slowing. Brazil is also rapidly slowing. With the Eurozone experiencing dislocation in most of its member states, and the US likely to embark on further monetary stimulus and facing sharp fiscal tightening early in 2013, a slowing emerging world is not helpful.

These four themes would tend to have one thing in common though: they speak to a lack of aggregate demand in the economy, and to look at that glass as half full, leaves plenty of room to keep rates very easy in the absence of inflationary pressures. It is for this reason that the Chart of the Week is interesting, showing the price of the active contract for corn following the drought in America's Midwest. This has been echoed across a number of foodstuffs over 2012, and suggests that complacency over inflation may be misplaced. Yet despite this, volatility remains low, and stock prices in the US are very close to their post-2008 highs. Is this crisis fatigue, or merely a growing belief that in a business-as-usual world we may moving beyond the ability of one factor to destabilize the whole story? It is tempting to believe, but it would be easier if the themes did not continue to point to risks to the downside.

Chart of the Week: Corn Active Contract 1/3/2012 - 8/28/2012



Data Source: Bloomberg, as at end August 24, 2012

Next Week:

Monday, August 27:

- Germany IFO Business Climate Survey is expected to decrease to 102.7 for August.
- US Dallas Federal Reserve Manufacturing Activity Index is expected to increase to -6.5 for August.

Tuesday, August 28:

- US S&P Case-Shiller Index is expected to decrease by 0.05% y.o.y. for June.
- US Consumer Confidence Survey is expected to increase to 66.0 for August.

Wednesday, August 29:

- Germany preliminary CPI is expected to increase to 1.9% y.o.y. for August.
- US GDP growth estimate is expected to be revised up to 1.7% q.o.q. from 1.5% for the second quarter.

Thursday, August 30:

- Germany Unemployment Rate is expected to remain at 6.8% for August.
- Eurozone Final Consumer Confidence Survey is expected to remain at -24.6 for August.

Friday, August 31:

- US Final University of Michigan Consumer Confidence Index is expected to remain at 73.6 for August.
- US Factory Orders are expected to increase by 2.0% m.o.m. for July.

Source: Bloomberg, as at end August 24, 2012

Central Bank Watch:

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on Dec. 2012 Interest Rate Futures Contract	Next Meeting
Fed	-75 bps	December 16, 2008	0% - 0.25%	0.13%	September 13
ECB	-25 bps	July 5, 2012	0.75%	0.04%	September 6
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.32%	September 19
BoE	-50 bps	March 5, 2009	0.50%	0.56%	September 6

Source: Bloomberg, as at end August 24, 2012

Market Review: Sovereign Bond Markets

United States

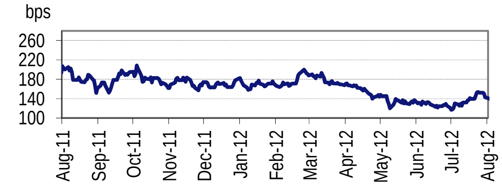
US Treasuries rallied this week following the release of the August Federal Open Market Committee (FOMC) meeting minutes on Wednesday, with the 10-year yield rallying almost 12 basis points through the week to end the week at 1.69%. The minutes of the August FOMC meeting were dovish, with most members acknowledging that additional monetary accommodation would be warranted unless incoming information pointed to a "substantial and sustainable" strengthening of the economy. This indicates that the Federal Reserve is much closer to further easing, with a high likelihood of an extension to low-rate guidance and perhaps another round of QE.

In economic data, existing home sales for the month of July grew slower than expected at 2.3% m.o.m. Although the headline durable goods orders number for July was higher than expected at 4.2% m.o.m., much of the growth was from the transportation (i.e., aircrafts) sector. Core capital goods orders were down 3.4% m.o.m., while the number for the previous month was revised downward from -1.4% m.o.m. to -2.7% m.o.m. On the employment front, initial jobless claims numbers for the week also came in slightly higher than expected at 371,000.

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	0.09	3	1	8
2 Yr	0.27	-2	-3	3
5 Yr	0.71	-9	-1	-13
10 Yr	1.69	-12	4	-19
30 Yr	2.80	-13	5	-9
2 - Fed	0.02	-2	-3	3
5 - 2	0.44	-7	2	-15
10 - 5	0.98	-4	5	-6
30 - 10	1.11	-1	1	10



Source: Bloomberg, as at end August 24, 2012

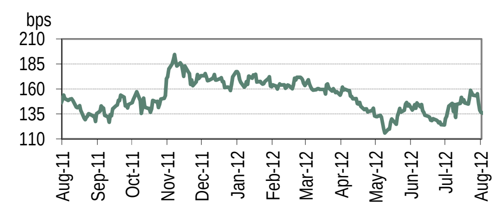
Europe & Japan

In the UK this week, second-quarter GDP was revised up from -0.7% to -0.5% q.o.q. This was largely anticipated, so there was minimal reaction to the change. The broader data this week was disappointing, and this combined with dovish FOMC minutes helped Gilts to recover from the sell-off seen last week. Ten-year Gilt yields fell 14 basis points to 1.53%, only a few basis points off the all-time lows.

In the Eurozone, PMI manufacturing was a touch better, mainly led by France and Germany. With a relatively light data week and the absence of any major summits or conferences, attention was drawn to the numerous and varied rumors and leaked-out headlines. These ranged from the ECB considering yield-band targets for peripheral debt yields to Germany mulling a "temporary" euro exit for Greece. Any official announcements are not expected until September, as the calendar fills up again and the ECB meeting on September 6 becomes a focus for the market. Germany 10-year yields fell 14 basis points on the week to 1.36%.

2- to 10-Year Bund Yield Spread

Europe		Change in Level (bp)		
	Current	1wk	MTD	YTD
ECB	0.75	0	-25	-25
1 Yr	-0.03	-1	-11	3
2 Yr	-0.01	3	-14	-16
5 Yr	0.35	-7	-26	-41
10 Yr	1.36	-14	-23	-47
30 Yr	2.16	-14	-17	-21
2 - ECB	-0.76	3	11	9
5 - 2	0.37	-10	-12	-25
10 - 5	1.00	-7	3	-7
30 - 10	0.81	0	6	27



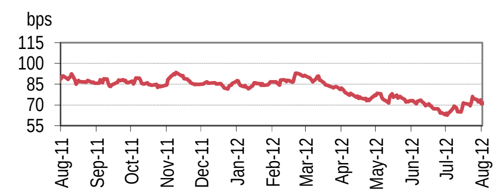
Source: Bloomberg, as at end August 24, 2012

In Japan, disappointing trade data underscored the struggling global economy as exports fell 8.1% in July. Within that there is a 25% drop in exports to the Eurozone, but also exports to China fell 12%, potentially indicating a worrying rate of slowdown in the world's second-largest economy. The government downgraded its assessment on the economy and many analysts are expecting Japan's GDP to contract in the third quarter. Ten-year JGB yields dropped three basis points to 0.81%.

Source: Bloomberg

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	1	-1	-4
5 Yr	0.21	-2	-2	-14
10 Yr	0.81	-3	-3	-18
20 Yr	1.65	1	-2	-10
30 Yr	1.90	2	0	-2
2 - BOJ	0.00	1	-1	-4
5 - 2	0.11	-3	0	-11
10 - 5	0.60	0	-2	-4
30 - 10	1.10	5	3	16



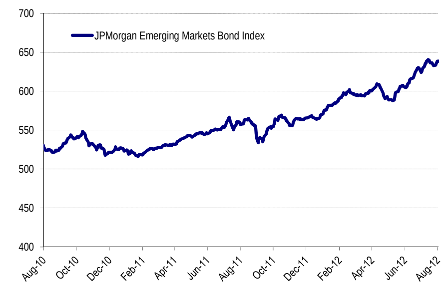
Source: Bloomberg, as at end August 24, 2012

Market Review: Emerging Markets

Positive sentiment returned this week triggering a resumption of the rally in emerging market (EM) bonds not seen since the beginning of June. The JP Morgan Emerging Bond Index Global (JP Morgan EMBIG) gained 0.93% over the week. EM currency performance was mixed with Eastern European currencies (e.g., the Hungarian forint, the Czech koruna, and the Polish zloty) outperforming. The South African rand, the Brazilian real and the Argentine peso were the laggards. The violence in South African mines triggered the rand to tumble to its lowest level in three weeks and subsequently, bond yields rose. EM bond funds registered inflows of US$627 million. This is a dip from the previous week but is unlikely to persist as the underlying asset markets have continued to strengthen.

Source: Bloomberg, Barclays Research

JP Morgan Emerging Markets Bond Index Global



Source: Bloomberg, as at end August 24, 2012

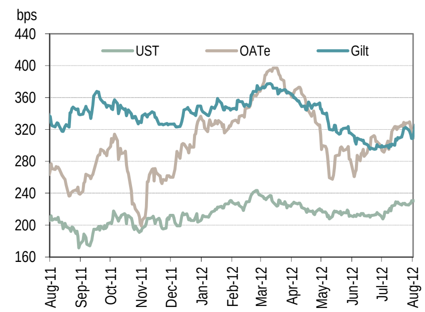
Market Review: Global Inflation-Linked Bonds

In the US, the US$14 billion five-year TIPS reopening was well received, clearing at a real yield of -1.286%, about 3.5 basis points more expensive than pre-auction trading levels. Strong auction demand and continued strength in commodity prices supported US breakeven inflation (BEI), with five-year BEI spreads widening about seven basis points over the week.

BEI in the UK and the Eurozone, however, did not perform well. In the UK, despite the news of utility-price hikes, concerns about an announcement of potential RPI changes by the Consumer Price Advisory Committee next month and syndicated supply scheduled for the second half of September pressured BEI spreads. Apart from UKTI 2013, which outperformed conventional Gilts, all other longer-dated index-linked Gilts lagged nominal yields in the rally. In the Eurozone, while front-dated BEI rates were well supported by rising energy prices, BEI rates in the 5- to 30-year sector saw a significant correction from their stretched valuations. Thirty-year French HICP BEI, for example, fell 10 basis points over the week to reach 2.26%.

Source: Bloomberg

GILBs - 10-Year Breakeven Spreads



OATe - French sovereign indexed to EU harmonized CPI

Source: Bloomberg, as at end of August 24, 2012

Market Review: Currency Markets

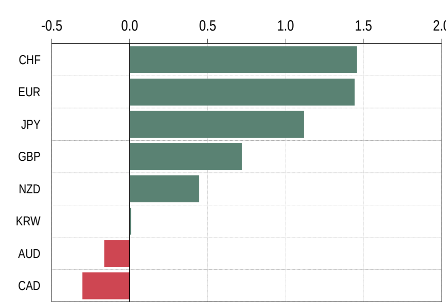
G10

European currencies were top performers this week as the Norwegian krone, euro, and Swiss franc led gains among major currencies. The euro rallied sharply on Tuesday after the British media reported that Jörg Asmussen, the German member of the ECB's executive board, would support ECB policy measures, which could include mass bond purchases in order to cap yield levels in peripheral Europe.

The US dollar then came under pressure mid-week following the release of the FOMC minutes, which despite improving recent US employment and retail sales data, suggested a strong likelihood of further QE by the Federal Reserve. The euro benefited from the US dollar sell-off, which was broad based. Both low-yielding safe-havens, such as the Japanese yen, and higher-yielding currencies—typically correlated with risky assets such as the Australian dollar—outperformed in the hours following the FOMC release. The Canadian dollar, however, was a notable underperformer over the course of the week. Canadian inflation data came in lower than expected as did retail sales data, which weighed on the currency.

Source: Bloomberg

US Dollar's WTD Performance Against Other Majors

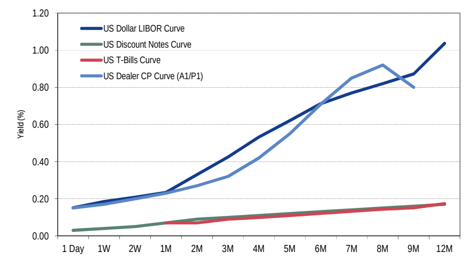


Source: Bloomberg, performance in percentage points (%), as at end August 24, 2012

Market Review: Money Markets

From the cash-market perspective, the week was a busy with the US SEC capitulating on money market reform. SEC Chairman Mary Schapiro could not gather sufficient support within the Commission to win the vote to propose new regulations, so she challenged either the Federal Stability Oversight Council (FSOC) or the Federal Reserve to take up the cause. Minutes from the last FOMC meeting disclosed a surprisingly dovish tone within the Federal Reserve, as many members appeared prepared to engage in further QE and again discussed lowering the interest rate on excess reserves (IOER), which would have adverse effects on money market funds. European markets were relatively quiet, as leaders met privately to discuss Greek and Spanish debt issues, and expectations were rising for the ECB to stem the crisis through bond purchase programs. Issuance in money markets was lighter than usual, but a larger percentage was issued in four- to six-month terms as top-name issuers look to lengthen maturities and investors reach to pick up yield with high-quality issuers.

Money Market Yield Curves



Source: Bloomberg, as at end August 24, 2012

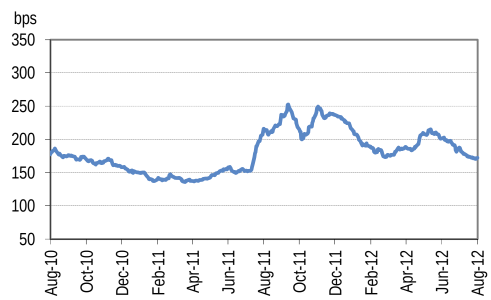
Sources: Wall Street Journal, Federal Reserve, JP Morgan

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

US corporate bonds slightly outperformed government bonds for the week, while European corporate bonds underperformed after four weeks of outperformance. There was limited news and data to drive the markets for the first half of the week; volumes and volatility were low as the late-August summer slowdown set in. The focus appeared to be on Bernanke's Jackson Hole speech on August 31. Risk assets performed better later in the week as the release of FOMC minutes and Bernanke's letter to Representative Darrell Issa suggested further Federal Reserve actions were possible if necessary. Additionally, increased talk of the ECB targeting yields for peripheral sovereign bonds filtered through the markets. US corporate bond issuance slowed considerably and long-end US Treasury yields rallied off the recent highs (10-year US Treasury yields down 12 basis points to 1.69% to close the week). US high-grade bond inflows remained strong at US$1.2 billion but were down slightly from last week's US$1.4 billion inflow. High-yield bond inflows increased to US$583 million from US$378 million last week. US corporate bonds outperformed Treasuries by 0.01% for the period and closed the week at 172 basis points (one basis point wider). European corporate bonds underperformed government bonds by 0.20% and ended the week at 203 basis points (seven basis points wider).

Investment-Grade Corporate Bond Index OAS

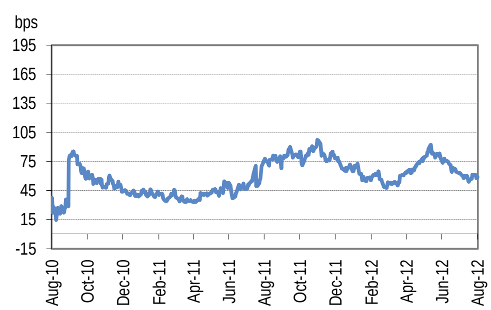


Source: Barclays Capital, as at end August 24, 2012

Mortgage-Backed Securities

The mortgage sector outperformed duration-matched Treasuries by five basis points this week. The Federal Reserve purchased US$6.5 billion of MBS this past week, mostly in conventional securities. Conventional primary rates have increased four basis points from the previous week. We are positive on structured products, including MBS, CMBS, and non-agency RMBS.

Agency MBS Current-Coupon Fixed-Rate OAS

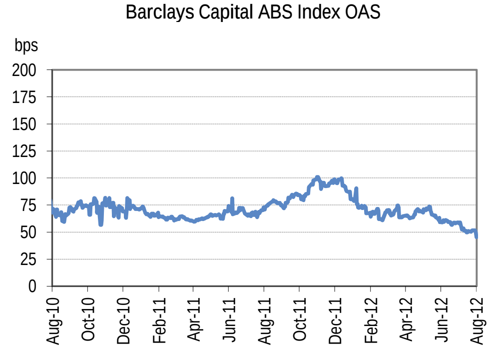


Source: Barclays Capital, as at end August 24, 2012

Asset-Backed Securities

Stronger weekly primary and secondary demand outpaced supply in the ABS market. In retail credit card ABS, US$1 billion priced during a quiet trading week. Spreads were relatively unchanged this week.

Barclays Capital ABS Index OAS



Source: Barclays Capital, as at end August 24, 2012

Sources: JPMorgan, Barclays Capital, Wells Fargo

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