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Market Review

The anticipated second liquidity injection by the European Central Bank (ECB) kept confidence buoyed for most of the month. Despite Greek bailout discussions grabbing most headlines, stronger than expected US economic data kept sentiment afloat. Credit spreads compressed and risk assets outperformed core government bonds.

The ECB allotted €529.5 billion at its second three-year longer-term refinancing operation (LTRO) to 800 banks; the uptake was significantly higher when compared with the previous LTRO in December, in which 523 banks participated. In total the ECB has provided over €1 trillion of extra liquidity to the European financial system since the end of 2011 and has expanded its balance sheet to 30% of eurozone GDP. European finance ministers agreed to provide Greece with the €130 billion of further funding that should see it through to 2014, though the deal comes with strict conditionality and strengthened mechanisms to ensure adherence to the programme. Most importantly, the outcome reduced the risks of an imminent disorderly default and subsequent contagion to the rest of Europe.

The People's Bank of China cut its reserve ratio requirement by 50 basis points (bps) releasing CNY400 billion of liquidity into the banking system. As expected, the Bank of England (BoE) Monetary Policy Committee (MPC) voted for another £50 billion of gilt purchases and highlighted that despite the recent improvement in activity indicators, the underlying pace of economic recovery remained slow, held back by fiscal consolidation and tight credit conditions. The Bank of Japan (BoJ) made a surprise announcement of an additional ¥10 trillion of JGB purchases, initiated to curb the recent appreciation of the yen and to support domestic economic activity. Elsewhere, the Swedish Riksbank cut rates by 25 bps while the Reserve Bank of Australia (RBA) surprised the market by keeping policy rates on hold.

Economic data releases in the US remained upbeat. The Conference Board Consumer Confidence Index surged 10.3 points to 70.8 in February; nonfarm payrolls reported a stronger than expected increase to 243,000 in January with the overall unemployment rate dropping to its lowest level since February 2009. Initial jobless claims touched a four-year low at 351,000. On growth, the second 4Q11 GDP estimate was revised up to 3.0% quarter-over-quarter (QoQ), the Chicago Purchasing Manager Index (PMI) jumped to 64.0 from 60.2 in January.

The stronger than expected labour data in the US contrasted sharply with that of the eurozone. Total eurozone unemployment reached an all-time high (since the formation of the euro) of 10.7%. Meanwhile, German unemployment remained at a 20-year low. 4Q11 aggregate eurozone GDP growth showed a contraction of 0.3%, while the headline print masked a significant divergence in growth at the country level. German GDP growth contracted 0.2% while southern European countries showed the largest contraction with Italian GDP growth contracting 0.7% and the Spanish economy contracting 0.3%. Interestingly, France reported stronger than expected growth in the fourth quarter of 0.2%. Turning to emerging markets, India's economy reported its slowest GDP growth in more than two years at 6.1% in the three months to December. The Chinese Prime Minister Wen Jiabao emphasized the government's ambition of focusing away from investments and exports toward domestic consumption, while lowering its annual growth target to 7.5%.

The US 10-year bond yield rose 20 bps while the German 10-year bund yield was largely unchanged. Spreads on peripheral European sovereign debt compressed with spreads of Italian 10-year bonds falling nearly 80 bps over equivalent-maturity German issues. Investment-grade credit spreads tightened by 25 bps as measured by the Merrill-Lynch Global Broad Market Corporate Index. The financial sector outperformed both industrials and utilities. The Merrill-Lynch US and European high-yield index tightened 60 bps and 120 bps, respectively. The S&P 500 and Euro Stoxx-50 both gained 4%, while the J.P. Morgan emerging market bond indices in hard and local currencies gained 3% and 3.5%, respectively. Increasing geopolitical tension surrounding the planned oil embargo on Iran saw oil prices gain 8.5%.

Outlook

While it is comforting to see the positive impact the ECB's liquidity provision has had on asset prices, we are by no means complacent at this stage. The situation in Greece remains fluid and the country continues to make tough fiscal adjustments while the final details of a private sector investor debt swap are still to be released. Major political transitions not only in Greece but also in the US, China and France punctuated by the geopolitical risks in the Middle East give us enough reasons to remain cautious.

Meanwhile, global macro developments, particularly in the US, continue to substantiate our view that the world economy should continue to grow at a modest pace. This is further supported by the global manufacturing activity indicators, which continue to improve. We have taken note of the recent rally in oil prices but feel that any potential impact of a supply shock will be met by Organization of the Petroleum Exporting Countries (OPEC), and will therefore marginally impact the overall global economy.

The shift by the ECB in acting as lender-of-last-resort has lifted sentiment markedly. The ECB has now provided the banking

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system with over €1 trillion of liquidity, which equates to roughly 130% of total European bank bond maturities through 2012 and 70% of 2012 and 2013 combined. As a result, liquidity in the peripheral eurozone has undoubtedly improved, though underlying fundamentals remain challenged.

Economic data coming out of peripheral Europe continue to disappoint as ongoing fiscal austerity continues to take its toll. On the political front, European Union (EU) leaders are moving closer to a fiscal compact, with 25 EU member states now signing on. However, deteriorating economic fundamentals in peripheral Europe will create some challenges in achieving these fiscal targets. The Spanish government has already announced that it now expects its deficit for 2011 to be 8.5% of GDP (against a target of 6%); the government also stated that at 5.8%, the 2012 deficit would be higher than its previous target of 4.4% of GDP. In France, the socialist candidate for the French Presidential elections Francois Hollande has made it very clear that further deficit cuts are not possible without growth; he proposes further negotiations on the EU treaty.

We responded to the dramatic spread tightening in Italy relative to German bunds by reducing our overweight to benchmark neutral, while covering our underweight to Spain. As a result, we now maintain an overall duration neutral exposure to peripheral Europe. We continue to look for tactical opportunities in the front end of this market where the curve has steepened more than we think is reasonable. We maintain an overweight duration position relative to the benchmark, which provides ballast to our spread product overweight. We are tactically managing our positions across the yield curve. We have shifted our overall underweight to US treasuries to an overweight position with an emphasis on longer-dated issues.

We have responded to the continued improvement in spread markets by further reducing some high-beta financial issues to calibrate overall risk positioning. We continue to believe that the financial subsector offers attractive value relative to the industrial and utility subsectors. Where permitted we maintain a modest allocation to high-yield corporate bonds and select non-agency mortgages.

In currency strategies we favour a short euro position versus a diversified basket of emerging markets and trade-surplus currencies. We remain constructive on emerging markets as a long-term secular theme that offers exposure to strong fundamentals. We have recently initiated an underweight to the Australian dollar to balance the overall currency allocation risks against the "risk-on/risk-off" market environment.