

Key Messages

Our asset allocation focuses mainly on the business recovery. Our key ideas are:

- **Bonds performance will be disappointing this year**
- **Look to shorten duration through the year**
- **Overweight riskier assets**

Central Banks Forecasts (2011 Q4)

	FED	ECB	BOE	SNB
Current level	0.25	1.00	0.50	0.25
Bloomberg forecast	0.50	1.25	0.75	0.75
bridport forecast	0.25	1.25	1.00	0.50

Negative long-term cycle (based on negative real growth and diminishing purchasing power) will weigh on the business cycle, but will not derail it.

- The recovery in the business cycle should continue.
- We expect a currency crisis to succeed the sovereign crisis through 2011, resulting from competition for export market share in a low growth environment.
 - It is difficult to estimate when central banks will hike rates as foreign exchange markets will significantly influence the timing of monetary policy mainly for England and Switzerland.

We expect Q1 to be negative for bonds due to banks and money managers increasing their equity exposure for 2011 at the expense of fixed income. Q2 and Q3 could be more favourable for bonds as investors may be disappointed with the speed of the recovery. There is also the risk that central bank timing disappoints.

We are **structurally overweight inflation-linked bonds**, based on the loss of purchasing power over the long-term cycle.

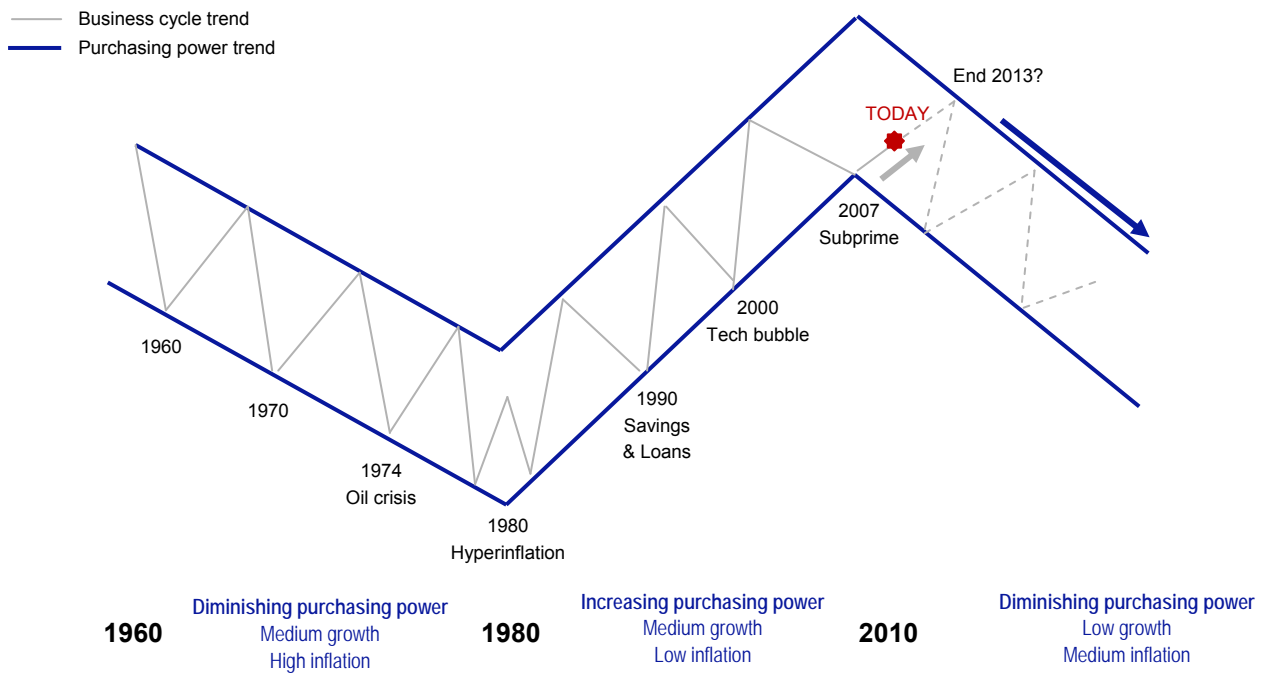
	USD	EUR	GBP	CHF
Bonds Asset Class	Underweight	Underweight	Underweight	Underweight
10 yr yield level	3.45	3.04	3.51	1.69
Bloomberg forecast (10 yr) - Q4 2011	3.53	3.28	3.79	2.07
bridport forecast (10 yr)	3.50	3.75	4.00	2.25
Duration	Neutral	Short	Short	Neutral
Low IG D/Swap level	183 bp	138 bp	162 bp	118 bp
Credit risk grading	Overweight	Overweight	Overweight	Overweight

Disclaimer

This document is based on sources believed to be reliable, accurate and complete. Any information in this document is purely indicative. This document is not a contractual document and/or any form of recommendation. Expressions of opinion herein are subject to change without notice. We strongly advise prospective investors to consider the suitability of the financial instruments, based on the risks inherent to the product and based on their own judgment. It is not intended for publication. This document may not be passed on or disclosed to any other third party without the prior consent of bridport & cie s.a. © bridport & cie s.a.

Macro environment

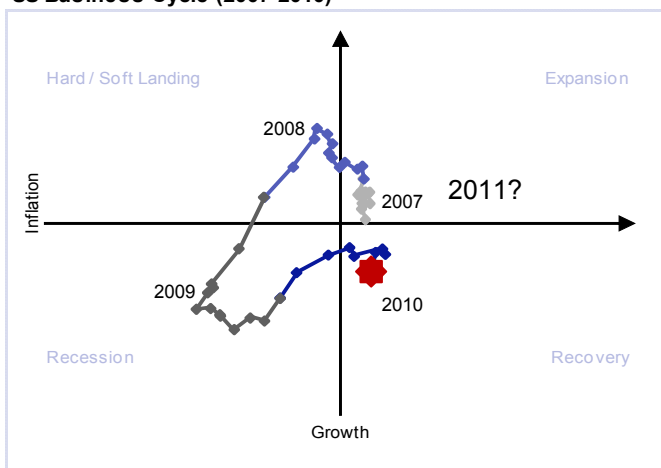
Negative long-term cycle (based on negative real growth and diminishing purchasing power) will weigh on the business cycle, but will not derail it.



The modest recovery in the business cycle continues although not as strongly as anticipated.

The feed through to the real economy is marginal.

US Business Cycle (2007-2010)

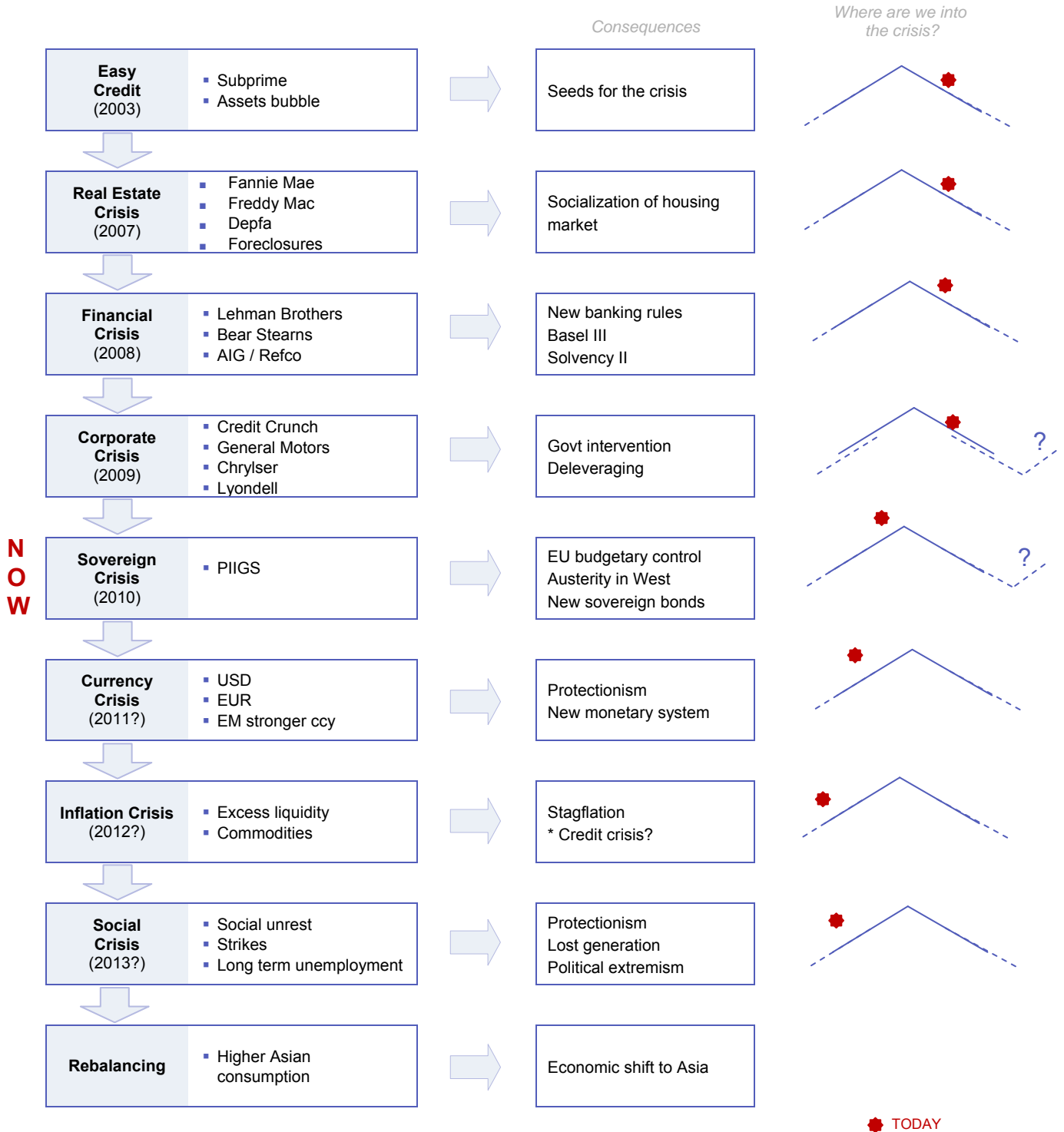


EU Business Cycle (2007 - 2010)



Macro environment

Long-term cycle reversal implies many crises through years.

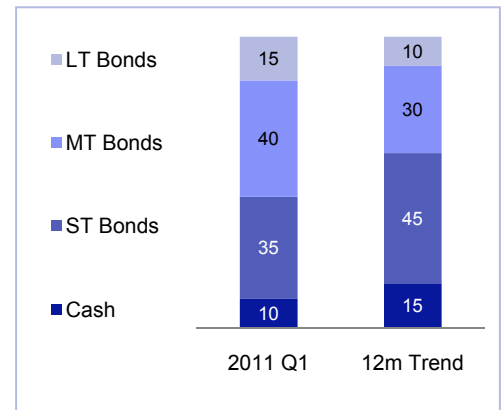


USD Government Rates

We are relatively neutral on USD bonds and would recommend staying neutral duration.

Profitability may be improved trading the long-end of the curve through the year, as the environment will remain volatile.

We do not expect the Fed to tighten monetary policy until 2012.



While the US economic outlook continues to improve, we feel the FOMC tone will remain dovish. The FOMC is frustrated with the pace of activity and the slow progress in achieving its dual mandate.

- Unless the Fed changes its forecasts and anticipates a stronger recovery, we do not believe FOMC members will vote for rate increases in 2011. None of the two key drivers according to the Fed's mandate point to a tightening.
- Activity is recovering, but from such low levels that unemployment is still high (9.6%). Inflation pressures are only a fear and not currently a reality (monetary multipliers are still low and credit demand remains weak).
- Despite the heightened criticism and rotation of several hawks to voting status, we see the dovish elements of the FOMC maintaining their advantage.

We expect the market to be disappointed at the tightening of monetary policy being delayed to 2012. The Taylor rule model prices negative Fed funds rates at -2.25bp. The path to rate increases is still long and policy makers will prefer to be late and keep the recovery on track rather than acting too soon.

Current market pricing fits market expectations which are more bearish than ourselves.

- Fed fund options imply unchanged rates for the next 6 months and then an upside bias. On the other side, the yield curve is flattening and momentum in bond prices is declining. Inflation-linked bonds price expected growth of 1.2% and expected inflation at 2.7%.

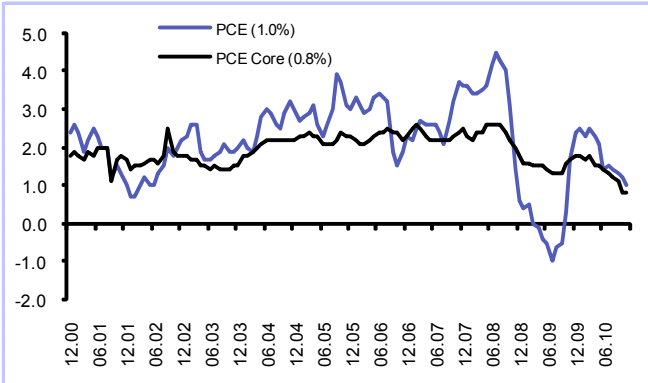
As a result of these elements, we expect the USD yield curve to finish 2011 approximately unchanged.

- The short-end of the curve will remain anchored, while the long-end will be more volatile switching from rate increase expectations to disillusion.
- We could see a weak start (Q1) and end to the year (Q4) with a rally in between (Q2 and Q3).

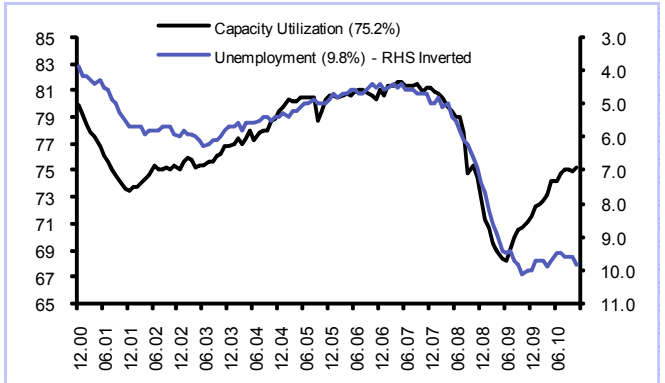
Clients with high turnover may choose to implement a barbell (buy short and trade long term bonds with a contrarian approach).

Clients wishing to buy and hold positions may choose to stay on the medium part of the curve.

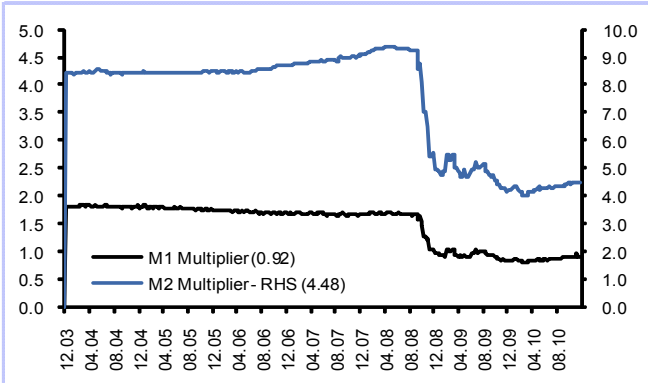
PCE & PCE Core (YoY)



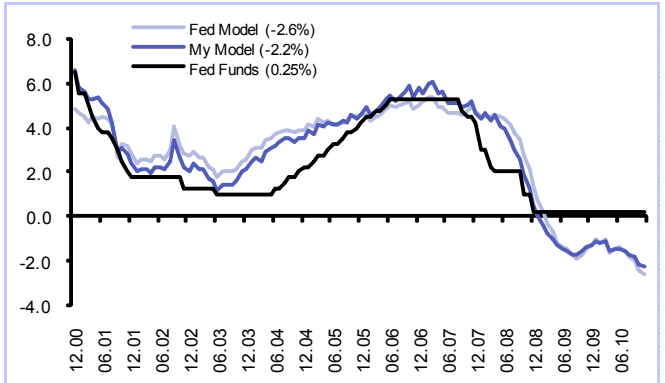
Capacity Utilization



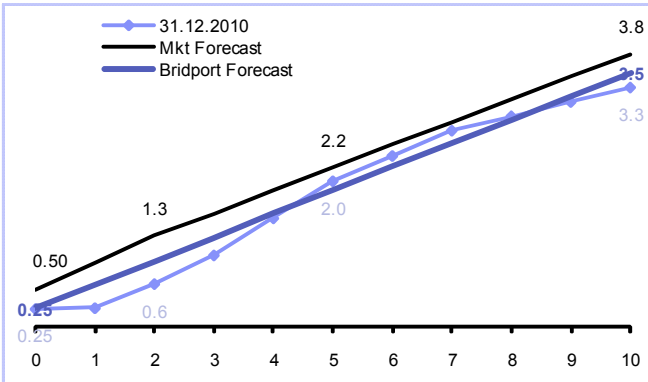
Monetary Multipliers



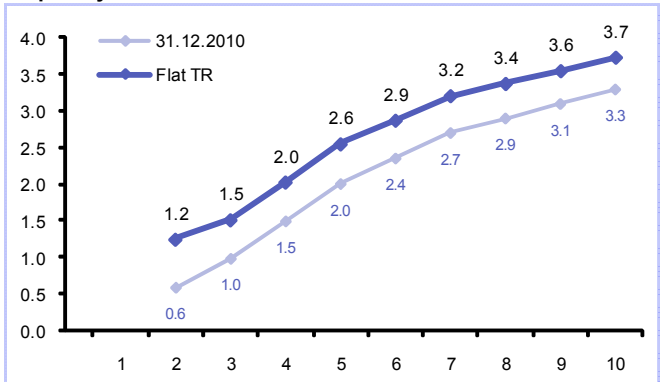
Taylor Rules



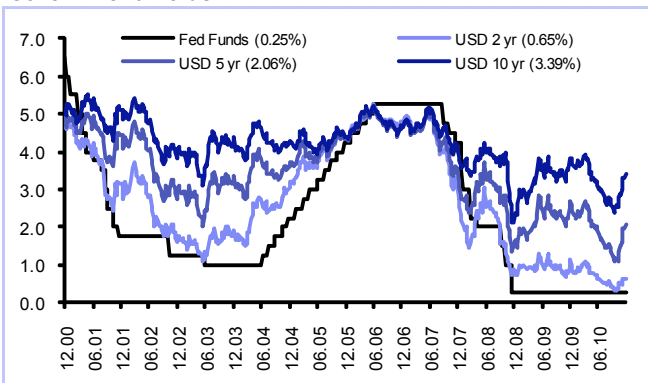
Government Yield Curve



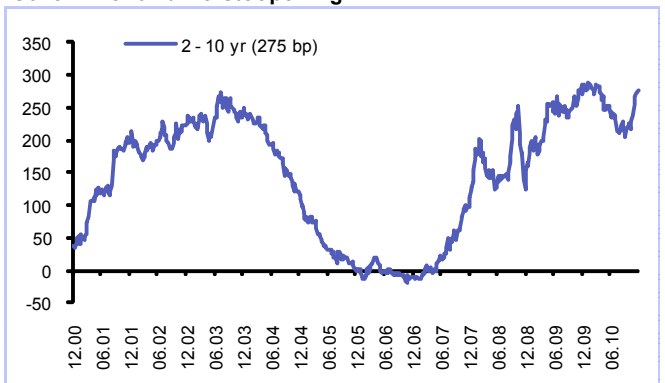
Implied yields in 12 months to have flat total return



Government Yields



Government Curve Steepening

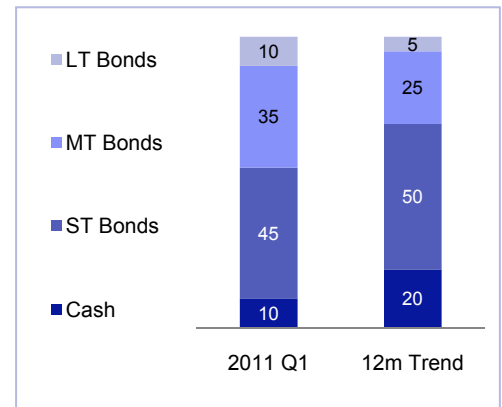


EUR Government Rates

We are negative on EUR bonds and recommend short duration positioning.

We hope EU authorities will announce credible and efficient measures rapidly, so the sovereign crisis climax may happen in the first half of 2011.

We expect the ECB to start hiking rates in late 2011, ahead of the Fed.



The ECB has to face a difficult situation: the Euro area contains some relatively big economies with relatively small problems and some small economies with relatively big problems. Euro area policymakers view problems as mostly structural. Consequently, they do not mix monetary and liquidity policies.

- Monetary policy (based on the repo rate) should continue to focus on the business cycle and potential inflation pressure among the biggest economies. The Taylor rule model shows that the current repo rate is fair value in the current economic situation. Consequently, a stronger recovery will require higher rates. **We expect the ECB to tighten in late 2011, ahead of the Fed. However, the tightening should be well communicated to markets beforehand.**
- Liquidity policy supporting weak countries is being done via ECB bond purchases or other temporary measures. We expect the sovereign crisis to climax in the next 6 months. Liquidity policy and support measures in favour of PIIGS should be expanded and authorities will announce more details on the European Financial Stabilization Mechanism bringing back confidence in EU sovereign stability.

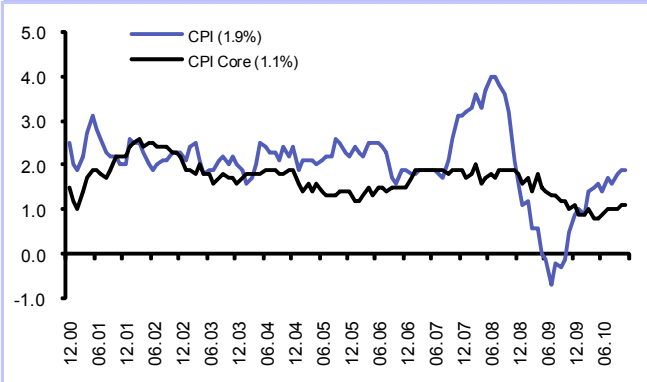
Current market pricing fits with market expectations but underestimates, in our view, the increase in yields to come.

- Euribor options imply unchanged rates for the next 9 months and then an upside bias. On the other side, the yield curve is flattening and bond prices are losing momentum. However, we consider the risk-reward on EUR bonds unattractive as yields are relatively low.

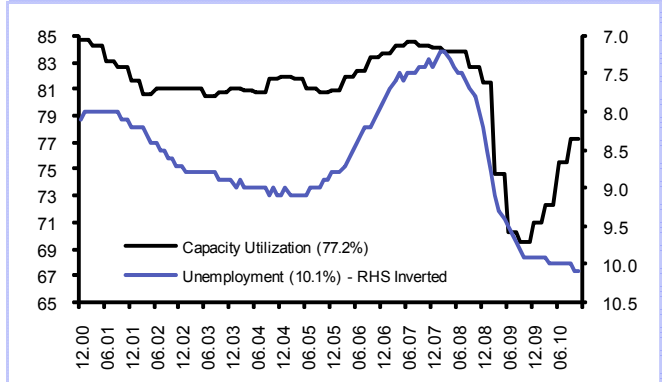
We are negative on the EUR yield curve. We expect yields to move higher and profitability to be disappointing. To protect capital, we recommend maintaining short duration positioning.

- If the sovereign crisis is “resolved”, ECB members will adopt a hawkish tone and may start to hike rates to counter the activity pick up in core countries and to control inflation risks. German unemployment is at a multi-decade low and consumer confidence is high.
- If the sovereign crisis and fiscal policies do not convince investors, repo rate increases will be delayed, but risk premium will increase, resulting in higher yields.
- Being short duration in the current low yield environment is costly; however short-term bonds remain the best protection against yield appreciation, which is likely in both of our envisaged scenarios.

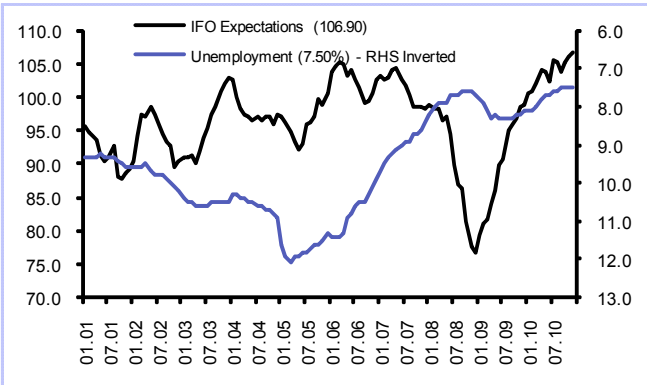
CPI & CPI Core (YoY)



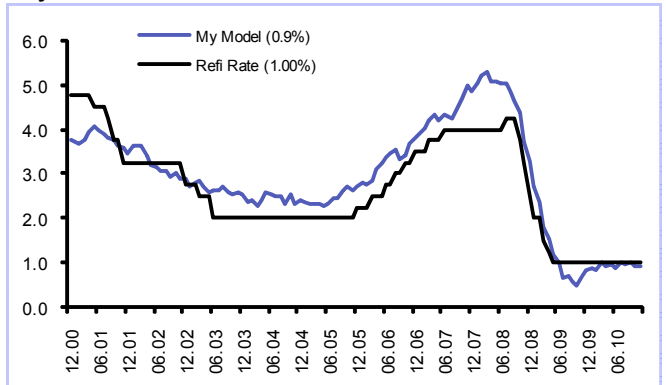
Capacity Utilization



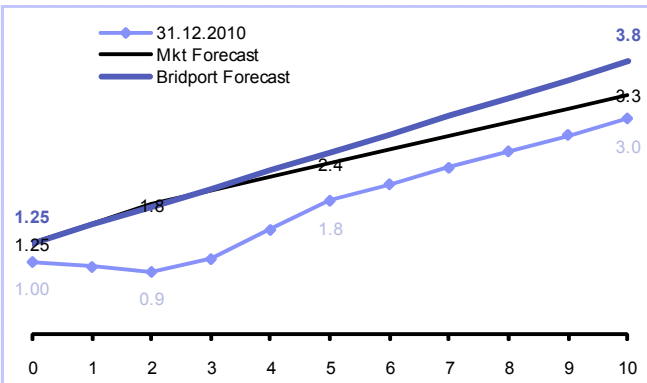
German Indicators



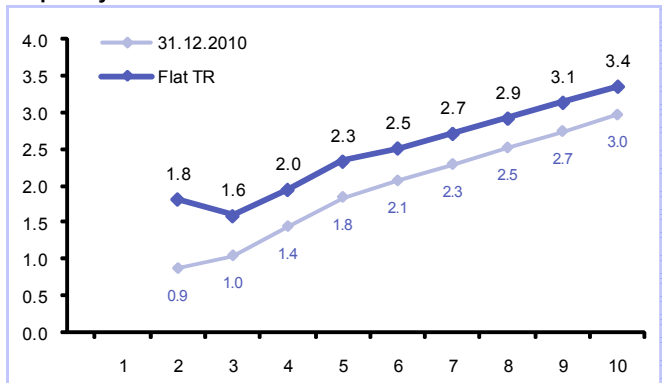
Taylor Rule



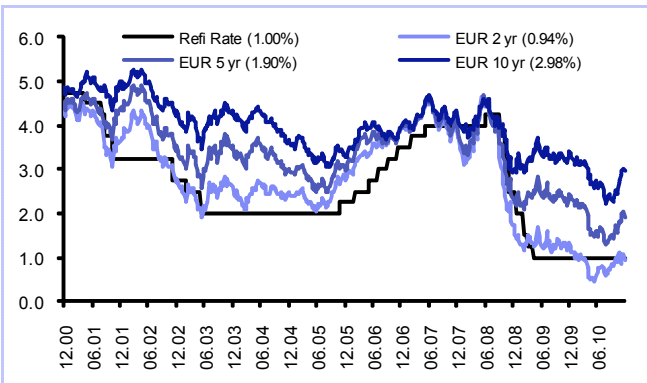
Government Yield Curve



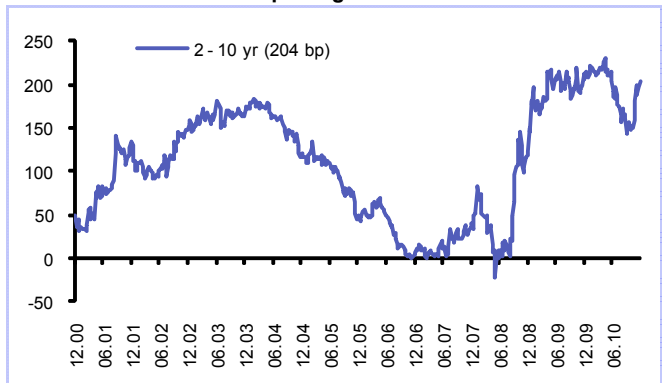
Implied yields in 12 months to have flat total return



Government Yields



Government Curve Steepening



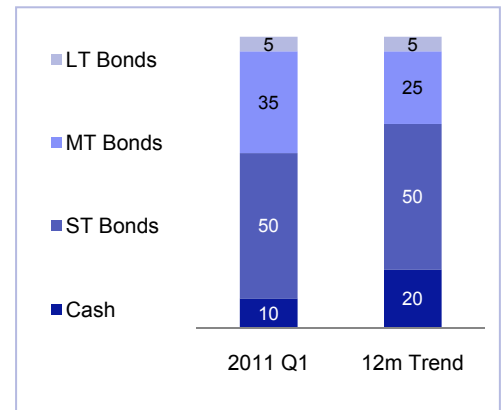
GBP Government Rates

Bond perspectives for 2011 are limited.

The UK economy has a high probability of stagflation.

If GBP continues to depreciate, the BOE could decide to imitate Fed Volker's policy and raise rates more aggressively than anticipated by the market.

Consequently, we favour short term and inflation-linked bonds.



The UK macro situation is more difficult than the US and Europe. **The economy has a high probability of stagflation:** the BOE have to manage high inflation expectations and weak growth potential.

- The economy continues to recover well but there are questions about the sustainability of growth. One key downside risk is the scale of fiscal tightening. We expect that the direct impact of the fiscal austerity plans will be significant.
- On the other side, the Governor of the BoE has now written nine times to the Chancellor to explain overshoots in inflation since the first half of 2007, the continuation of upside surprises in inflation risks the credibility of the BOE being called into question.
- Inflation has been sticky for a number of reasons: Sterling's fall since 2007, the rise in indirect taxes and the possibility that estimates of the output gap have been too wide.

We believe that current market conditions fit market expectations but underestimate the potential degree of central bank intervention.

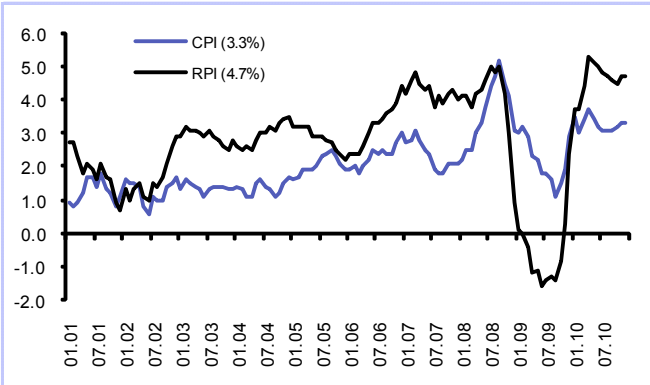
- Implied Sterling 90 day options price unchanged rates for all 2011 and anticipate the rising trend in 2012 H2.

Investors' attention has to be focused on forex and inflation:

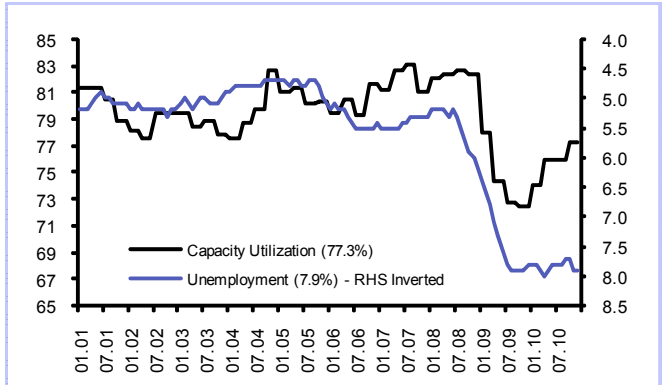
- If GBP continues to depreciate, the **BOE could decide to imitate Fed Volker's policy** and raise rates aggressively in order to fight imported inflation as soon as the international situation allows it.
- On the other side, we could expect the BOE to maintain low rates to support growth as a consequence of the heavy fiscal cuts.
- We favour case 1 as the BOE mandate relies mostly on an inflation target. However, we believe BOE will start adopting a hawkish tone and will wait as long as possible (around 2 to 3 quarters) before starting a tightening cycle.

Our outlook for GBP bonds for 2011 is not optimistic. **We recommend buying inflation-linked bonds as the best protection against stagflation and remaining at the short-end of the curve.**

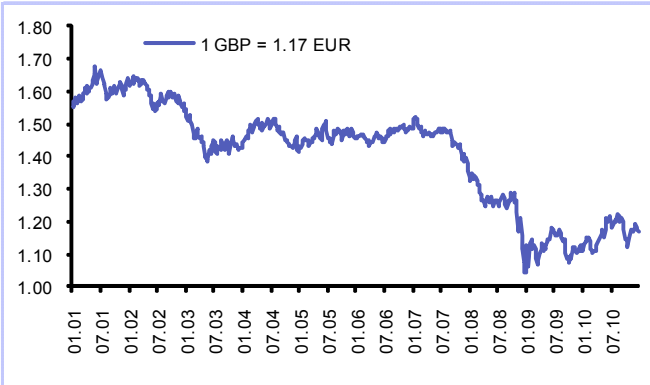
CPI & RPI (YoY)



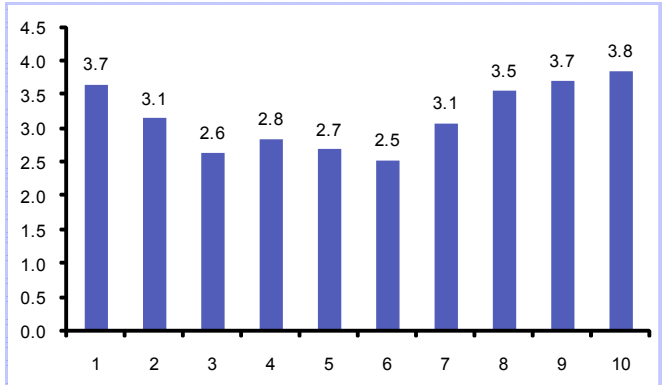
Capacity Utilization



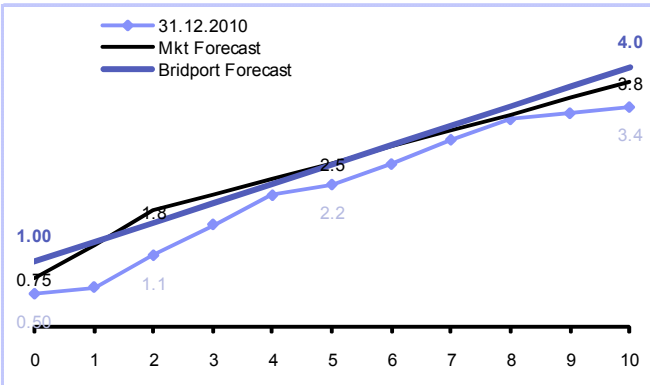
GBP vs. EUR



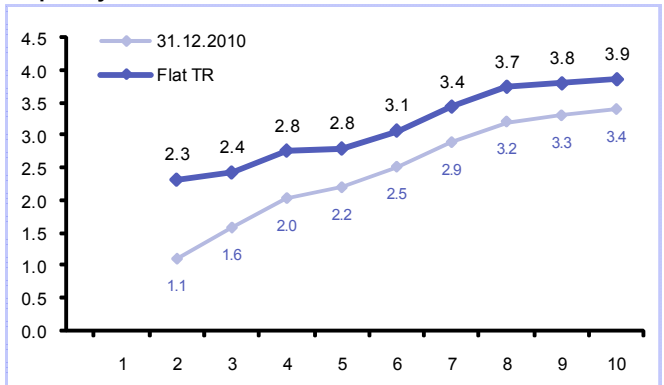
Forward Breakeven ≈ CPI (YoY) Expectation



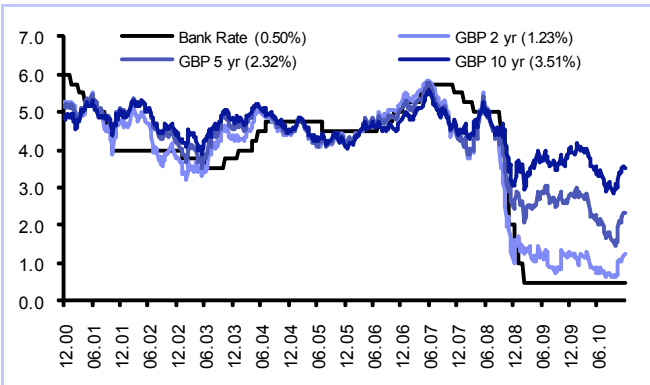
Government Yield Curve



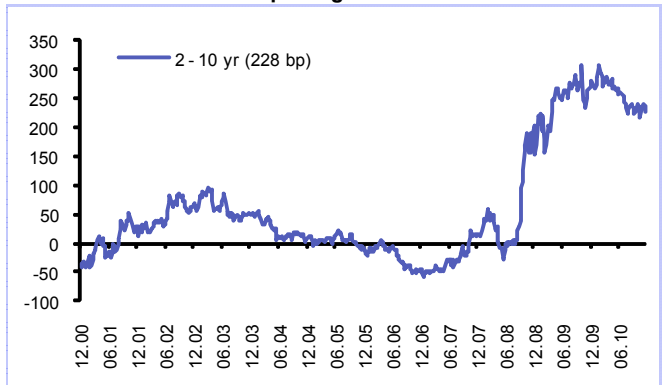
Implied yields in 12 months to have flat total return



Government Yields



Government Curve Steepening

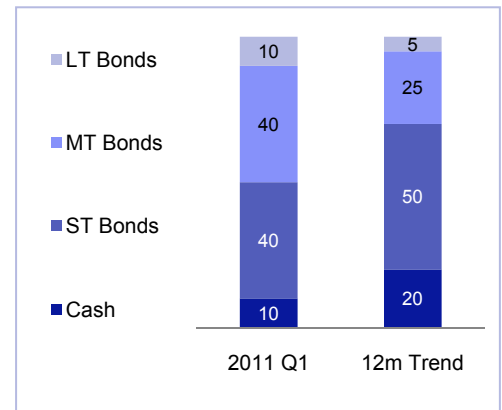


CHF Government Rates

We are slightly negative on CHF bonds based on the business cycle. Current yields already anticipate a recovery; we maintain a medium duration position.

The SNB is delaying the decision, but the next move will be on the upside.

We await a stabilization of core CPI above zero and the end of CHF appreciation vs. EUR before looking to shorten duration.



As domestic demand gains momentum, we expect the Swiss economy to continue its recovery. In our view domestic strength will be sufficient to offset the disinflationary forex impact.

- Private consumption benefits from a strong labour market situation. With a PMI above 60, the recovery in Switzerland remains robust. On the other hand, the fact that unemployment has peaked at a considerably lower level in this recession relative to the mid-1990s creates sound 'initial conditions' for continued growth in 2011.
- The external environment - in particular the demand coming from Germany - remains strong, and the high-value-added nature of Swiss companies suggests a low price-elasticity which will prove beneficial to Swiss manufacturers.
- The upside risk for inflation in Switzerland is limited. A strong CHF should help keep upward pressure on prices under control. However, we are keeping a close eye on the monetary multipliers which are rising.

We expect the SNB to hike rates in Q3 2011 with a risk that this forecast may be pushed out further if Swiss franc appreciation continues.

- SNB members will remain very active through speeches to control inflation expectations and to influence the forex rate with EUR (55% of Swiss exports go to the Euro Zone, while only 10% go to the US).
- The Taylor rule model suggests 3 month Libor should already be around 0.65%.

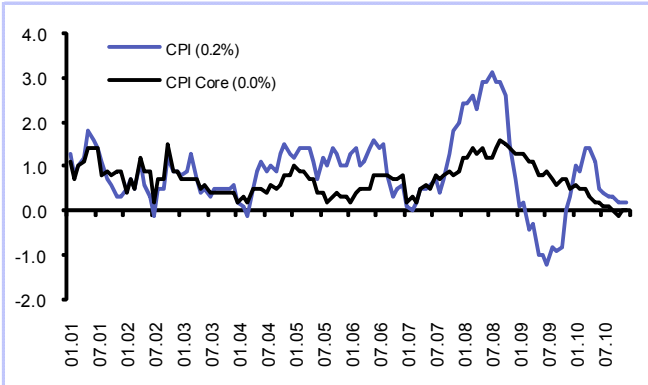
Current market pricing fits with both market and bridport expectations.

- The correction during Q4 in the CHF market has been so important that the current yield curve is already pricing in a recovery, while the USD and EUR curves are still pricing in recession.

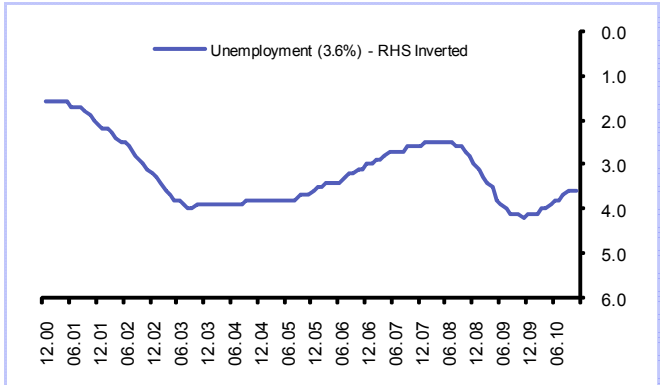
As the CHF market is fair value with the current macro situation and is a little ahead of other markets, the downside risk is limited and **we maintain a medium duration in bonds**. We await a stabilization of core CPI above zero and the end of CHF appreciation vs. EUR before looking to shorten duration.

- In the current low yield environment being short duration is costly.

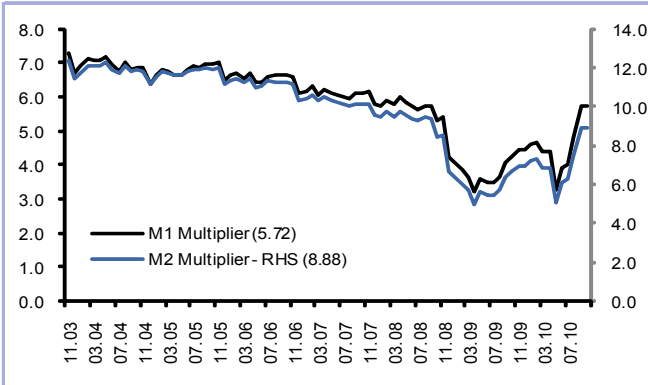
CPI & CPI Core (YoY)



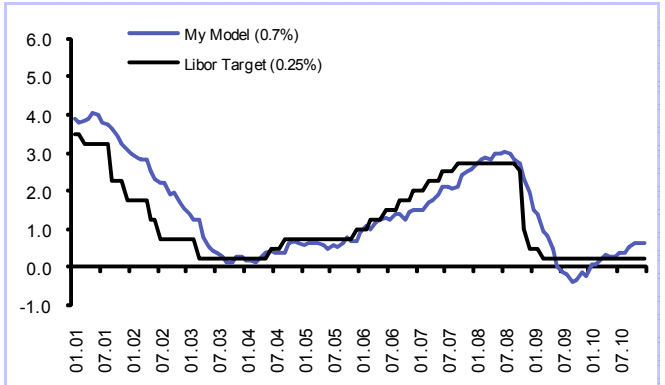
Capacity Utilization



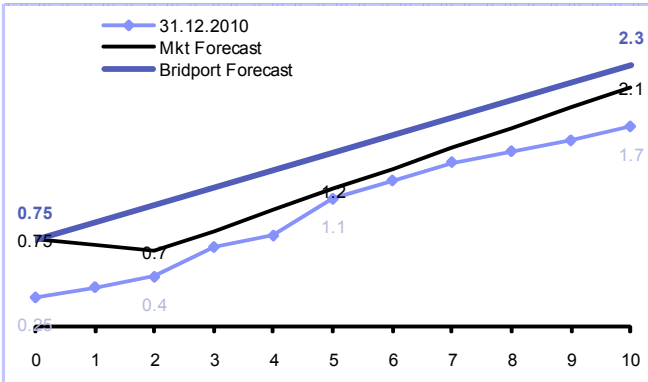
Monetary Multiplier



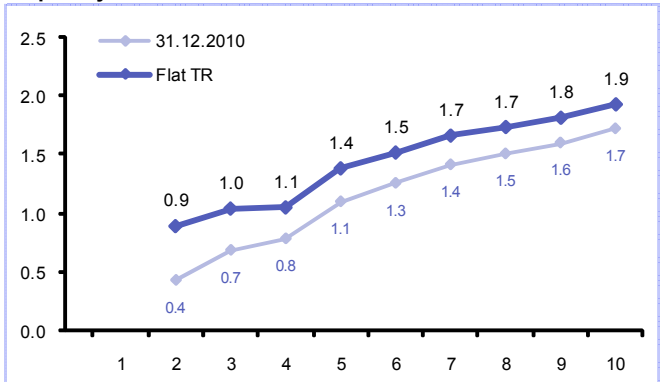
Taylor Rule



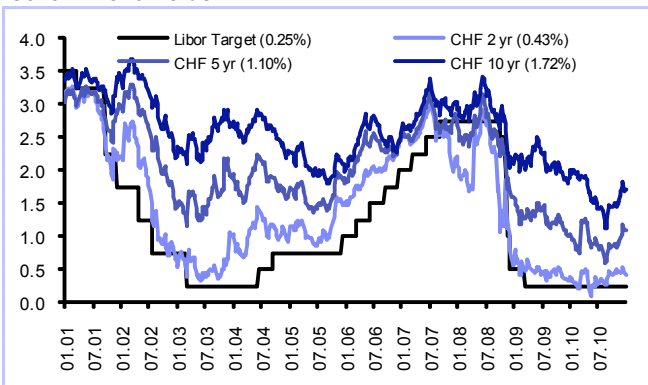
Government Yield Curve



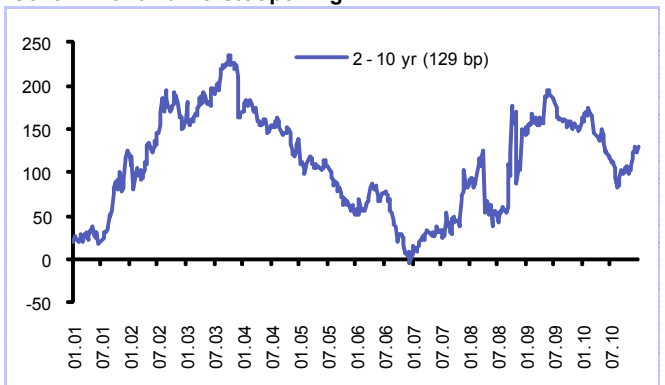
Implied yields in 12 months to have flat total return



Government Yields



Government Curve Steepening

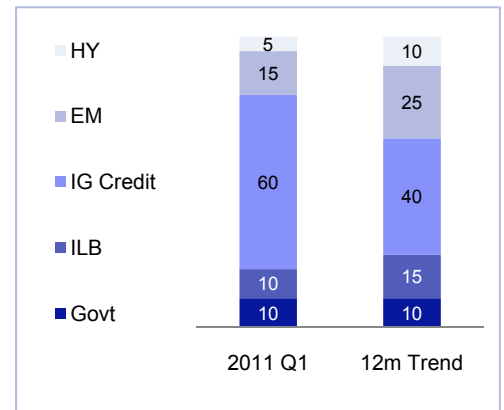


Credit Risk

We are overweight risk assets to benefit from the carry trade. Recovery with moderate inflation and relatively low yields will provide support.

We recommend an increased exposure to the riskiest assets allowable in your universe.

We believe range trading is likely the key rather than directional longs – as spreads could potentially be volatile and divergent.

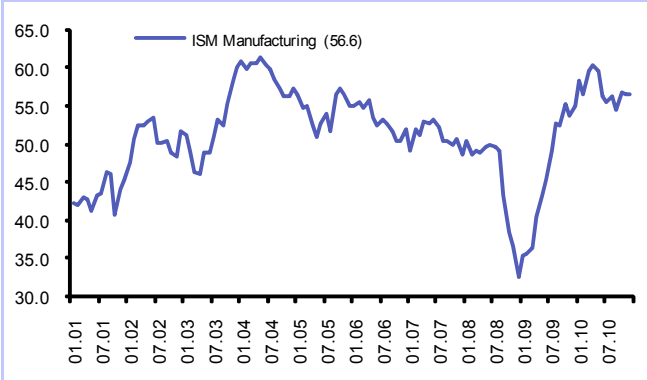


- We are **structurally overweight inflation-linked bonds**, based on the loss of purchasing power over the long-term cycle.
- Based on our view that the business cycle continues to recover, we maintain **an overweight on all risky assets** (inflation-linked, credit, emerging markets and high yield). Risk appetite is likely to improve as a result of recession risk receding, QE, and strong global growth build confidence.
- **We expect spreads to start reflecting the underlying fundamentals of the specific issuer.** Focus on issuers who have improved their key metrics since 2007 (Investment Case 2010.12).
- With the sovereign crisis, sectors exposed to domestic growth and austerity measures should be underweighted. On the EUR market, the sovereign crisis impact on some sectors means that globally speaking, EU spreads will not tighten as much as US ones.

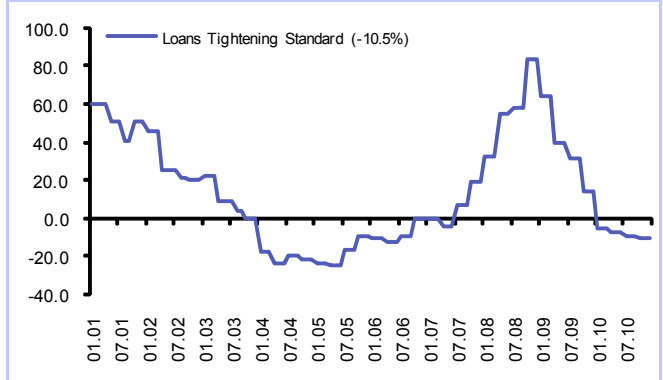
Our positive view on riskier assets is supported by:

- Credit continues to offer value in term of spread (same spread than YTD). On the other side, the high spread to yield ratio indicates that the value is in the spread not in the yield.
- Strong balance sheets: corporations are taking a more cautious stance with their balance sheets by restructuring and reducing their debt profiles.
- Negative net issuance is expected in EUR and flat in USD for corporate debt while positive net supply for government sector is expected.
- As long as defaults remain low and the yield differential between risky bonds and other fixed income asset classes remains significant, we do not see a fundamental reversal of recent trends. The main risk is deflation, as such an economic environment can ultimately lead to higher default rates.
- While QE1 benefitted IG and HY equally, QE2 will likely be more beneficial to HY. After all, IG markets are liquid and functional now. However, assuming QE2 helps bolster economic growth, HY credit should see a greater benefit than IG credit from a renewed search for yield.

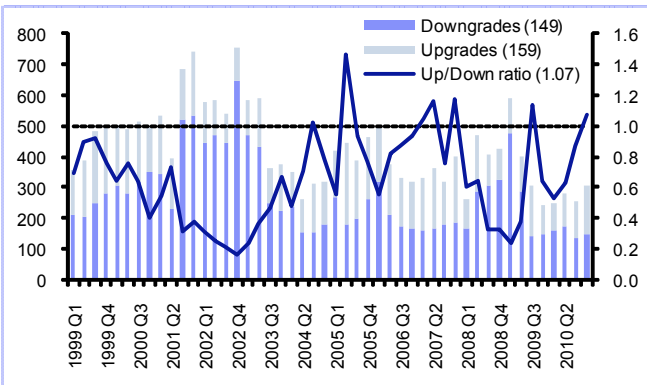
ISM Manufacturing



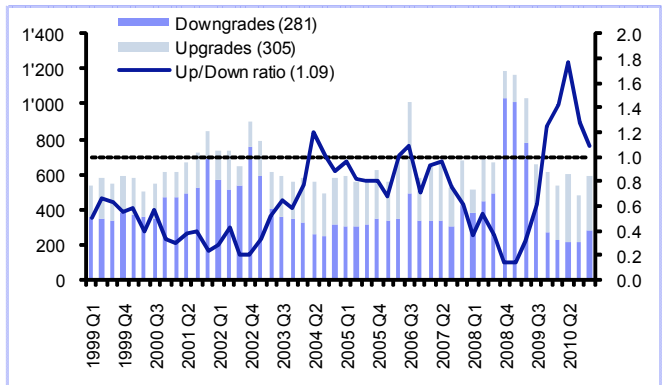
Loans Conditions



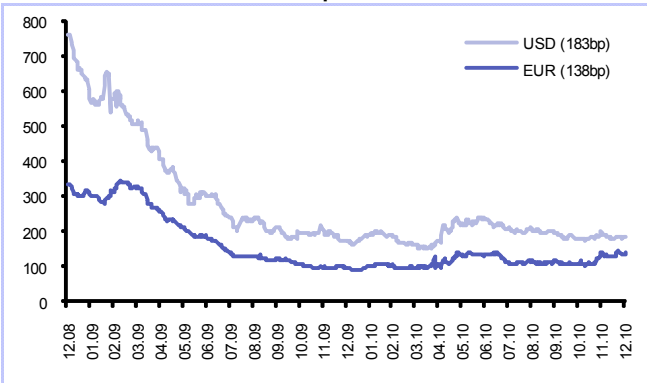
Investment Grade Corporate Rating Trend



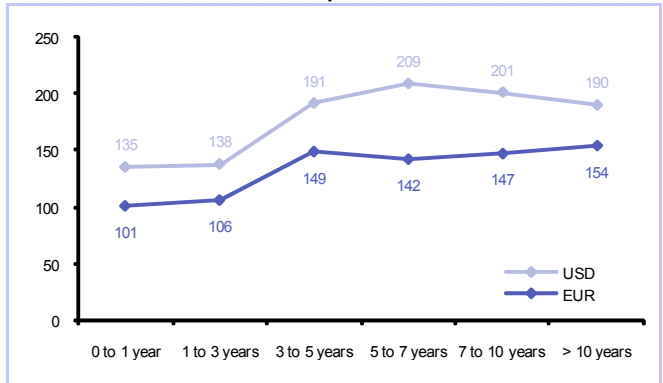
High Yield Rating Trend



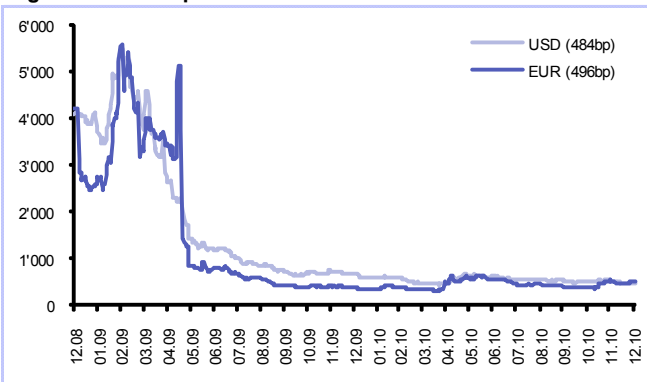
Low Investment Grade D/Swap



Low Investment Grade D/Swap Curve



High Yield D/Swap



High Yield D/Swap Curve

