

**Major Market Developments****Monday, May 14:**

- Japan April Domestic Corporate Goods Prices rise 0.8%, m.o.m.

**Tuesday, May 15:**

- US April core consumer price index rises 0.2%, m.o.m.
- UK April CPI and RPI rises 0.3% and 0.5%, m.o.m., respectively

**Wednesday, May 16:**

- US April housing starts edge higher from 1.518 to 1.528 million units; building permits fall from 1.544 to 1.429 million

**Thursday, May 17:**

- Japan Q1 GDP expands by 0.6%, q.o.q.
- BoJ meets and leaves policy rate unchanged at 0.50%

**Friday, May 18:**

- UK April retail sales falls 0.1%, m.o.m.

**Theme of the Week**

- **Treasury Sell Off Set to Fade**

***Treasury Sell Off Set to Fade***

**A confluence of technical factors spurred a sizeable sell off in Treasuries and lifted yields to their highest levels since February.** Many investors had placed bets for Treasuries to appreciate further; these sizeable long positions dulled investors' sensitivity to bond-friendly data -- including a benign CPI, further declines in housing permits and weakness in the index of leading economic indicators -- but left them vulnerable to positive economic news. The inability of Treasuries to rally forced many to close their long positions. Meanwhile, mortgage duration extension amid the rise in yields forced investors to shed duration by selling Treasuries or paying fixed in swaps, which further fueled increases in yields. Also, yields had breached above their 200-day moving averages – a sell signal for many – thus spurred many momentum-driven accounts to sell Treasuries.

Supporting the sell off was also a collective sense that the US economy is rebounding. Jobless claims confounded expectations for worsening employment outlook and fell for the fifth consecutive week. Meanwhile, the New York and Philadelphia Federal Reserve surveys indicated manufacturing expansion. Accordingly, second quarter GDP growth appears to rebound smartly from 1.3% in Q1 to around 2.5% in Q2 (revision to Q1 data suggests that growth was likely below 1%, even more meager than initial estimates).

**Still, Treasuries are not on the brink of a sustained sell off.** Stability in swap spreads by the end of the week suggested that mortgage convexity-related hedging activity has ebbed. Meanwhile, downside risks to growth remain abound. **First, the quality of employment growth in the US has deteriorated.** The April report revealed an increase in part-time employment, but a decrease in full-time work. The divergence in full-time versus part-time employment likely contributed to the decline in hours worked, and suggested that the non-farm payrolls survey likely overestimated employment gains. **Second, lingering housing inventory overhang and rising gasoline prices will likely constrain consumer spending.** In fact, with the exception of the manufacturing sector – boosted primarily by the dramatic resurgence in auto production – growth in other sectors appears modest. **Accordingly, we expect the recent sell off in Treasuries to fade.** From our perspective, Treasury yields are condemned to range trading for these next few weeks; ranges established for the year appear secure in their place.

**Market Review: Sovereign Markets**

**United States**

> **Duration: Neutral**

> **Yield Curve: Neutral**

Investors largely shrugged off bond market-friendly economic data and sold off aggressively. Position surveys indicated that real money accounts have held long duration positions, leaving them indifferent to bond-friend data but ill prepared for surprises, including low weekly jobless claims and a rebound in industrial production. Moreover, the steady rise in yields, coupled with negative technical indicators – yields had breached above their 200-day moving averages, may have forced some accounts to capitulate, exacerbating the selling momentum and pushing yields higher to levels last seen since mid-February.

**Europe**

> **Duration: Underweight**

> **Yield Curve: Neutral**

Bunds sold off aggressively, no doubt spurred by positive data out of US and Europe in recent weeks. However, investor positions and flows from CTAs also contributed to the price action. By contrast, gilt yields rose by a smaller magnitude. April retail sales were weaker than expected and inflation measures moderated on a monthly basis. However, the BoE's quarterly Inflation Report – including its reference to rising business confidence to pass through price increases – was considered somewhat hawkish. Additionally, despite forecast for inflation to fall back to the BoE's target of 2% by 2009, the forecast model included a policy rate hike to 5.75%. Thus, many interpreted the report as a strong signal for an additional rate hike.

**Japan**

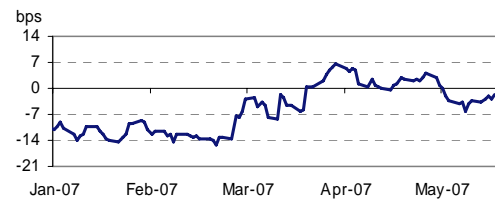
> **Duration: Neutral; Overweight Linkers**

> **Yield Curve: Flattener**

After intraweek swings that included a sell off early in the week and subsequent rally, JGB yields ended the week unchanged. GDP grew 2.4% in the first quarter on an annualized basis and was weaker than expected, largely due to unexpectedly weak business investment. Still, household spending and export growth were strong, supporting expectations for moderate expansion in growth. In addition, 2006 Q4 growth was downwardly revised from +5.5% to 5.0%. Against this backdrop, the JGB market resisted the bearish tone in other major bond markets. After the outperformance of JGB market, we converted our remaining Japan overweight / Europe underweight duration position into outright underweight in Europe.

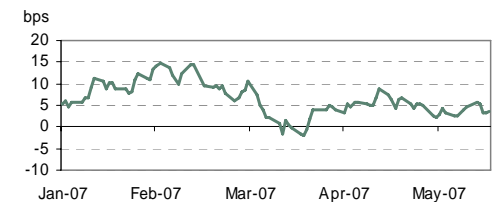
**Two- to 10-Year Treasury Yield Spread**

	US			
	Current	1wk	MTD	YTD
Fed	5.25	0	0	0
3 Mo	4.80	-3	-4	-21
2 Yr	4.82	11	22	1
5 Yr	4.73	14	22	3
10 Yr	4.80	13	18	10
30 Yr	4.96	11	15	15
2 - Fed	-0.43	11	22	1
5 - 2	-0.09	3	-1	3
10 - 5	0.07	-1	-4	6
30 - 10	0.16	-2	-3	5



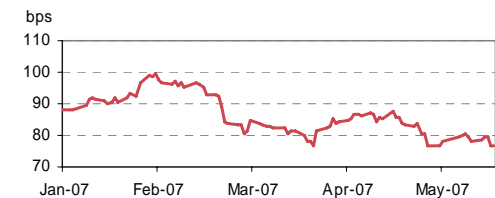
**Two- to 10-Year Bund Yield Spread**

	Europe			
	Current	1wk	MTD	YTD
ECB	3.75	0	0	25
1 Yr	4.26	8	10	39
2 Yr	4.28	10	15	37
5 Yr	4.29	10	15	37
10 Yr	4.31	9	16	36
30 Yr	4.44	6	14	39
2 - ECB	0.53	10	15	12
5 - 2	0.01	0	1	-1
10 - 5	0.02	-1	0	0
30 - 10	0.13	-3	-1	3



**Two- to 10-Year JGB Yield Spread**

	Japan			
	Current	1wk	MTD	YTD
BOJ	0.50	0	0	50
1 Yr	0.65	-1	-1	14
2 Yr	0.88	0	1	7
5 Yr	1.22	-1	1	-3
10 Yr	1.65	-1	2	-4
20 Yr	2.08	-1	1	1
30 Yr	2.31	-2	1	1
2 - BOJ	0.38	0	1	-43
5 - 2	0.35	-1	0	-10
10 - 5	0.42	0	0	-1
30 - 10	0.66	-1	-1	4



Source: Bloomberg

**Market Review: Global Treasury Inflation-Protected Securities (TIPS)**

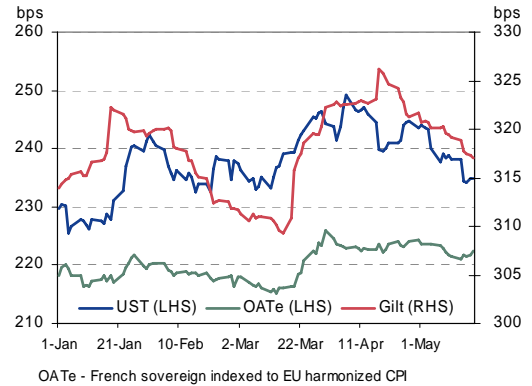
- > **Duration: Long US vs. UK; Short Sweden vs. Europe; Steepening UK real yield curve; Short Australian BEI; Short UK BEI**

US inflation moderated amid declining rental costs. Core CPI rose 0.177% in April, or 2.3% on a yearly basis. Headline CPI rose 0.4%, or 2.6% on a yearly basis. Real yields sold off alongside nominals, with the long-end outperforming others as a 20-year real yield of 2.50% attracted demand. After adjusting for inflation carry, intermediate-dated breakeven spreads narrowed 1 basis point, while the long-end widened 1 to 2 basis points.

European breakeven spreads were supported by an upward revision to Euro HICP, stronger-than-expected French inflation data, and a well-received reopening of BTANei10 and OATi17. Spreads in the 5- to 10-year sector widened 3 to 5 basis points, and in the long end, 1 to 2 basis points. UK breakeven spreads were largely unchanged as inflation data were in line with expectations. Headline CPI and RPI both fell, driven by the base effect of dropping last year's large utility rate hikes from the index.

**Global Linkers - 10-Year Breakeven Spreads**

Source: Bloomberg



**Market Review: Currency Markets**

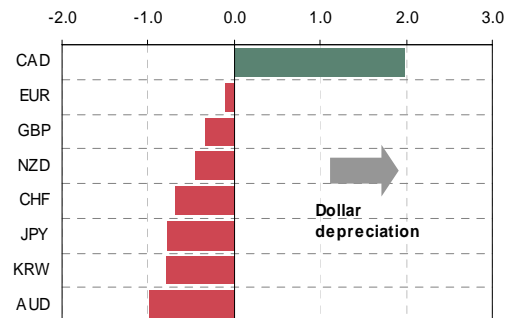
**G3**

- > **Position: Short USD vs. AUD, CAD, and SGD; Short EUR vs. NOK, SEK**

The US dollar continued to recover its losses against most other major currencies amid positive economic data surprises, including signs of improvement from the latest manufacturing reports. Meanwhile, despite widening interest rate differentials, the euro finished the week unchanged. By contrast, the Canadian dollar strengthened further and reached its 30-year high against the US dollar amid speculations that BoC will hike rates in the near-term. Despite the announcement that China is widening its currency trading band and is raising interest rates, currency market reaction was fairly muted. Apart from more strengthening in Asian currencies, the yen failed to benefit from the news and was unchanged for the day.

**US Dollar's WTD Performance Against Other Majors**

Source: Bloomberg



**Market Review: Credit**

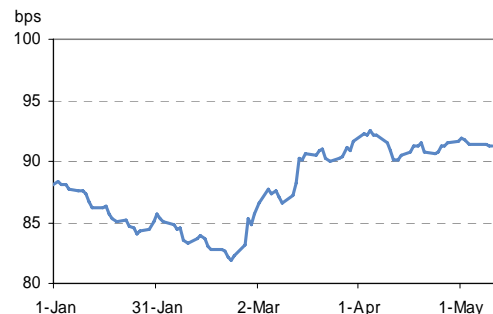
**US Corporates**

- > **Position: Modest Underweight**

Moderate CPI prints and improvements in industrial production activity in the US buoyed investor sentiment, with investment grade spreads grinding slightly tighter on the week. M&A activity and LBOs headlines continued apace, and have thus maintained investor interest in deals with change-of-control language. On net, the market has defied expectations for it to languish heading into the summer vacation season.

**Investment Grade Corporate Bond Index OAS**

Source: Lehman Live



**Market Review: Credit (continued)**

**European Corporates**

**> Position: Modest Overweight**

The European credit market was largely unchanged over the week while new issuance rose slightly. Telenor (a Norwegian Telecommunications company) came to the market with a €1 billion issue. Despite market consensus that pricing was rich, the deal was three times oversubscribed. The European Xover index traded within a tight range and closed the week near the tight end as sentiment remains quite strong. The absence of non negative news is expected to lead to a well-supported market at current levels in the near term. Single names continue to be dominated by LBO and M&A rumors.

**Mortgage-Backed Securities**

**> Position: Modest Overweight**

Mortgage spreads widened in sympathy with wider swap spreads and higher implied volatility. Specifically, mortgage duration extension amid rising rates forced many investors to shed duration, thus elevating their hedging costs. The sector underperformed comparable-duration Treasuries by 5 basis points and now stands at -2 basis points for the month.

Fundamentally, as measured by OAS, mortgages remain cheap on a historic basis. Unfortunately, today's marginal buyers of mortgages are less sensitive to OAS valuations. Instead, they are more focused on the absolute level of yields. Meanwhile, central banks have been reluctant to add MBS despite higher yields. Thus, dealers and domestics end users have adsorbed excess supply.

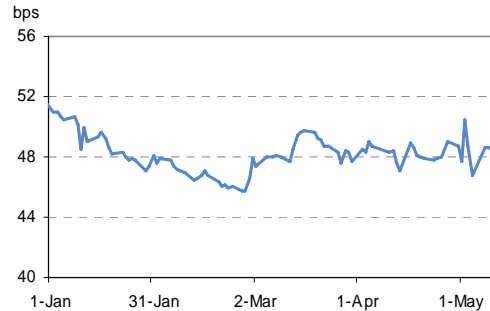
**Asset-Backed Securities**

**> Position: Tactical Overweight**

Issuance picked up in the US ABS market after a few slow weeks, with US\$22 billion in new supply. Continuing the theme of the past several weeks, issuance in the non-home equity sectors continued to strengthen, while the pace of issuance in the home equity sectors remains slow relative to 2005 and 2006. Spreads, specifically in the home equity subordinate sectors, continue to tighten across the capital structure amid strong investor demand for the sector. The highest quality sectors of the ABS market continue to be perceived as a safe haven for investors and remain well bid during the recent market corrections. We continue to monitor the subprime sector during this period of stress.

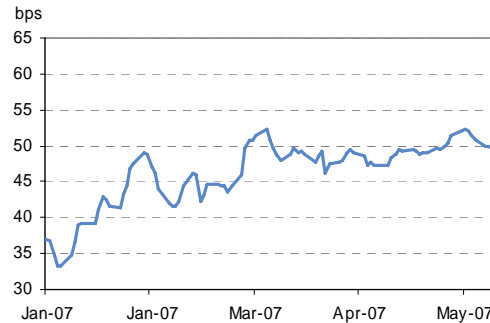
**Euro-Aggregate Corporate Index OAS**

Source: Lehman Live



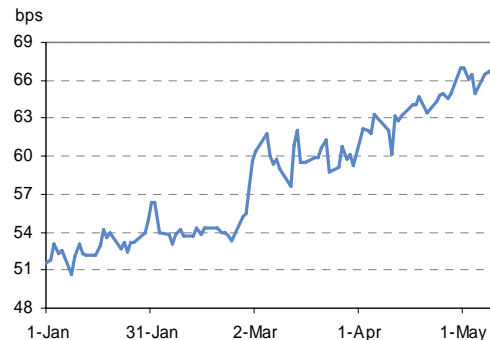
**Agency MBS Current-Coupon Fixed-Rate OAS**

Source: Lehman Live



**Lehman ABS Index OAS**

Source: Lehman Live



## Next Week:

### Tuesday, May 22:

- Germany May ZEW economic sentiment survey released
- Japan's Cabinet Office releases its May monthly economic report

### Wednesday, May 23:

- Bank of England releases its meeting minutes

### Thursday, May 24:

- US April durable goods orders to rise 0.8%, m.o.m.
- German May Ifo business outlook survey released

### Friday, May 25:

- US April new home sales to increase by 0.2%, m.o.m.; existing home sales to remain unchanged on a monthly basis
- UK Q1 GDP expected to expand by 0.7%, q.o.q.
- Japan May Tokyo core CPI to remain unchanged, y.o.y.; April national core CPI to fall by 0.1%, y.o.y.

## Central Bank Watch

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on June 07 Interest Rate Futures Contract	Next Meeting
<b>Fed</b>	+25 bps	June 29, 2006	5.25%	5.35%	June 28
<b>ECB</b>	+25 bps	March 8, 2007	3.75%	4.16%	June 6
<b>BoJ</b>	+25 bps	April 27, 2007	0.50%	0.68%	June 15
<b>BoE</b>	+25 bps	May 10, 2007	5.50%	5.82%	June 7

***In observation of the upcoming Memorial Day and Spring Bank holidays, the next Weekly Strategy Review will be published on June 4, 2007.***

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