



Global Financial Outlook

Interest Rate Forecast

Overview

In our previous outlook, we noted that until the U.S. Federal Reserve communicated changes to monetary policy or until the employment report revealed substantial gains for our labor force, the market may be left searching for direction. February had no shortage of market moving events though, as a surprise rate change by the Fed and a disappointing employment report with sizeable revisions to prior readings caught investors unprepared. Market participants had largely written off the possibility of monetary policy tightening following Chairman Bernanke's disclosure of the Fed's exit plan to its emergency measures, which failed to provide details on timing. Just a few days later, the Fed unexpectedly increased its Discount Rate by 25bps to 1 percent. It is important to note that the Discount Rate is not as influential to monetary policy as the Federal Funds Rate, but the move was symbolically important because it denotes the Fed's confidence in financial market conditions. Now, we consider when further changes may proceed. Unfortunately, anxiety towards the labor market reemerged following news that non-farm payrolls declined 20K in January, and December's figure was revised from -85K to -150K! Risk aversion emerged following both these events, and moving forward, financial markets could remain wary of the risk-seeking that had been previously encouraged by the massive amounts of liquidity which had been pumped into the system.

United States

Benchmarks	Year Ago	Current	30-Day Forecast	Year-End 10 Forecast
Fed Funds	0.25%	0.25%	0.00% – 0.25%	1.50%
3 Mth. Libor	1.27%	0.25%	0.25% – 0.75%	1.75%
10 Yr. Gov't	3.02%	3.62%	3.50% – 4.00%	5.00%
CPI (PCE Deflator)	0.20%	2.10%	0.50% – 2.50%	2.50%
Unemployment Rate	8.30%	9.70%	9.50% – 10.00%	8.00%

Now, more than ever, economic data out of the United States is critical in providing insights to the timing of potential tightening of monetary policies. Federal Reserve officials have neglected to provide specifics on further moves, but differing opinions on the need for the near-zero Fed Funds Rate and on the low levels for "an extended period" rhetoric have surfaced. Manufacturing data has improved and 4th quarter Gross Domestic Product expanded at 5.9 percent quarter

over quarter. But, skeptics cite the rebuilding of inventories rather than sustained demand from consumers as the backbone of the improving statistics. Furthermore, the last two months' employment reports have disappointed, following a series of optimistic prints in late 2009. Even if economic releases over the next few months fail to warrant monetary policy changes, the U.S. could eventually be forced to do so strictly to prove fiscal responsibility to international parties. China decreased their holdings of U.S. government bonds by \$34bn for the period ending December 2009. This unease over financing U.S. debts could underscore a new trend of central bank reserve diversification if U.S. borrowing persistently draws criticisms.

Europe

Benchmarks	Year Ago	Current	30-Day Forecast	Year-End 10 Forecast
ECB Refinancing Rate	1.00%	1.00%	0.75% – 1.25%	1.50%
3 Mth. Libor	1.83%	0.60%	0.55% – 1.05%	1.75%
10 Yr. Gov't	3.03%	3.10%	2.90% – 3.40%	3.75%
CPI	0.60%	1.00%	(0.50)% – 1.50%	1.50%
Unemployment Rate	9.01%	9.90%	9.50% – 10.50%	9.50%

The major headline out of the Euro-zone continues to be the sovereign debt issues of member states like Greece, Portugal, Ireland, and Spain. Greece needs to raise over 50bn Euros this year and faces more than 20bn of bond redemptions by the end of May, according to estimates. The European Union has established dates in mid March and May to evaluate Greece's progress in reducing its swelling budget deficit. Still, Greek leaders have vowed to limit the budget gap by 2012 to the 3 percent of GDP restriction that the EU has implemented. Major rating agencies do not seem to agree though, with one stating that multiple downgrades could be made to Greece's credit. Consequently, Bund yields continue to trade lower as investors have become more adverse to risk and turn to the safer fixed income investments. We continue to favor U.S. 10yr yields in comparison to the European counterpart. Additionally, rather tame European inflation metrics imply that there is no imminent threat of the European Central Bank tightening its policies.

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Asia/Japan

Benchmarks	Year Ago	Current	30-Day Forecast	Year-End 10 Forecast
BOJ Policy Rate	0.10%	0.10%	0.00% – 0.15%	0.10%
3 Mth. Libor	.635%	0.25%	0.25% – 0.65%	0.35%
10 Yr. Gov't	1.30%	1.30%	1.00% – 1.50%	2.00%
CPI (Nat'l CPI ex food)	(0.30)	(1.20)%	(2.00)% – 0.00%	0.00%
Unemployment Rate	4.80%	5.10%	4.90% – 5.40%	4.70%

Last month, we discussed China's move to reign in lending in its banking sector by increasing the reserve requirement by 50bps. We had

been caught off guard by the initial move, but not by the impact the move had on most financial markets. Commodities and global equities retreated on the notion that the steamrolling Chinese market could be attempting to cool down. Weeks later, Chinese authorities acted again and increased reserve requirements by another 50bps. With the initial shock of tightening out of the way, we feel that Chinese officials are acting responsibly. If their economy was at the risk of becoming a bubble and banks were funding projects irresponsibly, then the move to restrict lending is warranted. The cooling of production may weigh on the Asian economy as well, but we prefer that to the possibility of a bubble bursting and detrimentally effecting Asian economies down the road.

F/X Markets Forecast

	1 month	3 months	6 months	9 months	12 months
EUR	1.3400	1.3200	1.3000	1.2800	1.2600
JPY	92.00	95.00	98.00	100.00	103.00
GBP	1.4900	1.4700	1.4500	1.4300	1.4100
CAD	1.0700	1.0300	1.0000	1.0000	0.9800
AUD	0.9000	0.9200	0.9400	0.9600	0.9800
MXN	12.7000	12.6000	12.4000	12.2000	12.0000

OVERVIEW

As we head into March, we can only hope that Spring is just around the corner. Of course, in Cleveland, Spring typically involves freezing rain and the occasional blizzard. Nonetheless, we look forward to the changing of seasons and perhaps a changing of themes in the currency market as well. Over the past year, we harped on the concept of risk-taking vs. the safety of the U.S. Dollar. After the worst of the financial crisis had past, a bout of risk-taking took place at the expense of USD, due to our near-zero interest rate policy. The new year saw these Dollar funded trades unwind as the anticipation of central bank exit strategies emerged and as sovereign debt concerns from the Euro-zone drove investors back to safer assets. In February, many of the same issues were relevant. Despite rumors both proposing and denying a bailout for Greece, no substantial developments have been made, and the market still awaits the outcome for how the European Union or its member countries will handle the dilemma. China shook the market by announcing another increase to reserve requirements – its second effort to curb bank lending this year. Of particular importance, the U.S. Federal Reserve offered insights to an exit strategy from its ultra loose policies. First, look for the Fed to remove excess liquidity from the financial system. Proposed methods include reverse repos and term deposits. Next, officials would increase the Fed Funds Rate. And finally, the Fed would sell assets in order to reduce their balance sheet.

These events were not necessarily ground breaking, but the currency market behaved differently than it had in previous months. Currencies like the Euro and British Pound, whose central banks are expected to lag the U.S. Fed in terms of policy changes, suffered dramatically. The announcement of the Fed's exit plan and subsequent change to the Discount Rate has reminded the market that the U.S. central bank is in a position to act far before its European counterparts. On the other hand, fundamentally strong economies like Australia and Canada witnessed their currencies maintain strength. If this dislocation from the broad "risk-on" or "risk-off" attitude can endure, then we will continue to experience the outperformance of fundamentally strong currencies at the expense of those still struggling to cope with economic and fiscal problems.

EURO (EUR)

The Euro faced another month of downward pressure as the sovereign debt situation in Greece showed little signs of resolution in the near future. The concerns regarding Greece and other European Union sovereign debts have led traders to add to bets against the Euro. Also, economic data out of Europe has suggested that the Euro-zone recovery will vastly underperform that of the United States. Fourth quarter growth came in at an anemic 0.1 percent gain quarter over quarter, and inflation pressures remained tame during January, indicating that the European Central Bank will be able to leave policies loose while European Union members address their fiscal problems. In February, short positions, represented by the futures market, increased to their largest amount ever, which has put immense strain on the Euro-zone currency and has driven EUR/USD to its lowest levels since the financial crisis threatened global markets. If you recall, during the previous year, EUR/USD was a main beneficiary of the risk-taking mentality. Investors have recently become so pessimistic towards the Euro that EUR/USD has remained depressed even when risky asset classes such as equities, commodities, and currencies like Aussie and Canada's Dollar have rallied. We continue to forecast EUR/USD lower, but with the recent downward move being so dramatic, any positive news could create some reprieve for the Euro. A squeeze on the massive short positions would target 1.3850. In the long run, we expect EUR/USD to follow its descent. Watch for a breach of 1.3440 to open up a downward run to 1.3000.

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F/X Markets Forecast

JAPANESE YEN (JPY)

The Japanese Yen continues to benefit as a safe haven. However, it is difficult to find a reason for further Yen appreciation. Specifically, against USD, interest rate yields clearly favor the Dollar's potential for gains. The big question is timing though, as it appears that the Yen will maintain strength until the market becomes comfortable that sovereign debt quandaries have been settled. Following the U.S. Fed increasing the Discount Rate by a quarter percent, USD/JPY jumped higher. This should be a clear reminder that any tightening in the United States will have a drastic effect on USD/JPY, because the currency pair is highly sensitive to U.S. and Japanese yields. While U.S. yields will increase on policy moves, Japan still faces deflationary pressures that are likely to persist for the near future. The Bank of Japan is doing its utmost to fight deflation, but contracting inflation metrics imply that they will be forced to maintain the near zero interest rate policy for an extensive time. Last month, we noted that newly appointed Finance Minister Naoto Kan had felt that 95.00 would be a far more suitable level for Japanese exporters. We agree with Kan's target of 95.00 in the near term, and we project additional USD/JPY appreciation on decreased risk aversion and economical improvements in the U.S. On the downside, increasing sovereign debt concerns could diminish risk appetite. In response, USD/JPY could move lower, but is unlikely to fall to 85.00. The 2010 low for the currency pair is near 88.50, so watch for this support to hold if tested.

POUND STERLING (GBP)

The British Pound hobbled through the previous month while being battered and bruised by comments from Monetary Policy Committee members. February's highly anticipated policy meeting concluded optimistically after the MPC chose to halt its quantitative easing program at 200bn Pounds. However, minutes from the meeting revealed that the Bank of England may revisit increases to the QE program if economic conditions continue to deteriorate. GBP/USD fell sharply as various voting members of the Monetary Policy Committee admitted that they would entertain the idea of additional easing, with err on the side of leaving accommodative measures in place too long rather than restricting the economic recovery too early. It will be important to monitor inflation over the next few months. The Bank of England targets 2 percent inflation, but last month's CPI came in at 3.5 percent. While this spike in inflation suggests that tighter policies are warranted, the MPC wrote the event off to the higher VAT, fuel prices, and a weak Pound. Also weighing on the Pound is that the U.K. government is on the verge of electing a minority government, which could undercut the efforts for reducing their deficit and threaten the U.K.'s AAA credit rating. With the uncertainties of the quantitative easing program and general election, investors have steered clear of the U.K. The upcoming Bank of England meeting will again be monitored, and the U.K. general election must be held by this June. Unfortunately, the most likely scenario – a hung parliament, and the need for further easing – would be detrimental to the Pound. Having traded below 1.5000 already, GBP/USD must find support at 1.4780 if it wishes to prevent a decline into the low 1.4000's.

CANADIAN DOLLAR (CAD)

Well, it took a sudden death period to decide an exhilarating USA vs. Canada Olympic hockey rematch. In the end, Canada's Sidney Crosby snuck the overtime goal by the stellar U.S. goalie, Ryan Miller, to avenge an earlier defeat and secure gold for the Canadians. Akin to its hockey team, Canada's economy also showed resilience during the past month. Employment and real estate data remained buoyant and 4th quarter GDP beat expectations at 5 percent growth on strong consumer spending and exporters. Investors will undoubtedly be reassured that Canada's recovery has been driven by demand from the private sector. Meanwhile, regulators have addressed the possibility of a bubble forming in Canadian housing by enacting rules on mortgages that essentially limit speculation in the market. While we applaud the responsibility of such rules and believe that they ultimately instill stability, the monetary policy ramification is that the Bank of Canada will not need to raise rates in order to address inapt real estate strength. Furthermore, the Bank of Canada has been vocal about maintaining its target interest rate through the 2nd quarter of 2010, despite that the momentum in Canada's economy surely warrants policy action. Accordingly, we believe that a run towards parity in the near term would be disheartened as interest rates remained at the current levels. Although, we uphold our forecast that USD/CAD should reach parity in the second half of 2010. A run at parity will need to break through support at 1.0370 and then 1.0200. Conversely, we expect USD/CAD rallies to be limited by support around 1.0800.

AUSTRALIAN DOLLAR (AUD)

No central bank meeting will be more anticipated this month than the Reserve Bank of Australia's. In February, the RBA shocked the market by hesitating to hike its target interest rate, and maintaining it at 3.75 percent. The Reserve Bank noted a difficult credit environment, China's policy tightening, and concerns over sovereign debts in a statement pursuant to the decision. We were one of the many that had forecasted another 25bps raise due to consistently impressive data from Australia, including retail sales and employment measures. The wait-and-see attitude that the RBA had apparently adopted was undoubtedly a change of pace from the hawkish sentiment seen over the past months. After digesting the interest rate pause, investors began to favor Aussie yet again. AUD/USD is currently flirting with the 0.9000 level, as investors weigh the potential for the Reserve Bank of Australia to resume rate hikes at its upcoming meeting. We expect that the RBA will in fact hike its interest rate to 4 percent at its March meeting, and we preserve our view that 5 percent or higher will reflect a normalized rate. Despite China's policy tightening, Australia has experienced robust gains in its employment market and increases in business investments. As a result, we are shifting our outlook for AUD/USD to reflect a strengthening Australian Dollar. We have previously referred to Aussie as the epitome of risk-taking, but in reality, Australia's economy has become the epitome of health and growth potential. If AUD/USD can find can traction above 0.9000, look for the currency pair to take aim at 0.9400.

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MEXICAN PESO (MXN)

Last month, we cited apprehension towards sovereign debts as the reason that USD/MXN traded above 13.0000. The Peso actually regained its footing during February and ended the month near its best levels versus the U.S. Dollar. Improving manufacturing data in the United States and news that the U.S. economy grew at 5.9 percent during the 4th quarter have been beneficial for Mexico, because the U.S. buys roughly 80 percent of Mexican exports. Additionally, Mexico is attempting to bolster its foreign reserves by selling options that profit on Peso strength. This project will replenish the reserves that the Banco de Mexico used to stabilize its currency after the financial crisis drove USD/MXN over 15.0000. Thus, investors have regained some confidence in the Mexican economy and their central bank, causing USD/MXN to trade down near 12.7000. However, the USD/MXN move lower is just to the bottom end of its recent range and is not indicative of a downtrend. USD/MXN is unlikely to create fresh lows until there is some resolution regarding emergency aid for Greece and sovereign debt concerns ease. Watch for the currency pair to breach support around 12.6000 and 12.5000 if a bailout for Greece is announced. If sovereign debts elsewhere start to sour, USD/MXN could quickly find itself back in a familiar position – right around 13.0000.

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