KeyBank

Global Financial Outlook

Interest Rate Forecast

Overview

Market participants appear balanced between two frames of thought. One idea is that the unwinding of massive liquidity measures by central banks could pull the lifeline on the stimulus-assisted economic developments of the preceding months. On the other hand, private sector activity appears to be gaining momentum after recessionary environments suffocated the global economy just months ago. In February, three different blizzards blasting the Northeast failed to weigh down the U.S. labor market. The Employment Report printed just -36k, despite a consensus estimate looking for massive losses due to the suboptimal weather conditions. Also, accelerating PMI measures out of the U.S. and Europe suggests that the manufacturing sector is gearing up for progress in the global recovery. While investors remain vulnerable to shifting sentiment, we believe that the all important non-farm payrolls number should have a significant bearing on the market in the short-term. The perceived strength of the recovery and its pace could influence the timing of the U.S. Fed's first interest rate move. Do not be mistaken, we are hardly calling for a policy change at the upcoming Federal Reserve meeting. But, a strong employment reading could allow Fed officials to abandon the "exceptionally low" or "extended period" rhetoric that retains a dovish tone.

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	1.18%	0.29%	0.25% – 0.75%	1.75%
10 Yr. Gov't	2.65%	3.85%	3.50% – 4.00%	5.00%
CPI (PCE Deflator)	0.05%	1.80%	0.50% – 2.50%	2.50%
Unemployment Rate	8.90%	9.70%	9.50% – 10.00%	8.00%

Last month, 10-year U.S. Treasury yields surged to their highest levels since June of 2009. Additionally, 10-year U.S. swap spreads turned negative for the first on record due to the rally in Treasury yields. The swap spread is the difference between Treasury yields and the cost of exchanging floating rate investments for fixed rate investments. While our outlook does call for U.S. Treasury yields to increase to 5 percent over the next year, we also caution investors on its implications for U.S. debt. In three separate offerings last week, the U.S. government had to pay higher than current market rates on its Treasury bonds in order to entice investors. Factors that contributed to the poor auction results included trade conflicts with China, tentativeness towards the massive amount of U.S. debt, and the impending end to the Fed's MBS purchase program. Additionally, the passing of the healthcare plan is estimated to cost roughly $940bn over the next ten years. If a trade war with China were to ensue, or if the Federal deficit were to worsen, we could easily see our 5 percent call be on the shy end of forecasts.

Europe

Benchmarks	Year Ago	Current	30-Day Forecast	Year-End 10 Forecast
ECB Refinancing Rate	1.50%	1.00%	0.75% – 1.25%	1.50%
3 Mth. Libor	1.49%	0.58%	0.50% – 1.00%	1.75%
10 Yr. Gov't	2.99%	3.08%	2.90% – 3.40%	3.75%
CPI	0.60%	1.50%	(0.50)% – 1.50%	1.50%
Unemployment Rate	9.20%	10.00%	9.50% – 10.50%	9.50%

In contrast to its U.S. counterpart, 10-year German Bund yields were close to their lowest levels of 2010 after the European Union and International Monetary Fund's aid for Greece failed to suppress anxiety that the country will not reduce its budget deficit. The rescue plan, a combination of IMF and EU bilateral loans, will only be used as a method of last resort if Greece is unable to raise funds in the open market. Thus, investors increased their demand for the safest Euro-zone debts, German Bunds, and Greek 10-year Bond spreads over Bunds rose to more than 300 basis points. Watch for safe-haven demand to contain Euro yields and allow for the relative spread against U.S. Treasuries to widen to 100 basis points by year end. Currently, the U.S./Euro 10-year spread has closed in on a three year high around 77 bps.

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	0.60%	0.24%	0.20% – 0.60%	0.35%
10 Yr. Gov't	1.35%	1.36%	1.00% – 1.50%	2.00%
CPI (Nat'l CPI ex food)	(0.10)%	(1.20)%	(2.00)% – 0.00%	0.00%
Unemployment Rate	5.00%	4.90%	4.70% – 5.20%	4.70%

Japanese officials have been vocal of late that the Bank of Japan should increase efforts to combat their deflationary environment. In response, last month, the central bank doubled its 3 month lending facility to 20tr Yen. With CPI readings showing contracting price pressures, additional

(continued on page 2)

efforts may be warranted, and could materialize with the extension of the program to 6 months. We are skeptical that the adjustments to the lending facility will significantly impact Japan's deflation problem, because consumers are unwilling to spend regardless of their credit availability. Unfortunately, the Japanese government is reluctant to expand stimulus spending, due to its already worrisome public debt load. Accordingly, we look for the Bank of Japan to patiently maintain its near-zero interest rate stance throughout 2010. This path of continued easing will set Japan apart from other industrialized nations that have begun to remove excess liquidity measures and can potentially make policy changes later this year.

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	94.00	96.00	98.00	100.00	103.00
GBP	1.5000	1.4700	1.4500	1.4300	1.4100
CAD	1.0100	1.0000	0.9800	0.9600	0.9500
AUD	0.9200	0.9300	0.9400	0.9600	0.9800
MXN	12.4000	12.2000	12.0000	11.8000	11.6000

OVERVIEW

Quarter-end selling of the U.S. Dollar has allowed for various currencies to finish the month on an upbeat note versus USD. Do not let this flow driven behavior distract from the true headline, though. In March, the U.S. Dollar reigned king. Additionally, global equities have climbed to 18 month highs. This remarkable rally in stocks and the U.S. Dollar is noteworthy for two particular reasons. First, the one year anniversary of the bear market lows in U.S. equities passed on March 6th. Although not statistically significant, we have come along way from 667 in the S&P 500 (roughly 75% higher, in fact) and it is a strong indicator that equity bulls may sustain. Secondly, the correlation of the Dollar and stocks underscores the prior trend of risky asset classes competing against USD. We believe this shift in sentiment reflects the fundamental outlook for the U.S. economy and, in turn, the U.S. Dollar. Over the past few months, economic data has established that the United States is likely to outperform the recoveries seen in other major economies, like the Euro-zone, United Kingdom, and Japan. Before investors get poised for the imminent tightening of monetary policies, we must look for clues that the Fed is gearing up to take action. Reverse repos and term deposits will be used to remove excess liquidity and should act as precursors to policy changes. However, the market will remain wary of any surprises while the Fed maintains its "exceptionally low" for an "extended period" language regarding the Fed Funds Rate.

We have cautioned on multiple occasions that both an uptick in consumer spending and employment would be necessary for the U.S. Fed to gain comfort in abandoning its loose monetary policy. Unfortunately, there has been pessimism over the mind-set of the U.S. consumer, and by extension, the U.S. economy. These metrics, however, often lag other economic indicators and will only begin to increase months after the economy is healthy. Leading indicators have consistently improved, and consumer confidence surveys have been recovering slowly after hitting historic lows last year. Furthermore, this month's employment report could show a substantial increase to the highly awaited non-farm payrolls, which would certainly benefit the U.S. currency. Dollar strength could also escalate if the Fed were to enact measures to drain liquidity, such as the reverse repos or term deposits, in eagerness of a future rate hike. On the contrary, a disappointing employment report or the continuation of dovish rhetoric from the Federal Reserve could allow for a pullback in USD versus other currencies.

EURO (EUR)

The Euro was again directed by news/rumors over a Greek rescue package. In addition to conflicting bailout reports, a major rating agency issued a downgrade of Portugal's credit, which exacerbated concerns over Euro-zone sovereign debts. Consequently, EUR/USD fell to its lowest levels in over 10 months, below 1.3300, during mid-March. Alas, the Euro was granted some reprieve as the agreed upon emergency aid finally emerged. The package includes both bi-lateral loans from Euro-zone members as well as partial backing from the International Monetary Fund. However, the aid is meant to be a last resort for Greece if they are unable to raise upwards of 70bn Euros by year end. Thus, market participants will be attentive to Greece's bond auction results. Greece has already tested the market with a 7 year offering that raised 5bn Euros. The results showed that investors are clearly demanding a substantial return for funding Greek debts, as the deal yielded 300+ basis points over equivalent German bunds. The success of further bond offerings and narrowing of credit spreads will be imperative for investors to gain comfort with the Euro-zone. If credit spreads for countries like Greece and Portugal can narrow, the market can focus on risky asset classes such as the booming commodities and equities, and perhaps EUR/USD can rise as well. Euro rallies should be curbed below 1.3850 versus the Dollar, though. Failure at this resistance level earlier in March implies that investors remain bearish towards EUR/USD. In addition to lingering concerns over sovereign debts, disappointing economic data on retail sales and employment solidifies our call for the U.S. to tighten policies ahead of its European counterpart, the European Central Bank. Look for EUR/USD to trudge below 1.3000 by year end.

(continued on page 3)

Global Financial Outlook

F/X Markets Forecast

JAPANESE YEN (JPY)

In our previous outlook, we noted that the potential for rising U.S. yields versus the Japanese equivalents would influence USD/JPY to move higher, as the currency pair is closely tied to the rate differentials. We then cautioned that the timing of such a move was in question, though, due to the Yen's appeal as a safe-haven and the presence of fears regarding sovereign debts. In fact, USD/JPY tested support below 88.50 as uncertainty over the Greek bailout and a downgrade to Portugal's credit plagued the market. As expected, the U.S. Dollar held its ground and USD/JPY remained supported just below the previous 2010 low. Subsequently, the U.S. Dollar has surged higher versus the Yen following several notable developments. First, the U.S./Japanese 3 month Libor spread turned positive for the first time in 6 months! Recall that the decline in U.S. Libor Rates had initially allowed higher-yielding trades to be funded with the Dollar rather than the traditionally used Japanese Yen. Next, the Bank of Japan effectively increased quantitative easing by raising the ceiling on its emergency 3 month lending facility from 10trn Yen to 20trn. Thirdly, the financial year ending in Japan meant that investors would repatriate funds. But now, the market will look for funds to flow out of Japan and into foreign assets. We project that USD/JPY should trade to 95.00 in the near-term, and if it can settle above 97.50, then a run at 102.00 could be forthcoming. Alternatively, the Yen could experience demand as a safe-haven if sovereign debt concerns are not alleviated and if economic conditions worsen globally. Expect these USD/JPY dips to be short-lived, however, as investors will now fund most carry-trades using the Yen, particularly when it appears overvalued.

POUND STERLING (GBP)

Similar to the Euro, the British Pound remained under pressure during the prior month. Large M&A flows, ongoing budget concerns, ultra-loose monetary policy, and uncertainty surrounding an upcoming election have all been GBP negatives. Last month we commented that GBP/USD would need to find support at 1.4780 if it wished to prevent a freefall into the low 1.4000's. Luckily for long GBP investors (if there are any), the Pound was in fact able to resist new lows, despite a largely disappointing release of the U.K.'s budget plan. As we headed into month end, a spat of encouraging economic reports has elevated the British Pound. We attribute this move higher as a squeeze on the historically large short positioning, and we are cautious that the risk to the Pound is still to the downside. A general election must be held by early June and is currently expected to take place in May of this year. As debates begin, we look for both the Labour Party and the Conservatives to address plans for reducing the swelling budget deficit. Ultimately, investors will be unwilling to fund U.K. debt unless the government can define specific spending cuts and lower the deficit/GDP. If neither party is able to take a sizeable lead, which is currently the case, uncertainty over future policies will cause hesitancy towards the Pound. Furthermore, Bank of England officials have yet to rule out additional quantitative easing. Recent comments suggest that the weaker Pound has benefitted exporters, and 4th quarter gross domestic product was revised higher. A weaker Sterling could be the antidote to lift the economy. We maintain our forecast for GBP/USD to decline into the 1.4000's. A new leg lower should be met with support at 1.4780, but watch for political uncertainties or further monetary easing to encourage a breach of this level. A move above 1.5530 would lead us to question whether bearish sentiment has abated.

CANADIAN DOLLAR (CAD)

The Canadian Dollar restored its impressive streak by firming against the U.S. Dollar in March. Previously, we had mentioned that USD/CAD would need to break support at 1.0370 and then 1.0200 to convince investors that a run at parity may be in the cards. Well, with crude oil well above $80 per barrel, Canadian employment gaining 21k, and housing starts reaching their best levels since October of 2008, it finally seemed like USD/CAD parity was beckoning. Moreover, comments from the Bank of Canada came across as considerably more hawkish at the March meeting. Specifically, Bank officials dropped the wording that Canadian inflation risks were "tilted downward," and also negated the reference to having "flexibility at low rates." In response, USD/CAD pushed as low as 1.0060 before succumbing to general U.S. Dollar strength. Moving forward, we project that the Canadian Dollar will maintain strength versus its U.S. counterpart. Retail sales printed higher than expected last month, and manufacturing shipments have shown resilience this year. While the economy continues to fire on all cylinders and commodities boom, look for USD/CAD to again near par, if not succeed in its conquest. Investors will pay close attention to the minutes from the Bank of Canada's meeting this month, looking for comments on rising pricing pressures or indications that the housing market may be overheating. Either of these developments could lead to a sooner-than-expected tightening of policies. Otherwise, we still predict that the Canada will experience rate hikes in the second half of 2010. If USD/CAD is again rejected on a run at parity, we could see the currency pair trade as high as 1.0500 or 1.0800. Although, we have no reason to believe that USD/CAD will exceed those levels.

AUSTRALIAN DOLLAR (AUD)

Recently released Australian data has modestly cooled rate hike expectations for next week's Reserve Bank of Australia meeting. Retail sales fell 1.4%, while the market was looking for an increase of 0.3%. Also, building approvals declined 3.3%, which is second large monthly decline, and surely puts less pressure on the RBA to hike rates. Prior to these setbacks, though, the market had expected that a 25 or 50 basis point raise was in line as Australia has persistently set the bar for economic performance. The housing market has stayed hot, there has been a slew of M&A activity, and the RBA has come across as hawkish by indicating that interest rates should be closer to 5 percent. That being said, we would not be surprised to see a pause in rate changes this month in favor of renewing the wait-and-see approach. Regardless, Aussie still offers the best value for carry trades as a high-yielding currency. For this reason, AUD/USD is unlikely to trade south of 0.8900 in the near-term, even if a rate pause

(continued on page 4)

F/X Markets Forecast

disappoints some investors. In our March outlook, we amended our forecast to reflect the Australian Dollar strengthening over the next 12 months. The Asian region offers the best opportunity for growth potential, and Aussie will undeniably benefit as it is backed by a country rich in raw materials and has attracted significant business investment. AUD/USD rallies will target 0.9400 in the near-term, and we can envision Aussie trading as high as 0.9800 in the next year.

MEXICAN PESO (MXN)

Last month, we mentioned that USD/MXN was unlikely to create fresh lows until there was some resolution regarding emergency aid for Greece and sovereign debt concerns subsided. With a bailout package announced in late March, the market was eased by the resolution, albeit only a method of last resort for Greece. Nevertheless, the Mexican Peso benefited and soon found itself trading at its best levels versus the U.S. Dollar in over 17 months, just below 12.4000. USD/MXN was unable to sustain these lows, however, due to the government's intent to accumulate more foreign currency reserves. The market took this news as meaning that the Banco de Mexico would be purchasing U.S. Dollars, and effectively strengthening the USD/MXN currency pair. Also, the rapid Peso appreciation could be somewhat concerning as a stronger Peso makes Mexican exports less competitive, and the country is still attempting to recovery from its deep recession. Thus, USD/MXN still runs the risk of drifting back into its previous range, where it traded between 12.5000 and 14.0000. Conversely, we believe that Peso strength is warranted and that USD/MXN should continue to create fresh lows. As the U.S. economy shows improvements in consumer and employment data, Mexico will profit because the U.S. is the largest purchaser of their exports. Also, inflation pressures in Mexico could influence the central bank to raise interest rates, adding to Mexico's yield appeal. Since violating 12.4000, USD/MXN has no real strong support. The recent fall settled around 12.3000, so we will monitor this level to see if it can stick.

For more information, contact your Foreign Exchange Professional at:

Foreign Exchange

Boston Sales Desk	Chicago Sales Desk	Cleveland Sales Desk	New York Sales Desk	Seattle Sales Desk
800.539.3679	800.539.3679	800.990.7647	800.539.3679	800.304.1402