

KING & SHAXSON

At the tail end of 2011, breakeven inflation rates generally around the globe rose, mainly as a result of the move higher in oil prices and the more positive tone in the equity markets.

UK

In the UK, this has been exacerbated to a certain extent by a lack of supply in index-linked gilts over the past few weeks. Inflation has been stubbornly high for a long time but is set to fall sharply this year, reflecting base effects, including last year's VAT increase and commodity price rises dropping out of the annual comparison and slightly stronger sterling.

Given this likely fall in UK inflation, UK breakevens appear to be a little high (see 10 year BEIR graph below). However, there appears to be a good correlation between UK BEIRs and the UK equity market. Should the current strength of equities be maintained, then we should be able to sell breakevens at higher levels e.g. selling 10 year breakevens at nearer 2.9% compared with the current 2.74% (see 10 year BEIR graph below).

As for the breakeven curve, we feel that 50bps between 10s/30s in the UK appears to be a little steep i.e. 2.74% (10yr) to 3.24% (30yr). On that basis, when the time is right to buy breakevens, we would favour the longer end.

EU

We feel that breakevens in the eurozone are at the moment fundamentally too low, given the ECB's target range of "below but close" to 2%. This would suggest a long run equilibrium breakeven of about 2.25%. This compares with the current 10 year breakeven (DBRi 3.75% 2020 v DBR 3.25% 2020) in Germany of 1.67% and 1.98% (FRTR 2.1% 2023 v FRTR 4.25% 2023) in France. see figures below.

Although a meaningful resolution of the eurozone problems does not look imminent, to say the least, over time German breakevens should revert back to at least 2%. From a French perspective, the recent reports of President Sarkozy's idea of "social VAT" in his annual presidential address will have the effect of increasing the standard rate of VAT of somewhere between 2% - 4%. If you are holding French conventional bonds, consider buying French breakevens at these levels.

UK 10 Year Breakeven Rate

GRAB 99<GO> to exchange issues. Use FIT to execute this Swap/Switch: SST<GO>

SPREAD SUMMARY	HSET SELL 1000	1457 BUY HSET	DIFFERENCE	RATIO
	UKTI 1 11/22/22	UKT 4 03/07/22	Buy-Sell	Sell/Buy
PRICE	128.400000	117.450000	-10.9500	1.0932
YLD Cnv/Semi/Ann/InC	-0.64589	2.08321	2.72910	-0.3100
ACCRUED INTEREST	0.26786	1.40659	1.13874	.1904
PRICE +ACCRUED	128.66786	118.85659	-9.81126	1.0825
	Yield Beta: 1.0			
DURATION	9.9958	8.4968	-1.4991	1.1764
ADJUSTED DURATION	9.7728	8.4092	-1.3636	1.1622
RISK MEASURE	14.5638	9.9949	-4.5689	1.4571
CONVEXITY	1.0544	0.8345	-0.2199	1.2635
SETTLEMENT DATE	1/13/12	1/13/12		
WORKOUT DATE/PRICE	Mrst11/22/22 100	Mrst 3/ 7/22 100		

SPREAD HISTORY

1/12/11 to 1/12/12

Yields : 5 Decimals

HI 3.302
AUG 2.925
LO 2.501

14JAN11 11FEB 11MAR 8APR 6MAY 3JUN 1JUL 29 26AUG 23SEP 21OCT 18NOV 16DEC
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2012 Bloomberg Finance L.P.
SN 633818 H381-219-1 12-Jan-12 8:28:39 GMT+0:00

Source: Bloomberg

	UK		US		FR		GER	IT		CAN		SWE	AUS	NZ
	10Y	30Y	10Y	30Y	10Y	30Y	10Y	10Y	30Y	10Y	30Y	10Y	10Y	7Y
IL BOND	1.875%22	.625%42	0.625%21	2.125 41	2.1%23	3.24%29	1.75%20	2.1%21	2.55%41	4.25%21	2%41	0.25%22	3%25	4.5%16
REAL YIELD	-0.66	-0.12	-0.16	0.71	1.33	1.60	-0.18	5.41	4.60	-0.18	0.36	0.13	1.29	0.97
RPI/CPI	5.16	5.16	3.40	3.40	2.50	2.50	2.40	3.70	3.70	2.90	2.90	2.80	3.50	4.60
TOTAL RETURN	4.50	5.04	3.24	4.11	3.83	4.10	2.22	9.11	8.30	2.72	3.26	2.93	4.79	5.57
12MTH HEDGE			0.40	0.40	0.79	0.79	0.79	0.79	0.79	-0.29	-0.29	-0.79	-3.11	-1.98
TOT.RET. £	4.50	5.04	3.64	4.51	4.62	4.89	3.01	9.90	9.09	2.43	2.97	2.14	1.68	3.59
CONV BOND	4%22	4.5%42	2%21	3.125%41	4.25%23	5.5%29	3.25%20	5%22	5%40	3.25%21	4%41	3.5%22	4.75%27	6%17
YIELD	2.09	3.09	1.92	3.00	3.32	3.74	1.50	6.81	6.93	1.94	2.51	1.64	4.18	3.34
SIMPLE BEIR	2.74	3.21	2.08	2.29	1.99	2.14	1.67	1.39	2.33	2.12	2.15	1.51	2.89	2.37

Note : All yields have been annualised.

Denzil Morgan - Director of Marketing - King & Shaxson Limited - denzil.morgan@kasl.co.uk - 020 7929 8482

The information used here is obtained from sources that we consider to be reliable but its accuracy and completeness cannot be guaranteed. The opinions and conclusions contained are those of King & Shaxson Limited. ("K&S"), and are subject to change without notice. No responsibility is taken for any losses, including any consequential loss, which may be incurred by acting upon such recommendations or information.

Whilst all reasonable care has been taken to ensure that the facts stated herein are accurate and that the forecasts opinions and expectations contained herein are fair and reasonable, neither the author nor K&S has verified the information contained herein and accordingly none of the author, K&S nor any of their respective directors, officers or employees makes any representation or warranty, express or implied as to the accuracy or completeness of the information or opinions contained herein and shall not be in any way responsible or liable for the contents hereof and no reliance should be placed on the accuracy, fairness or completeness of the information contained in this document. No person accepts any liability whatsoever for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith. Nothing in this paragraph shall exclude liability for any representations or warranties made fraudulently. The material does not attempt to describe all the economic, political, competitive and other factors that underlie any estimates, forecasts, or opinions, or potential changes that could affect the assumptions on which these estimates, forecasts and opinions are based. K&S makes no representation that the information is current. In particular, but without limiting the preceding sentence, statements of fact or opinion regarding securities, investments, financial products, companies, markets, territories or particular circumstances may not be up-to-date or may not represent the current opinion of K&S.

Any opinions, forecasts or estimates herein constitute a judgment as at the date of this report. There can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. This information is subject to change without notice. It may be incomplete or condensed and it may not contain all material information concerning the Company.

This document does not constitute or form part of and should not be construed as any offer for sale or purchase of (or solicitation of or invitation to make any offer to buy or sell) any securities nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

The information contained in this transmission is legally privileged and confidential information intended only for the use of the individual or entity named above. If the reader of this message is not the intended recipient you are hereby notified that any dissemination, distribution or copy of this facsimile or any parts of it is strictly prohibited. If you have received this facsimile in error, please notify us immediately by telephone +44 (0)20 7426 5950 and speak to Compliance).

King & Shaxson Capital Limited Reg. No. 2863591 and King & Shaxson Limited Reg. No. 869780, members of the London Stock Exchange, and King & Shaxson Asset Management Limited Reg. No. 3870667. The Registered Office for all companies is 6th Floor, Candlewick House, 120 Cannon Street, London, EC4N 6AS. All companies are registered in England and are part of the PhillipCapital Group.

King & Shaxson Capital Limited (FSA Reg. No. 169760), King & Shaxson Limited (FSA Reg. No. 179213), and King & Shaxson Asset Management Limited (FSA Reg. No. 193698) are Authorised and Regulated by the Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS.