From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

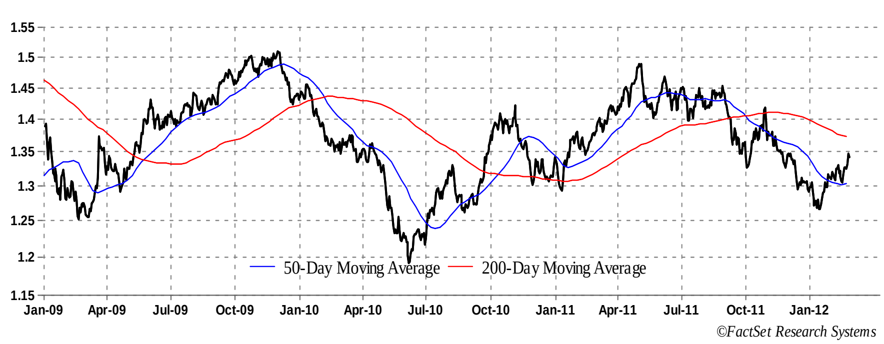
Oil Rises, Yen Weakens and Euro Stabilizes

- **Oil prices have risen about 10% so far this year. We believe this is more a function of fears of an Israeli strike against Iran than a significant change in the supply/demand balance.** We are oil and energy bulls, and we believe that the long-term supply demand dynamics will drive prices higher in the long run. However, we do not expect conflict in the Middle East to prompt a return to $150 per barrel oil in 2012. Israel does not currently have either the capacity or US support to launch a successful unilateral strike, in our view. We see Iran as a rational, astute political player that has no desire for a war with the United States or Israel before reaching nuclear parity. This was made evident in mid-February as the USS Abraham Lincoln Carrier Strike Group sailed through the Strait of Hormuz in direct defiance of Iranian warnings not to do so. The Iranians decided to do nothing, suggesting to us that their bark was louder than their bite.

- A $10 per barrel increase in oil prices adds roughly $0.30 per gallon to gasoline prices over time. We've observed that consumers can tolerate a trend of rising oil prices, but they react to price spikes. When gasoline prices spiked in 2008, $4 per gallon was the tipping point for consumer behavior – we believe $4 gasoline equates to oil prices between $120 and $130 per gallon. WTI crude oil (West Texas Intermediate) ended last week at $110 per barrel. In 2008, as oil rose to $150 per gallon, energy companies held gasoline prices at around $4 per gallon, causing profit margins to suffer. We will become more cautious about both energy companies and the economy if WTI oil prices rise over $120 per barrel.

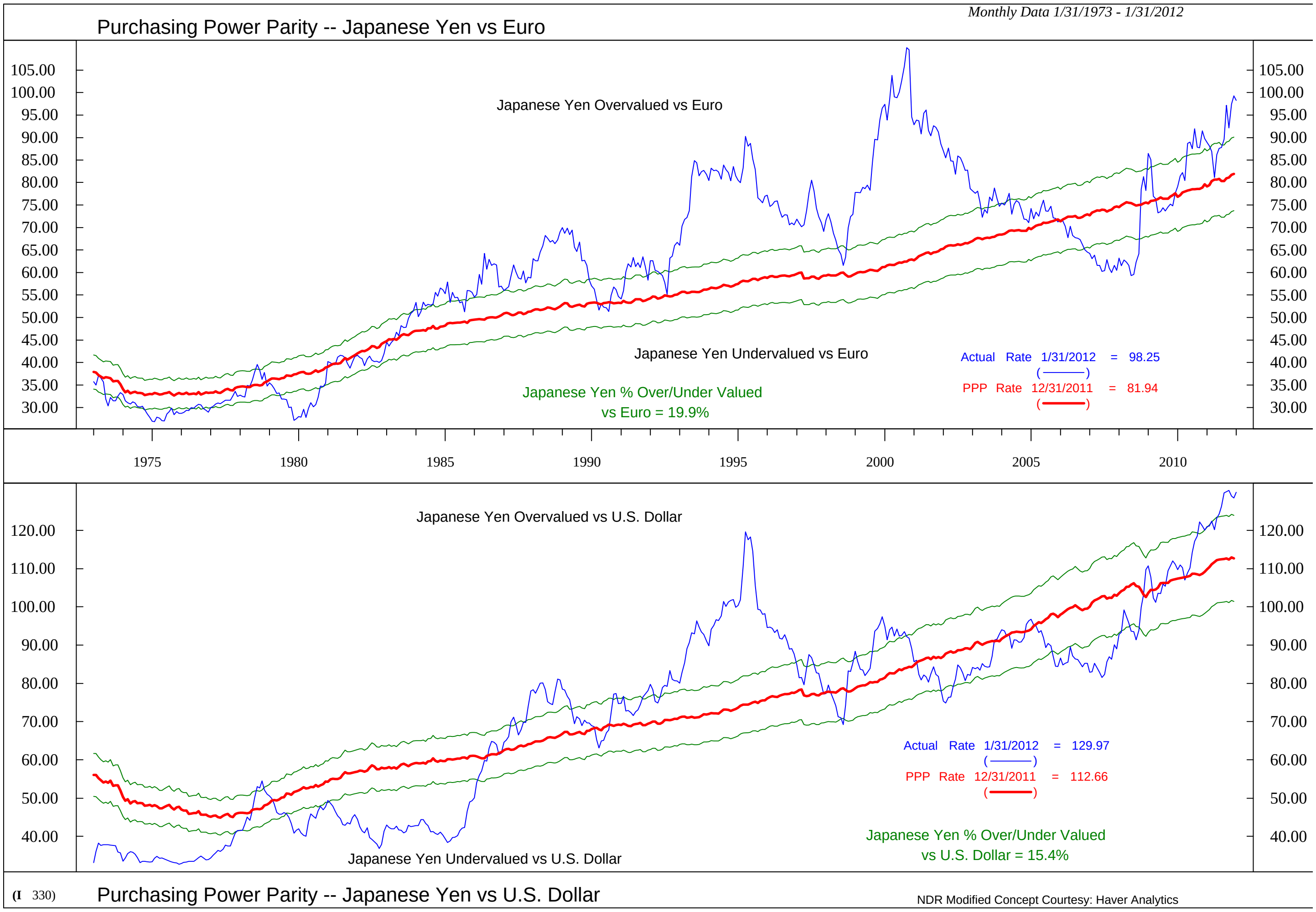
- **We are changing our euro view from 'sustained weakness' to a 'trading range around current levels'.** It has become increasingly clear that the 2010 and 2011 periods of significant euro weakness were more related to fears of a euro break up rather than European Central Bank (ECB) money printing. With the ECB willing to aggressively support European banks through its three-year loan program, and as other central banks try to weaken their currencies, we expect the euro to trade mostly between $1.25 and $1.45 to the euro.

U.S. Dollar per Euro



We see the latest Greek deal as a time-buying tactic and expect private sector Greek bond holders to get less than the agreed 50% haircut, as official creditors (mainly the ECB) negotiate their losses and demand protection. We think the bond holders are expecting an orderly write-down of Greece's debt. Thus, while we still think a Greek exit from the euro is a realistic probability, we do not see it as the catalyst for contagion – the euro's future lies with Spain and Italy, not Greece, in our view. The decreasing likelihood of systemic risk in Europe prompted us to sell our position in long-term US Treasuries last week.

THE WEEKLY CHART: THE YEN IS OVERVALUED



The strong yen has been hurting Japan's export economy for several years and, in terms of purchasing power, the yen is overvalued against both the euro and the dollar, as illustrated in the chart above. Recently, the Bank of Japan increased its rhetoric about setting a positive inflation target after 13 years of deflation. We will judge Japan by its actions and not its words, but we think a 20% decline in the yen would be a significant boost for Japan's manufacturing sector, as well as its whole economy. Such a decline would require much more determination from Japan's policymakers than seen in the past. While the yen is has started weakening on that hope, we need further evidence of currency depreciation and higher prices before we add exposure.