Crude Oil (since 1/03) hit $57/bbl in March

- Non-Deliverable Forwards (NDF) are for currencies where there is no orderly forward market. Find out how they can be used against a possible CNY revaluation. (p. 2)

- In the aftermath of the Fed Statement hinting kindling inflationary pressures, the yield curve, swap spreads, and volatility reacted strongly. (p. 3)

- Keep investments in shorter maturities despite current higher yields, as market is still looking for further tightening. …. 4.0~ 4.50% Fed Funds target by early 2006….? (p. 4)
FOREIGN EXCHANGE:
Non-Deliverable Forwards

While FX forward contracts protect buyers and sellers of foreign currencies by locking in a rate today for future delivery, not all currencies have freely tradable forward markets. This is especially true in emerging markets currencies such as Argentina or Brazil and restricted currencies such as China and Taiwan. In many instances, the most volatile currencies in the world are often also those without active and open forward markets, leaving companies that do business in those countries exposed to unpredictable exchange rates. In situations in which access to forwards are nonexistent or restricted, Non Deliverable Forward Contracts (NDFs) provide an efficient method to protect the dollar value of foreign currencies and reduce the inherent uncertainty of exchange rates.

Like standard forward contracts, Non Deliverable Forward Contracts fix exchange rates for conversion on a future date. But unlike forward contracts, there is no delivery of underlying foreign currency. Instead, the net US dollar is settled with a compensating payment made or due based upon the difference between the NDF contract rate and the exchange rate prevailing at maturity. Effectively, the NDF user is economically protected from exchange rate fluctuations by the compensating US dollar payment paid or received based upon the NDF fixed rate even though there is no exchange of foreign currency.

NDF Example*:
Company XYZ imports from China and is concerned about the effects a potential upward revaluation of the Chinese Yuan may have on its import costs. To protect itself, XYZ enters into an NDF contract per the following terms:

-Company XYZ buys CNY NDF
  - Amount: CNY 2,030,500
  - Rate: CNY 8.1220/USD
  - USD Amount: $250,000
  - Maturity: 6-months

The principal amount, maturity and corresponding NDF contract rate are set at the inception of the contract. The NDF contract rate varies by tenor and is based upon market conditions.

Two days prior to contract maturity, an exchange rate fixing reflecting the prevailing market spot rate is set to determine the net settlement of dollars. For the Chinese Yuan, the fixing rate is the Chinese Central Bank’s official published exchange rate. The fixing rates for NDF contracts are typically an official published rate or otherwise publicly available exchange rate and are stipulated in advance.

As mentioned earlier, no exchange of foreign currency occurs at maturity. Instead, the net settlement of dollars only is calculated with a compensating payment made or received by XYZ based upon the exchange rate fixing as follows:

**Scenario 1: CNY has appreciated vs. the NDF contract rate.** Fixing= CNY 8.00 (<8.1220 NDF contract rate).
⇒ XYZ receives $3,812.50
(CNY2,030,500/8.00 = $253,812.50 - $250,000).

XYZ is protected at the NDF contract rate of 8.1220 and receives a compensating dollar payment between the fixing rate at maturity and the NDF contract rate.

**Scenario 2: CNY has weakened vs. the NDF contract rate.** Fixing= CNY 8.25 (>8.1220 NDF contract rate).
⇒ XYZ pays $3,878.79
(CNY2,034,500/8.25 = $246,121.21 - $250,000).

XYZ is fixed at the NDF contract rate and makes a compensating payment equivalent to the difference between the fixing rate at maturity and the NDF contract.

List of available NDF currencies:

<table>
<thead>
<tr>
<th>Currency</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Argentina peso</td>
<td>Chinese Yuan</td>
</tr>
<tr>
<td>Brazil real</td>
<td>Indonesian rupee</td>
</tr>
<tr>
<td>Colombia peso</td>
<td>Korean won</td>
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<tr>
<td>Chile peso</td>
<td>Malaysian ringgit</td>
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<tr>
<td>Peru Sol</td>
<td>Philippine peso</td>
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<tr>
<td>Taiwan dollar</td>
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</table>
**Market Summary:** The FOMC and inflation data during March brought out the bears (in prices) in the bond market as Treasury yields broke major technical levels across the board. Despite the Fed keeping the “measured” language in their statement, they still managed to take the market by surprise by stating that they were concerned that “pressures on inflation have picked up in recent months, and pricing power is more evident.” The core CPI inflation rate rose again for the sixth consecutive month, at 0.3%, pushing the YoY rate up to 2.4% from 2.3%. Back in August of last year, the core CPI inflation rate was 1.7%. The futures markets is pricing in a 50% chance that the Fed will raise rates 50bp at the next May 3, FOMC meeting. By year-end, the market is pricing in that Fed Funds will be at 4.25%.

**Swap Rates:** The interest rate swap market was awash with flows after the FOMC announcement and the release of the CPI data. Most of the trades were from panic trading and from participants making final adjustments to their portfolios for quarter end. Yields on the 10-year Treasury note rose as high as 4.67%, before closing at 4.51% on March 31.

The swap curve resumed its flattening trend with the 2s - 10s falling below the key 80bps level again. Look for chances that it may break below 70bps in the near future (see chart below).

**Volatility:** Implied volatility had been drifting lower going into the FOMC meeting, and softened further initially, as the market breathed a sigh of relief that the words, “measured”, and “accommodative” were still present in the statement. However, as the sell-off in the 10-year T-note continued, volatility rose, reaching higher levels we saw at the end of last month. The fundamental picture for longer-dated volatility has not really changed, but there have been some speculative players as of late, selling on the up-tick, with corporates still on the buying side (see chart below).
As expected, the Federal Reserve raised overnight fed funds target by 25bp to 2.75% (see chart on right). In the accompanying statement, they continued to say they would raise rates at a “measured pace” and describe monetary conditions as “accommodative.” However, they added, “pressures on inflation have picked up.” This suggests that the Fed is farther away from describing monetary conditions as “neutral”. The market’s focus has shifted from labor market conditions to inflation (CPI). Most analysts believe that this means we could have an overnight fed funds rate between 4.00 - 4.50% by early 2006, requiring 5 to 7 more Fed rate hikes in the future. The next FOMC meeting is on May 3 where they will most likely raise overnight rates another 25bp to 3.00%. Some hawks, however, look for either a 50bp hike or even an interim meeting, should inflationary pressures accelerate.

In early March, it was announced that the top four accounting firms decided that corporations should classify Auction-Rate Securities as investments instead of cash equivalents. As a result, there were a few days of some concern, spreads widened out to around 20bp cheaper on Auction Rates versus Commercial Paper. There have been no reports of extreme selling pressure, and generally few problems as a result of the reclassification.

Currently the two-year Treasury Note is yielding 3.90%; 38bp higher than the last time the Fed met and raised rates. The ten-year Treasury Note is yielding 4.64%, 37bp higher than the last Fed meeting.

Even though the economy faces the challenge of higher energy prices and interest rates, robust growth is the most likely outcome. Though productivity growth is slowing and may fall below its trend, it is and will likely remain solid by historical standards. Consequently, core inflation should reach and peak out between 2.5 - 3%.

This means that inflation surprises are likely even though a lot of bad news has been priced into the bond market. This scenario should continue to push yields even higher. A fair target for the two-year Treasury Note should be 4.125-4.375% (see chart on right) and 4.875-5.125% for the ten year Treasury Note.

Investors should continue to remain defensive, concentrating their purchases with short maturity, higher credit securities like Treasury Bills, Agency Discount Notes and higher rated commercial paper. As long rates rise, investors should shift their purchases further out the yield curve “locking in” those yields. Treasury Notes, Agency Debentures and highly rated corporate debt are good vehicles for this strategy.

**2 yr T-Note yield History (since 1/1/04)**

**Short-term interest rate history (from 1/1/90 to now)**

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Camee Lewis
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