



### Review

In April, the broad fixed income market as measured by the Barclays Capital Aggregate Index posted a total return of 1.11%. All major fixed income spread sectors, with the exception of asset-backed securities, underperformed duration-equivalent Treasuries as renewed anxiety over the European debt crisis came to the fore.

The securitized sector posted -24 bp of excess return, mostly attributable to the agency mortgage-backed sector (MBS) which lagged Treasuries by -24 bp. Wider swap spreads, and heightened refinancing risks due to policy changes that have made it easier for homeowners to refinance contributed to the underperformance. The commercial mortgage-backed sector (CMBS) lagged Treasuries by -21 bp; however, the sector has a firm tone as reflected by the ease with which the market absorbed the Federal Reserve's auction of a \$7.5 billion senior CDO bond collateralized by CMBS from the Maiden Lane III portfolio. In a reversal from earlier months, higher-rated and shorter-maturity tranches outperformed subordinate and longer-maturity tranches. Persistent strong-demand for short maturity/high quality assets continue to benefit the asset-backed sector (ABS) which modestly outperformed duration-equivalent Treasuries by +8 bp.

The U.S. credit index widened 9 bp during the month as risk aversion came back in vogue, resulting in -50 bp of underperformance. Sector excess returns were evenly distributed: industrials -52 bp, utilities -39 bp, and financials -44 bp. The sell-off was evident across the credit-quality spectrum as well, Aa-rated -45 bp, Baa-rated -55 bp. The high yield sector held up much better with an underperformance of only -5 bp. In this "risk-off" environment, Treasury

yields fell by 7 to 30 bp with intermediate to longer maturity yields declining the most. As a result, the 2-year/30-year Treasury yield differential narrowed 14 bp to 286 bp.

The non-dollar markets were confronted with an increasing number of countries in Europe entering double-dip recessions, while economies in Asia were slowing down. However, most developed country bond markets underperformed the U.S., with the exception of Australia, as risk-aversion re-emerged. Heightened expectations for the Reserve Bank of Australia to embark on a credit easing path to counteract the sharp economic slowdown resulted in a significant narrowing in Australian/U.S. yield spreads as 2-year government yields in Australia dropped by almost 50 bp for the month. On the other hand, yield differentials (versus the U.S.) widened by 17 to 20 bp for the United Kingdom, Canada, Germany and Japan. The U.S. dollar index declined modestly by -0.3%. The Japanese yen led the advancers, strengthening by 3.8%, while the British pound and the Canadian dollar strengthened by 1.4% and 1.1% respectively. The euro, reflecting the crisis in Europe, declined by -0.8% against the U.S. dollar. Although the Australian dollar gained 0.8%, the New Zealand dollar remained flat for the month.

### Outlook

Following a string of better than expected economic data over the past few months, recent indicators have been mixed. Although the April unemployment rate ticked down to 8.1%, non-farm payrolls for the month increased a disappointing 115,000. Even with upward revisions to prior months, employment gains over the past two months have averaged 135,000, a sharp deceleration

compared to the prior 3 month average of +252,000. However, U.S. vehicle sales (14.4 million on an annualized basis) are on a firm trend, while “core” retail sales (ex-vehicles, gasoline and building materials) also reflect an improving environment. Manufacturing and service sector surveys have diverged, as strength in manufacturing (fastest pace in almost a year) continues to lead the economy, while the service sector report was less robust. Risks remain for the global markets. These include the on-going European sovereign debt crisis, the tension in the Middle East related to Iran’s nuclear weapons ambitions, and slowing growth in China. On the fiscal front, election year politics in the U.S. are causing uncertainty about how the record budget deficit will be effectively addressed, and the consequence of the impending fiscal cliff. Although the likelihood of a recession in the U.S. has diminished significantly, the Federal Reserve has reiterated its commitment to keep the interest rate it controls close to zero until late 2014 due to the risk of contagion from Europe, continued weakness in the housing market and a still elevated unemployment rate. Furthermore, the Federal Reserve has not ruled out further expansion of its balance sheet through asset purchases if the economic outlook worsens.

While originations have picked up on an increase in refinance activity, net supply is flat. The Federal Reserve’s additional sponsorship has tilted the supply/demand balance in favor of MBS. Mortgage prices remain at levels empirically associated with considerable negative convexity. Additionally, while HARP 2.0 could have a modest impact on prepayments, prepayment speeds are benign by historical standards as a large part of the mortgage universe is credit-impaired with limited ability to refinance even as rates linger at historical lows. With the Fed on extended hold, carry trades remain in vogue. We generally have a positive allocation bias to securitized products in our portfolios, particularly emphasizing CMBS, as our

analysis suggests the potential for material capital gains. Also, high-quality, liquid, short-duration consumer ABS provide an opportunity for yield enhancement as cash surrogates. In the credit sector, given the magnitude of the spread tightening from last year’s wide levels and still considerable macro uncertainty, reduced risk exposures are warranted. While credit fundamentals remain intact and market technicals are positive, issuer selection is becoming more critical as some issuers are shifting to more shareholder-friendly strategies. Voter backlash to the severe austerity measures being implemented in Europe is spreading, especially in the peripheral countries. As a result, there are increasing risks for a renewed bout of volatility as concerns resurface about the stability of some of the European debt markets.

Lastly, we remain underweight Treasuries and Agencies.