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Market Review and Outlook
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Review

In February, the broad fixed income market as measured by the Barclays Capital Aggregate Index was almost flat with a total return of -0.02%. All major fixed income spread sectors outperformed duration-equivalent Treasuries as stronger economic data coupled with the European Central Bank's second leg of its Long Term Refinance Operation (LTRO) helped bolster risk assets.

The securitized sector continued its recent winning streak, outperforming Treasuries by +51 bp. Buying by the Federal Reserve as well as demand from money managers, banks and REITs helped the agency mortgage-backed securities (MBS) sector earn +37 bp of excess return. Lower coupons lagged due to the decreasing likelihood of another round of quantitative easing by the central bank. The improved tone in the global markets led the commercial mortgage-backed (CMBS) sector to be one of the top performers in the Aggregate Index, earning +152 bp over Treasuries. The asset-backed (ABS) sector posted +24 bp of excess return in response to strong demand for short-maturity, high quality securities; new issue spreads are now at post-crisis tights. The U.S. credit sector continued to outperform the overall market as the sector's spread tightened by 24 bp, generating +157 bp of excess return. Financials led the way posting +189 bp, a third consecutive month of positive excess returns. The industrial and utility sectors also had a good month, with outperformances of +158 and +152 bp, respectively. Lower quality issues benefitted from improved investor risk appetite: AA-rated +93 bp, BBB's +211 and high yield +284 bp. Despite the strong performance for risk assets, Treasury yields only rose modestly by 8 to 17 bp across the coupon curve. The yield on the 10-year Treasury ended the month at 1.97%. The Treasury yield curve (as measured by the 2-year/30-year yield differential) steepened by 7 bp to 279 bp.

The European Central Bank's expansion of its balance sheet by more than $700 billion through a second loan facility for banks helped stabilize non-dollar (especially European) markets. Recession fears in Europe and additional monetary stimulus in Japan resulting in Germany and Japan outperforming the U.S. across the yield-curve. The U.S. dollar weakened against most developed market currencies. The Japanese yen was a notable exception, losing 6% versus the dollar. The euro recovered from its mid-month low of 1.29 to finish the month up 1.84%.

Outlook

Economic data releases for the U.S. are increasingly pointing to signs of a self-sustaining economic recovery. The February employment report showed an increase of 227,000 jobs, while the January increase was revised up to 284,000. Over the last six months, job growth has been the strongest since 2006. Auto sales in February came in at a 15.1 million annual rate, the highest since March of 2008, while chain store sales were up 7% year-over-year. However, there are risks to the global markets. These include the on-going European sovereign debt crisis, the rising 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. 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 and the recent FOMC statement re-affirming low rates until late 2014, 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, the high quality and liquidity that short-duration consumer ABS provide as cash surrogates make them attractive. In the credit sector, given the magnitude of the spread tightening and still considerable macro uncertainty, we have reduced our risk exposure, especially in the brokers and money center banks as well as some of the higher-beta industrials. Although earnings estimates are being lowered for non-financials, credit fundamentals are intact and spreads offer incremental carry over Treasuries. Issuer selection, as always, remains critical. In the non-dollar markets, despite improved sentiment, the elusiveness of a permanent and lasting solution to the debt crisis in Europe remains a risk over-hang.

Finally, we remain underweight Treasuries and Agencies.