# Market Review & Outlook

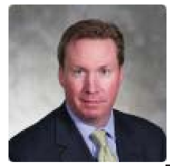
## 1st Quarter 2013

SMITH GRAHAM
HOUSTON • NEW YORK

## Highlights

- *Among the major developed countries, the U.S. is further along on the economic growth curve.*
- *Massive expansion of central banks' balance sheets has significantly increased inflation risks.*
- *We continue to maintain a positive bias to spread sectors.*


Cyril M. Theccanat
*Chief Investment Officer,*
*Co-head of Fixed Income*


Peter Heine
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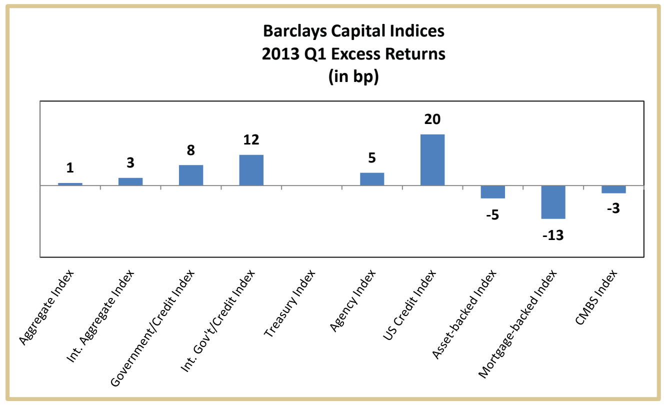
*Co-Head of Fixed Income*


## Review

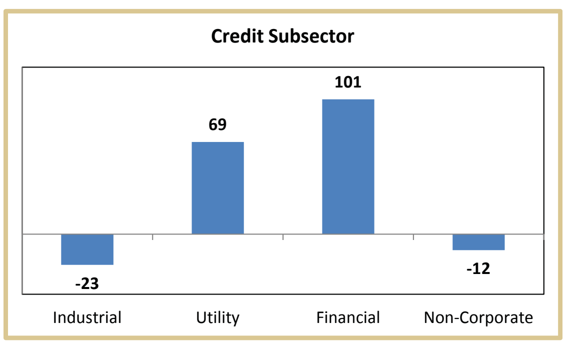
In the first quarter of 2013, the broad fixed income market represented by the Barclays Capital Aggregate Index posted a total return of -0.12%, its first negative return for a first quarter since 2006. Despite the "risk-on" environment, fixed income spread sector performance was mixed with only the U.S. credit and agency sectors generating modestly positive excess returns.

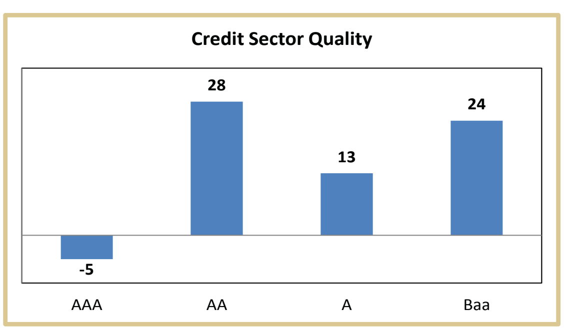
The securitized sector had a rather subdued first quarter as both swap spreads and sector spreads widened. The agency mortgage-backed securities (MBS) sector posted -13 bp of excess return. The weaker tone resulted from investor uncertainty regarding the continuation of the Federal Reserve's MBS purchase program, in terms of scale and timeline. Production coupon MBS, which constitute the bulk of the Fed's purchases, underperformed by more than -80 bp relative to higher coupons. Within the mortgage sector, GNMAs lagged their conventional counterparts on fading overseas demand. The commercial mortgage-backed sector (CMBS) modestly underperformed. Heavy new-issue supply pressured spreads, while seasoned senior bonds, which soon will be current payers, widened on prospects of refinancing and early liquidation of problem loans. Despite weakness at the top of the capital structure, lower-rated tranches outpaced their AAA counterparts as the need for yield prevailed. The asset-backed sector (ABS) finished the quarter with some softness. Performance within the ABS sector was mixed, as autos outperformed and cards/utilities underperformed.




Source: Barclays Capital

**2013 Q1 Excess Returns**
**(in bp)**




Source: Barclays Capital

In the credit sector, the option-adjusted spread (OAS) tightened as investors continued to search for yield. Similar to last year, financials were the top performer during the quarter earning returns well above those generated by the industrial and utility sectors.

During the quarter, lower credit-quality continued to outperform. Improved U.S. economic data led to marginally higher interest rates further out the yield curve. The yield curve as measured by the 2-year/30-year yield differential steepened by 16 bp to close the quarter at 286 bp.

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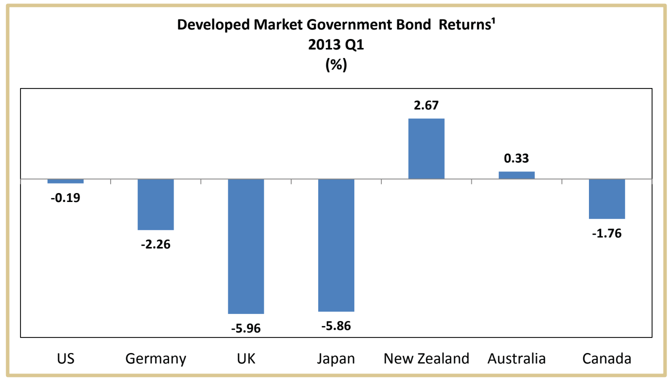
Most non-dollar developed-country bond markets outperformed the U.S. in the first quarter due to weaker economic growth relative to the U.S. Fears of a triple-dip recession in the U.K. narrowed interest rate differentials, versus the U.S. In Canada, slowing domestic spending coupled with significant excess capacity and inflation slowing more than expected has kept the central bank's monetary policy on an extended pause. Two and five year Canadian government bond yields ended the quarter 13 bp lower than corresponding U.S. government securities.

Continued economic weakness in the eurozone, underscored by a likely 6th consecutive quarter of economic contraction, pressured German yields lower. In Japan, expectations for aggressive measures to boost the Japanese economy caused long-maturity yields to drop sharply. Australia was the only region to underperform the U.S. Rising consumer confidence, increased spending and stronger employment growth pushed Australian government yields higher as investors anticipate the timing of monetary policy tightening by the Reserve Bank of Australia. Intermediate interest rate spread differentials versus the U.S. widened.

The foreign exchange markets reflected the better economic tone for the U.S. with the British pound and Japanese yen underperforming the U.S. dollar, while the Canadian dollar and euro lagged. On the other hand, the Australian and New Zealand currencies gained.

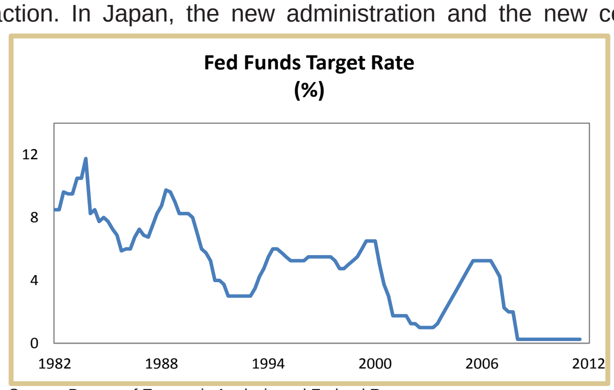



Source: Barclays Capital
[1]U.S. Dollar, Unhedged

## Outlook

Economic growth in the U.S. is tracking in the 2.5%+ area for the first quarter. While there are still some near-term legislative hurdles such as the negotiations to raise the national debt limit and to cut entitlement programs to bring down the budget deficit, the overall economic picture is somewhat upbeat. The housing market, which was one of the major drags on the economy over the past several years, is gaining traction. Corporations are likely to start spending the huge cash stockpiles built over the past few years as the uncertainty regarding tax policy has been lifted. This should offset the negative effects from fiscal policy (via the sequester) going into reverse. On the other hand, monetary policy will continue to be accommodative as the Federal Reserve has now provided quantitative metrics for the unemployment rate and inflation which would trigger a reversal of the Fed's ultra-accommodative monetary policy. The threshold for the unemployment rate is 6.5%, well above the current rate of 7.6%. Although our longer-term outlook for the Treasury yield curve is for a flattening, in the short-term, the front-end of the curve is likely to remain supported by the Fed's accommodative policy. As a result, further signs of improvement in the economy could steepen the yield curve with a negative impact on long maturity securities.

While weak economic growth in Europe will continue to be underpinned by an accommodative central bank (ECB), there are increasing signs that growth in Germany, the eurozone's largest economy, is gaining traction. In Japan, the new administration and the new central bank governor have pledged to break the decade-long grip that deflation has had on the economy through even more aggressive monetary and fiscal measures with a bold target of raising inflation to 2% in 2 years. These stimulative measures will be positive for global growth. The new leadership in China is likely to promote policies that will help sustain the recovery taking place in the world's second-largest economy. For the U.S., the confluence of these factors (domestic and international) could result in a year when the economy surprises to the upside.




Source: Bureau of Economic Analysis and Federal Reserve

While mortgage originations have picked up on an increase in refinance activity, net supply is essentially flat. Despite some ambiguity about the Federal Reserve's future sponsorship, and the ensuing volatility, the supply/demand balance still favors MBS. With the Fed on extended hold, it is our view that spread volatility will remain contained and selective high-quality carry trades retain the potential to add value to our portfolios. This is especially true in agency MBS, high quality CMBS and the short-duration, liquid consumer ABS sector which still offers attractive yields as a cash surrogate. Furthermore, selective lower rated tranches offer incremental yield and have potential to tighten further as structured product credit curves have room to flatten further on improving fundamentals. In credit, technicals remain positive for the sector and spreads offer attractive carry over Treasuries/Agencies. Issuer selection will be more critical going forward as expectations are for increased merger/acquisition activity as well as debt-funded dividend/share repurchases. Within the credit complex finance, cable and media remain attractive. The Federal Reserve has a benign outlook for inflation over the medium term. However, the explosive growth in its balance sheet (currently over $3 trillion from just $700+ billion before the financial crisis), and the significant expansion in the balance sheets of other major central banks have materially increased inflation risks. Consequently, Treasury Inflation Protected Securities (TIPS) are attractive despite their negative real yields.

Among the major developed countries, the U.S. is further along on the economic growth curve. The U.K. faces the threat of a triple-dip recession, while the eurozone remains mixed in a recession. The dramatic quantitative easing efforts by the Bank of Japan have moved monetary policy further into uncharted waters. Even the natural resources-rich Canadian economy has slowed down to a year-over-year growth rate of just 1%, the slowest in four years. As a result, the U.S. dollar is likely to remain firm in the near to medium term with higher volatility in the non-dollar markets.

Lastly, our portfolios have a positive bias to spread sectors.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