Market Review & Outlook
1st Quarter 2014

SMITH GRAHAM
HOUSTON • NEW YORK

Cyril M. Theccanat

Chief Investment Officer
Co-Head of Fixed Income

Peter A. Heine

Senior Portfolio Manager
Co-Head of Fixed Income

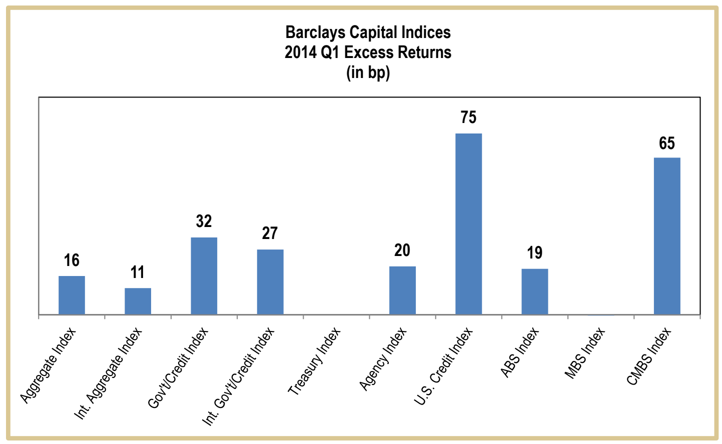
Highlights

- *Underpinnings for U.S. economy are improving following bad weather-induced economic weakness earlier.*
- *Despite explosive growth of central banks' balance sheets, inflation remains no-show across the developed economies.*
- *Massive shadow banking system and escalating debt levels in China pose risk to global economic growth.*

Review

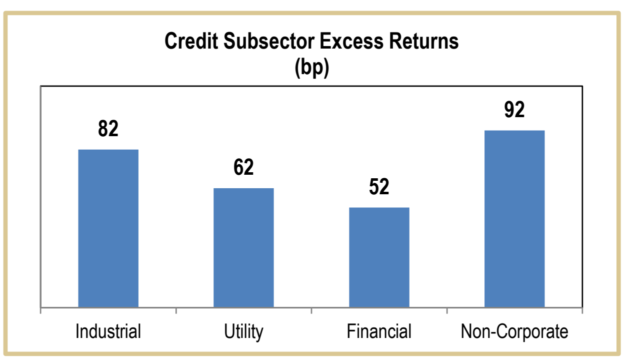
In the first quarter, the broad fixed income market as represented by the Barclays Capital Aggregate Index posted a 1.84% total return, as weaker economic data (primarily bad weather-related) resulted in lower yields. Despite the decline in Treasury yields, most spread sectors outperformed duration-equivalent Treasuries.

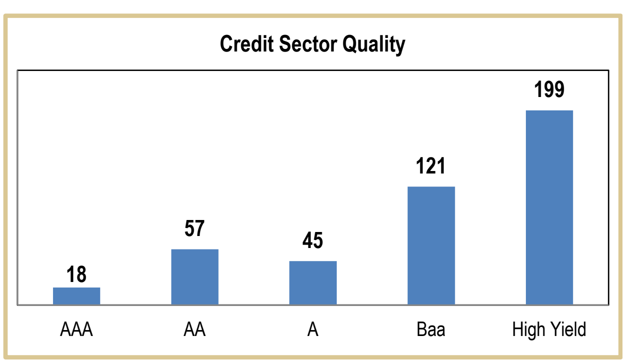
The securitized sector started the year on a rather uninspiring note, lagging Treasuries. Although modestly wider swap spreads had a negative effect, sector underperformance was primarily attributable to the agency mortgage-backed securities (MBS) sector. A continued reduction in the Fed's purchase of MBS weighed on the sector. Within the MBS sector, the Freddie Mac program experienced a technical bounce and outperformed Fannie Maes. 15-year mortgages held up better, while 30-year MBS lagged. Spreads tightened in the commercial mortgage-backed sector (CMBS) enabling it to outperform Treasuries. Investor demand remained firm after several new issue deals were oversubscribed, while secondary market activity pushed seasoned CMBS spreads tighter. Supply remains a positive technical factor as issuance has been less than investors anticipated. Lower-rated tranches outperformed their AAA counterparts. In the high-quality segment, seasoned shorter maturity tranches performed the best. Within the asset-backed (ABS) sector, performance was also good. Credit trends across the ABS market remain favorable. New issues priced at or through guidance, driving secondary spreads tighter; however, wider swap spreads offset some of the tightening. Auto ABS were the best performers.



Source: Barclays Capital

2014 Q1



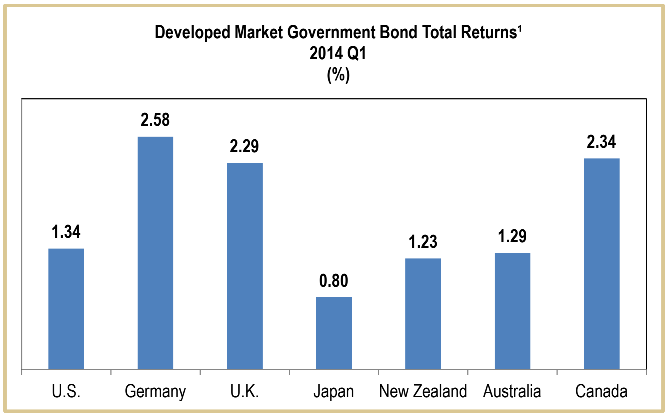


Source: Barclays Capital

In the credit sector, the option-adjusted spread (OAS) tightened 8 bp. Industrials led the way, although utilities and financials also outperformed. In credit, the long-maturity finance sector was the lone underperformer. With the pronounced flattening of the Treasury yield curve, credit curves steepened by 8 bp.

As expected in this "risk-on" environment, lower credit-quality issues outperformed their higher-rated counterparts: Aa-rated +57 bp, A-rated +45 bp, Baa-rated +121 bp and high yield +199 bp. Shorter maturity Treasury (2-year and 3-year) yields actually rose during the quarter while 10-year and 30-year yields fell by 30 - 40 bp. As a result, the yield curve, as measured by the 2-year/30-year yield differential, flattened 45 bp to end the quarter at +314 bp.

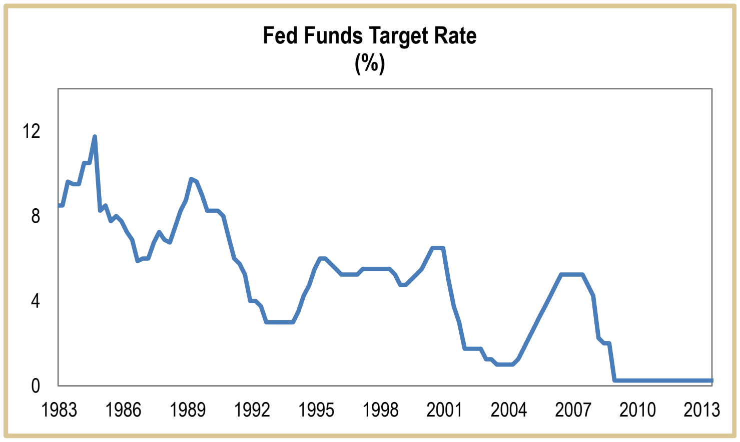
Performance in non-dollar developed markets was mixed. Stronger than expected economic data in the U.K. pushed short to intermediate U.K. government yields higher. As a result, yield differentials versus the U.S. widened. On the other hand, sub-par economic growth in other developed countries/regions such as Canada, Europe, and Japan resulted in lower government yields in those markets. Currency performance was also mixed for the quarter. While the Canadian dollar declined by almost 4% against the U.S. dollar, most other currencies were little changed (the British pound and the euro) to higher by 2% to 5% (yen and New Zealand dollar).



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

Outlook

Although the U.S. economy began the year on a weak note, this was driven by the unusually harsh winter weather across the country. In the December/January period, the average monthly jobs gain was just 114,000. But for the last two months of the first quarter, the monthly average increased to 195,000. The underpinnings for the U.S. economy are improving. The current unemployment rate of 6.7% is near a 6-year low, while the weekly jobless claims figures are at a 7-year low. Improving consumer sentiment and stronger spending are reflected in the 16.3 million annualized rate for auto sales which is a 7-year high. Increasing economic traction is likely to result in a 3+% GDP growth in the second half of this year. Economic growth has also picked up outside the U.S. laying the foundation for a synchronized global expansion. The International Monetary Fund (IMF) sees global growth becoming stronger and more broad-based. As a result, Treasury yields are likely to move higher in 2014. A sub-3% 10-year yield would not be consistent with the global growth picture that is unfolding. There is a risk that the Federal Reserve, and other central banks, may fall behind the monetary policy curve as economic growth surprises to the upside. A defensive interest rate exposure profile is warranted for fixed income portfolios this year.



Source: Bureau of Economic Analysis and Federal Reserve

While the Fed's $15 billion reduction in monthly MBS purchases has had a negative effect, the MBS sector, in the near-term, remains firm since mortgage originations have slowed down. However, we expect the basis to come under pressure as the Fed comes closer to ending its asset purchase program. The CMBS sector continues to recover with property performance improving as the economy grows. Additionally, the sector is currently cheap to corporates. In the ABS sector, selective lower-rated tranches offer incremental yield and have the potential for spread tightening as credit enhancement builds with deal seasoning. One risk for the securitized sector is a widening in swap spreads from the current tight levels if Treasury yields rise abruptly. Corporate bond spreads across the credit spectrum are back to pre-crisis levels. Our risk/reward analysis points to an underweight position in the credit sector. S&P 500 operating margins are at or near record highs, and companies are rewarding shareholders at the expense of bondholders by issuing debt to fund shareholder returns.

While the explosive growth of the Federal Reserve's and other central banks balance sheets has increased future inflation risks, inflation remains a no-show across much of the world due to continued economic slack.

One of the risks in 2014 is the massive shadow banking system in China, estimated to be equivalent in size to more than half of China's total economy. The credit explosion in China, at the corporate and local government level, has greatly increased the country's debt service ratio to dangerous levels. Although economic growth has picked up globally, growth differentials continue to favor the U.S. which should serve to underpin the U.S. dollar.

For additional Information, please contact:
Faith Stevenson, Managing Director · (212) 487-5073
Lynda DiBari, Director · (212) 487-5104
Marcus Smith, Vice President · (713) 292-2114