Market Review & Outlook
4th Quarter 2013

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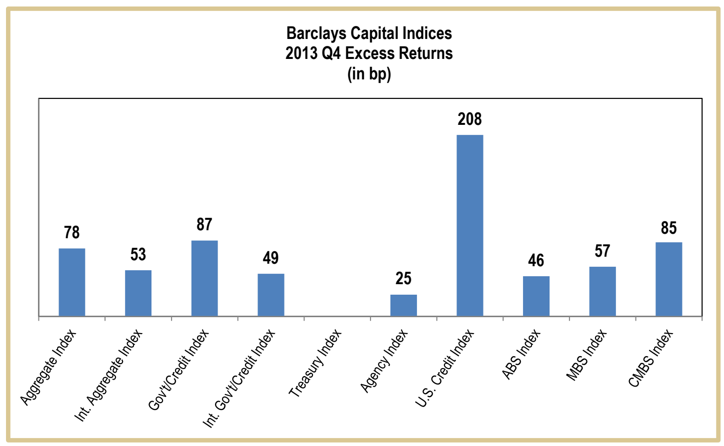
Highlights

- *All major fixed income spread sectors outperformed in Q4.*
- *10-year Treasury yield below 3% not consistent with unfolding synchronized global growth picture.*
- *Economic growth differentials continue to favor the U.S. and will underpin the U.S. dollar.*

Review

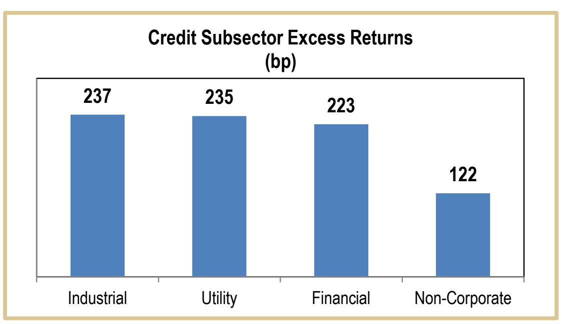
In the fourth quarter, the broad fixed income market as represented by the Barclays Capital Aggregate Index posted a total return of -0.14%. The "risk-on" environment persisted through the quarter as improved economic data outweighed the potential for the Federal Reserve to begin tapering earlier than the consensus view of the first quarter 2014. The 10-year yield breached the 3.00% level closing the year at 3.03% on the last trading day of the year. Given this backdrop, all major fixed-income spread sectors outperformed duration-equivalent Treasuries for the quarter.

The securitized sector had a good quarter. Overall, the sector benefitted from tighter swap spreads, carry, and lower realized volatility. The agency mortgage-backed securities (MBS) sector outperformed duration-equivalent Treasuries due to convexity demand and continued limited issuance. This outperformance arose despite the Fed taper announcement in mid-December that it would reduce its monthly MBS purchases to $35 billion from $40 billion beginning in January 2014. Leading the outperformance were the higher coupons as they benefited from investors shifting into shorter duration mortgages. The commercial mortgage-backed sector (CMBS) beat Treasuries. The sector profited from strong investor demand despite the heavy new-issue calendar. In fact, 2013 saw the highest new issuance since the financial crisis. Seasoned CMBS spreads kept pace with the primary market due to the on-going search for yield. Tighter spreads also enabled subordinate bonds to outperform their AAA counterparts. Activity was rather subdued within the asset-backed sector (ABS); however, spreads remained firm as persistent solid demand for short maturity assets continued to benefit the sector, which outperformed duration-equivalent Treasuries. ABS new issue volumes fell short of 2012 levels; yet, it was the second most active year since the financial crisis.



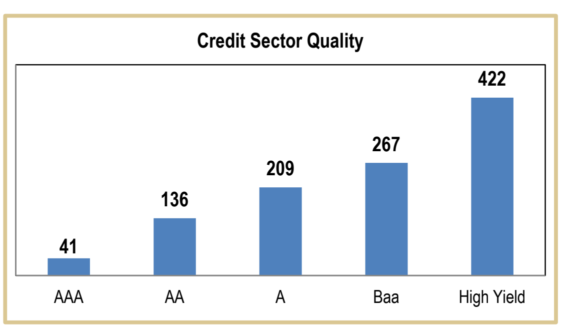
Source: Barclays Capital

2013 Q4



Source: Barclays Capital

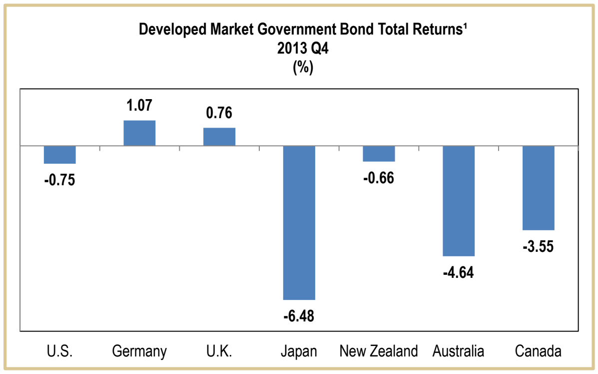
Performance was strong across credit sub-sectors: Industrials +237 bp, Utilities +235 bp and Financials +223 bp. The credit curve flattened as longer-maturities tightened more than their intermediate counterparts.



Source: Bloomberg

As expected in this "risk-on" environment, lower quality issues outperformed higher credit-quality: Aaa-rated +41 bp, Aa-rated +136 bp, A-rated +209 bp, Baa-rated +267 bp and high yield +422 bp. The 2-year yield remained fairly well-anchored, only rising 6 bp to 0.38%, whereas intermediate yields rose +40 bp and long yields increased +28 bp. The yield curve, as measured by the 2-year/30-year yield differential, steepened +22 bp to end the year at +359 bp.

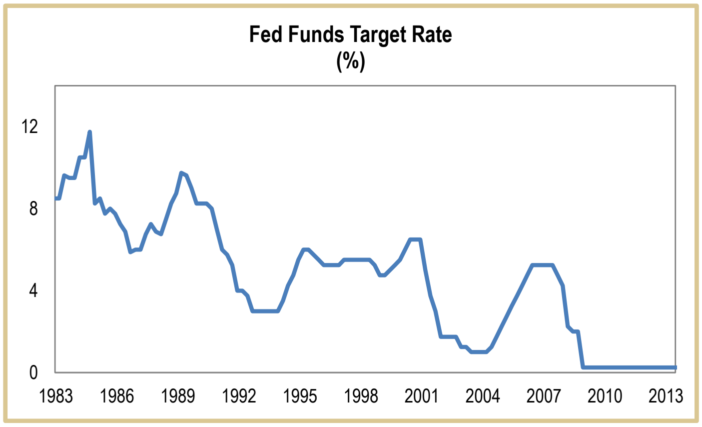
Most developed-country bond markets outperformed the U.S. as their economic growth rates lagged that of the U.S. Interest rate differentials versus the U.S. for intermediate maturities narrowed by 12 to 36 bp for the United Kingdom, Canada, Germany, and Japan. Reflecting the more favorable U.S. economic growth prospects, most foreign currencies underperformed the U.S. dollar. The Japanese yen was the weakest, falling -6.7% against the dollar in response to the continuation of the aggressive monetary stimulus policy by the Bank of Japan. The Canadian and Australian dollars declined on the heels of weaker economies. Only the euro and the British pound gained. The pound benefitted from the unexpected economic rebound in the U.K., while the lack of aggressive easing by the ECB supported the euro.



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

Outlook

For most of 2013, investors fretted on whether the Federal Reserve would or would not announce the start of a tapering in its bond purchase (QE) program. Uncertainty surrounding this issue created significant volatility in the financial markets as investors handicapped economic data and statements by Fed officials. However, by the time the official announcement on a taper was made after the December FOMC meeting, the markets had fully discounted the much-feared action and risk markets rallied. With the U.S. economy on a firm footing, as evidenced by the 4% GDP print for the third quarter of 2013, and expectations for a 3+% figure for the fourth quarter, the focus in 2014 will turn to the pace of the Fed's taper program, and the timing of a hike in the federal funds rate. The Federal Reserve's official forecast is for a measured pace in the reduction of the asset purchase program. Forward guidance also implies that the record low federal funds rate will be maintained for an extended period of time, even past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the Fed's 2% longer-run goal. Although the December payroll report was unexpectedly weak with an employment gain of just 74,000, most economic data releases have been firm as reflected by stronger consumer spending, a narrowing trade deficit, and jobless claims near 6-year lows for over a year. Economic growth has also picked up outside the U.S. laying the foundation for a synchronized global expansion. 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

Mortgage valuations have richened over the past several weeks even after the Fed tapering announcement. However, the unprecedented nature of the Fed's quantitative easing program has provided mortgages with a technical advantage as current mortgage production stands about 60-80% from the peak summer months. Until the Fed further reduces its MBS purchases by a substantial amount, technicals should remain firm through at least 2014 Q1. We expect the CMBS sector to keep recovering as property performance will coincide with an improving economy. Additionally, currently cheap to corporates, the sector should remain well-bid as absolute yield bogeys for investors will either keep spreads steady or tighter. Furthermore, selective lower-rated ABS tranches offer incremental yield and have potential to tighten since they are legitimate upgrade candidates with credit enhancements increasing as the deals season. A risk to securitized performance, though, could be the current historically tight swap spreads which could widen significantly if benchmark rates abruptly rise. The OAS on the Credit Index is now back to pre-crisis levels (in '07) at +111 bp. We are seeing some deterioration in overall credit metrics as low coupons are beginning to mature, which will pressure interest coverage ratios. Additionally, companies issuing debt to fund shareholder returns, coupled with S&P 500 operating margins near all-time highs bring risks to the credit complex. Using our risk/reward framework a lighter position to credits (particularly at the longer-end of the maturity spectrum) appears warranted after two strong years of excess 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.