



Review

In October, the broad fixed income market as measured by the Barclays Capital Aggregate Index posted a modest total return of 0.2%. Despite lackluster corporate earnings and the uncertainty about the U.S. presidential election, most spread sectors outperformed Treasuries.

Although the overall securitized sector underperformed by -5 bp, this was solely driven by the underperformance in the agency mortgage-backed securities (MBS) sector which lagged Treasuries by -10 bp. The widening of the mortgage basis was due to a combination of short-term technical factors such as a decline in overall agency MBS purchases by the Federal Reserve, and an increase in MBS origination volume. Production coupons lagged their higher coupon counterparts by more than 40 bp. The commercial mortgage-backed (CMBS) sector, however, remained resilient, earning +70 bp over Treasuries. Spreads held firm in the asset-backed (ABS) market as well. A number of new-issue deals were several times oversubscribed. Overall, the ABS sector posted +13 bp of excess return, benefiting from tighter swap spreads and strong demand. The credit sector continued its recent trend of outperformance and posted +130 bp of excess return for the month. The utility sector led the way with +169 bp, while the industrial and financial sectors were not far behind with excess returns of around +145 bp. A heavy new issue calendar was met with strong demand; mutual fund bond inflows reached their highest levels since November 2009 as issuers continued to take advantage of the low interest rate environment. Despite the decline in the equity market (S&P 500, -1.9% for the month) and rising volatility (VIX, +18%), lower credit-quality issues outperformed their higher-quality

counterparts: Aa +49 bp, A-rated +127 bp, BBB +178 bp; high-yield, however, lagged with only +105 bp of outperformance. Despite the strong bid for spread sectors, Treasury yields only rose modestly with short to intermediate yields increasing 5 to 10 bp, while long maturity yields rose by 3 bp. The muted yield curve reshaping left the 2/30-year Treasury yield differential nearly unchanged at +258 bp.

Similar to the U.S., developed country bond markets were little changed for the month. Relatively better economic data in the U.S., and the weakness in Europe as well as Japan, resulted in a widening of 5 to 10 bp in intermediate yield spread differentials (versus the U.S.) for Canada, Germany, Japan and New Zealand. The stronger economic data also underpinned the U.S. dollar which rose against most major currencies (+2.3% and +1.6% versus the yen and Canadian dollar respectively); only the euro gained, rising +0.8% against the U.S. dollar.

Outlook

Although the U.S. economy has lost momentum from earlier in the year, recent data point to a modest growth outlook. Third quarter real GDP came in at 2.0% as solid gains in consumer spending and a rebound in housing activity offset the softness in business demand and exports. The October employment report showed an unexpectedly large increase in payrolls of 171,000, which brought the 3-month average to 170,000, sharply higher than the prior 3-month average of 104,000. The unemployment rate also remained below 8% for the second consecutive month. Initial estimates of the impact of Hurricane Sandy

suggest a modest drag of around 0.5% for fourth quarter GDP with a rebound as the recovery/rebuilding begins in earnest.

The deepening economic malaise in Europe, and the spreading downturn in emerging market powerhouses such as China, India and Brazil have increased global recession risks. The ongoing conflicts in the Middle East and rising tension related to Iran's nuclear weapons ambitions remain a major concern. The outcome of the U.S. elections is that despite small gains by Democrats in both the Senate and House, the status quo is being maintained in the executive and legislative branches of government. As a result, the likelihood of protracted gridlock is high on contentious issues such as the upcoming fiscal cliff. The Federal Reserve is expected to maintain its highly accommodative posture for a considerable time to offset the numerous headwinds facing the economy.

While originations have picked up on an increase in refinance activity, net supply is essentially flat. The Federal Reserve's 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 is having 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, selective high-quality carry trades remain in vogue. This is especially true in agency MBS, high quality CMBS and the short-duration, liquid consumer ABS sector which still offer attractive yields as a cash surrogate. Although technicals remain positive in the credit sector, a lower risk profile is warranted given the significantly tighter spreads and considerable macro uncertainty. With two-thirds of S&P 500 companies reporting third quarter earnings thus far, sales are down 2% year-over-year,

while earnings have fallen 1%; excluding financials, earnings are down 4%. The outlook and forward guidance from corporate management teams will likely result in downward revisions to analysts' estimates for the fourth quarter and 2013 as well. We will look to selectively add credit spread exposure on any material spread widening. Issuer selection, however, continues to be critical. The Federal Reserve has a benign outlook on inflation over the medium term. However, the explosive growth in its balance sheet (currently almost \$3 trillion from just \$870 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 negative real yields.

While the ECB's announcement of supportive programs to help stem the crisis in Europe sharply reduced the tail-risk associated with a break-up of the Eurozone, the austerity measures required are worsening the economic downturn in the peripheral countries and are beginning to negatively impact even the stronger economies. Additionally, the likelihood of a political and economic union in Europe any time soon is low. As a result, volatility and risks in the non-dollar markets are likely to remain high.

Lastly, while we have increased our defensive posture by selectively reducing spread sector overweights, our portfolios continue to have an overall positive bias to spread sectors.