Market Review & Outlook
2nd Quarter 2013

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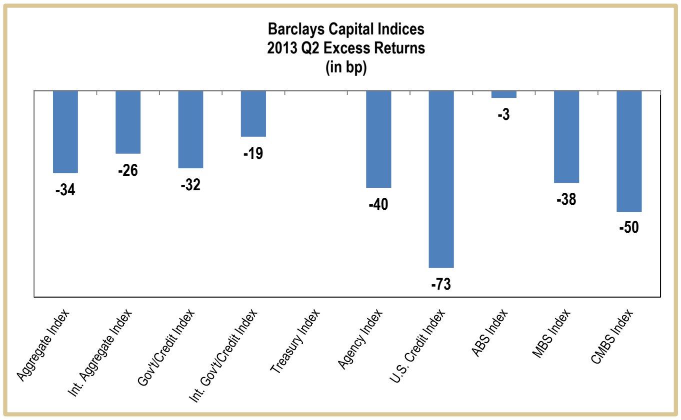
Highlights

- *Sequestration has only had muted effects on the U.S. economy as consumer spending offsets cutbacks in government spending.*
- *While the Federal Reserve is likely to commence ununwinding its QE3 program this year, "tapering" does not mean "tightening".*
- *Massive expansion of central banks' balance sheets has raised future inflation risk; however, no near-term catalysts for a rise in inflation due to continued slack in the economy.*

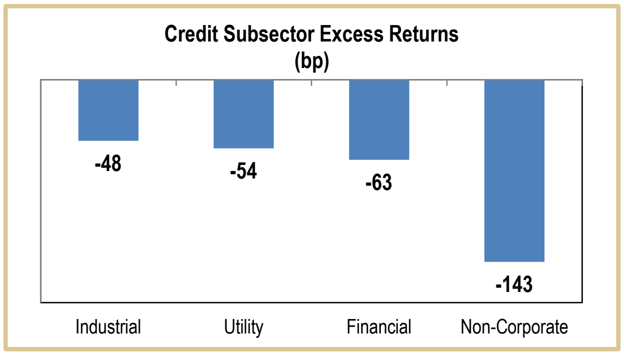
Review

In the second quarter, the broad fixed income market represented by the Barclays Capital Aggregate Index posted a total return of -2.32%, as interest rates spiked higher on concerns the Federal Reserve would begin to "taper" its QE3 bond purchase program. Against this backdrop, all spread sectors underperformed duration-equivalent Treasuries.

The agency mortgage-backed sector (MBS) was negatively impacted by increasing signs that the Federal Reserve would soon reduce the size of its $40 billion monthly MBS purchase program. As a result, the MBS sector lagged Treasuries due to convexity losses, wider spreads and a spike in volatility. Primary mortgage rates rose sharply. MBS underperformance was concentrated in the lower coupons which have been the focus of the Fed's monthly purchases and, therefore, the most sensitive to any talk about a tapering of the program. Lower coupons lagged their higher coupon counterparts. Furthermore, GNMAs lagged conventionals due to a lack of sponsorship and heavy selling from Asia. The commercial mortgage-backed (CMBS) sector was not immune to the sell-off in spread sectors and ended the quarter lagging Treasuries. While underperformance was somewhat uniform across the CMBS quality curve, spread widening led to more significant underperformance for recently-issued, longer-maturity CMBS tranches. Despite market volatility, new issuance was strong but weighed on spreads. Activity was rather subdued in the asset-backed sector (ABS) with pockets of demand for selective bonds which helped limit spread widening in the sector. The ABS sector was the best performer in the Barclays Aggregate Index.

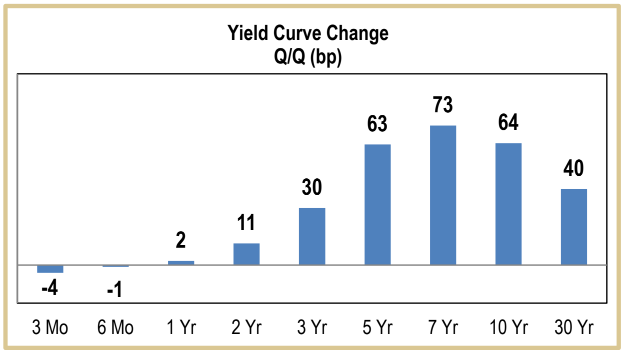


Source: Barclays Capital



Source: Barclays Capital

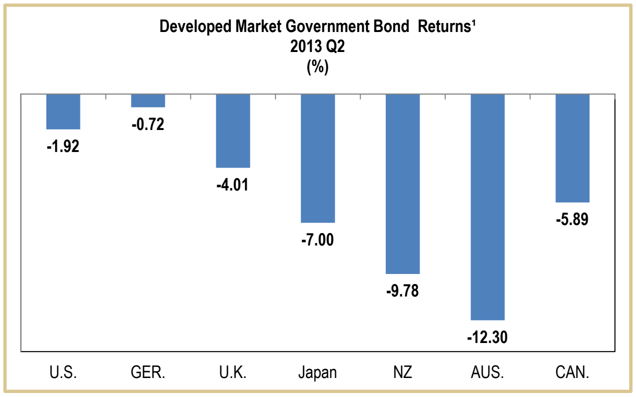
In the credit sector, the option-adjusted spread (OAS) widened 14 basis points resulting in underperformance for all credit sectors. The credit curve steepened significantly as long-maturity issues underperformed intermediates. However, quality-based performance was mixed.



Source: Bloomberg

Generally improving economic data shifted market focus from the negative effects of the federal government's sequester to "pricing-in" the potential end of the Federal Reserve's QE3 program. As a result, Treasury yields rose significantly. While 2-year yields increased 12 bp, intermediate yields (5-10 years) shot up 63-73 bp, to levels not seen since 2011. Although the rise in the 30-year Treasury yield was less, it still climbed and ended the quarter at 3.50%. The Treasury yield curve, measured by the 2-year/30-year yield differential, steepened to 314 bp.

Weaker economic growth prospects compared to the U.S. caused most non-dollar developed market/U.S. yield differentials to narrow. In Canada, weaker exports and slower government spending have slowed economic growth and introduced material slack in the economy. As a result, the Bank of Canada has cut its growth outlook. The spread differential between 5-year Canadian and U.S. government securities narrowed. The sixth consecutive quarterly economic contraction in the eurozone and a record high unemployment rate resulted in outperformance for 5-year German bunds. In Japan, a reiteration by the Bank of Japan to continue with its aggressive easing of monetary policy by doubling the monetary base helped cap the rise in Japanese yields. Five-year JGB's increased by 19 bp versus the +67 bp rise in 5-year U.S. Treasury yields. The Reserve Bank of Australia responded to a softening economy and a rise in the unemployment rate to 5.5% from 5% over the past year by cutting official rates by 25 bp to a record low 2.75%. This left 5-year Australian government yields virtually unchanged for the quarter in stark contrast to the sharp jump in yields globally. The U.K. was the only major region to experience a bigger increase in yields compared to the U.S. There have been encouraging signs that the U.K. economy is healing. Contrary to widespread expectations for a triple-dip recession, first quarter GDP showed growth. In the second quarter, the 5-year U.K./U.S. yield differential widened.



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

The foreign exchange markets, for the most part, reflected economic growth differentials. For the quarter, the Canadian dollar and the yen declined by -3.4% and -5% respectively versus the U.S. dollar. Declines for the Australian and New Zealand dollars were much steeper at -12.2% and -7.5%. The British pound was little changed, while the euro rose 1.5%.

Outlook

The automatic federal government budget cuts (sequestration) that kicked in on March 1st have not had an unduly adverse effect on the U.S. economy as initially feared. The biggest slump in government projects in over a decade has led to a softening in the manufacturing and services sectors. In May, the closely-watched Institute for Supply Management (ISM) index dropped below 50 (threshold that demarcates expansion and contraction) to 49. However, the drag from the cutbacks in government spending is being offset by consumers who are not pulling back due to a brighter jobs picture, low borrowing costs and rising consumer wealth. In the first half of 2013, private payrolls increased at an average monthly rate of 206,000 compared to 189,000 for 2012. The unemployment rate, while still elevated at 7.6%, is near a five-year low. Consumer confidence is at 7-year highs, and in June total vehicle sales were 15.9 million (annualized rate), the highest level in six years.

Continued improvement in the economy is likely to lead to a tapering later this year in the Federal Reserve's $85 billion monthly bond purchase program (QE3). However, "tapering" does not mean "tightening". The federal funds rate is unlikely to be raised for at least another 1½ years or longer. Low inflation and a still high unemployment rate will warrant an accommodative monetary policy. As a result, further signs of an improvement in the economy could steepen the Treasury yield curve.

In the near-term, a further sharp increase in Treasury yields is unlikely to be sustained for a couple of reasons. First, the strength in the housing market has been an important contributor to economic growth. The 70+ bp increase in primary mortgage rates has already dampened refinancing activity; over the past year, home refinancings are down 43%. Higher interest rates will act as a self-stabilizing mechanism by bringing down growth expectations. Secondly, the 5%+ GDP growth in emerging countries (led by China's 9%+ growth) has been a major driver for global growth over the past five years as record low interest rates in the developed countries encouraged strong capital flows into emerging economies. A reversal of these flows will also reduce economic growth expectations. On an important and related note, the pronounced strength in China's economy is the direct result of the $650+ billion stimulus package implemented back in 2008. One of the negative consequences has been the credit explosion and over-investment that has greatly increased the country's debt service ratio in the economy to dangerous levels. The new leadership in China is undertaking significant measures to apply the brakes and soft-land credit growth. The risk is that China, the world's second-largest economy, sees its growth rate drop below 7% with adverse consequences for the global economy.

During the quarter, we reduced our lower coupon MBS position to an underweight. MBS spreads are now out to early 2012, pre-QE3 levels. Mortgage option-adjusted spreads (OAS) are attractive; however, the unprecedented nature of the Fed's quantitative easing program, the large scale of its portfolio holdings and monthly portfolio activity, how it has impacted markets and how the whole process will unwind have introduced a fair degree of uncertainty. We, therefore, remain cautiously underweight with a bias to buy opportunistically. Although broad market volatility has led to the recent weakness in CMBS, we expect the sector to recover as markets stabilize and continue to find CMBS spreads attractive. The liquid consumer ABS sector continues to offer attractive yields as a cash surrogate. Furthermore, selective lower-rated ABS tranches offer incremental yield and have the potential to tighten as they are legitimate upgrade candidates as credit enhancement builds with deal-seasoning. In the credit sector, concerns over rates and the "Great Rotation" out of fixed income have pushed spreads out to the wides of the year. Our medium-to-longer term view is that spreads remain attractive, but we expect volatility in the short-term to remain an impediment for spread tightening. As such, we have lowered our allocation particularly to higher-beta credits, though we still retain a slight overweight to credit in general.

While the explosive growth of the Federal Reserve's balance sheet and the significant expansion in the balance sheets of other major central banks have increased future inflation risks, there are no near-term catalysts for a rise in inflation due to the continued slack in the economy. We exited our Treasury Inflation Protected Securities (TIPS) positions earlier in the quarter, and remain on the sidelines despite the subsequent cheapening.

Although the eurozone remains in a recession with a sixth consecutive quarterly contraction in GDP, there are glimmers of light. Economic growth in Germany, the largest economy in the zone, is gaining increasing traction. Germany's unemployment rate is near a record low. While manufacturing activity is France and Italy (2nd and 3rd largest economies) is still contracting, the rate of decline has materially slowed. Importantly, investor and consumer confidence measures in several eurozone countries have been on a rising trend. In Japan, the aggressive fiscal and monetary policies enacted late last year are bearing fruit. A key survey of the manufacturing sector has turned positive for the first time in two years, while housing starts climbed above the 1 million rate for the first time in five years. Despite the improved tone in other developed markets, the U.S. remains further along on the economic growth curve which will continue to underpin the U.S. dollar.

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

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