



Highlights

- Given more timely economic indicators, expectations are pointing to a second-half rebound.
- Although inflation remains benign across much of the world, inflation indicators have started to “perk-up” in the U.S. and U.K.
- Our portfolios are positioned with an underweight to duration given our expectations of an improving U.S. economic outlook and the current low interest rate environment.

Review

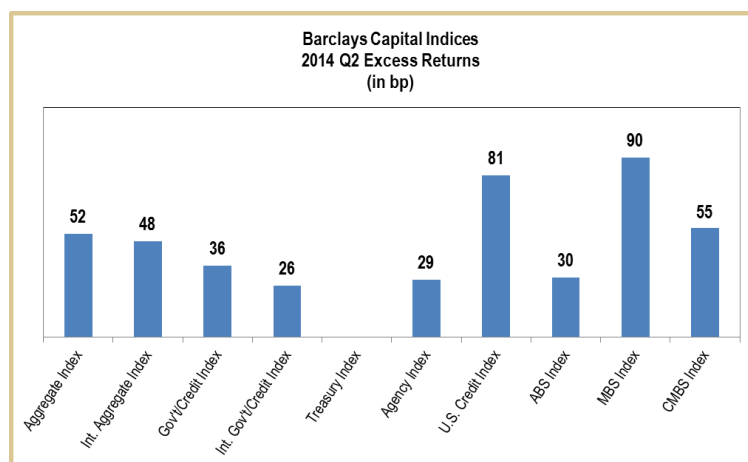
In the second quarter, the broad fixed income market as represented by the Barclays Capital Aggregate Index posted a 2.05% return, as a slower-than-expected economic rebound resulted in lower yields. Despite the decline in Treasury yields, all major spread sectors outperformed duration-neutral Treasuries.

The securitized sector had a very good quarter. The outperformance was mostly attributable to the agency mortgage-backed securities (MBS) sector as mortgages tightened despite the Fed’s taper. The MBS sector outgained its duration-equivalent Treasuries as the sector benefited from low volatility, carry and a lack of origination as both refinance and purchase activity remain muted. Among mortgage sectors, GNMA’s lagged conventionals due to expectations GNMA speeds will outpace FNMA/FHLMC speeds as persistent transitions to conventionals through cash-outs, rate refis and turnover continue. The commercial mortgage-backed sector (CMBS) outgained its duration-equivalent Treasuries. New issue demand remained solid after several new issue deals were oversubscribed while at the same time seasoned CMBS kept pace with the primary market due to the on-going search for yield, as a result,



Peter A. Heine

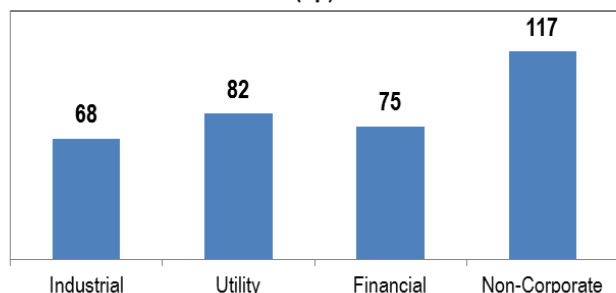
*Managing Director
Head of Fixed Income*



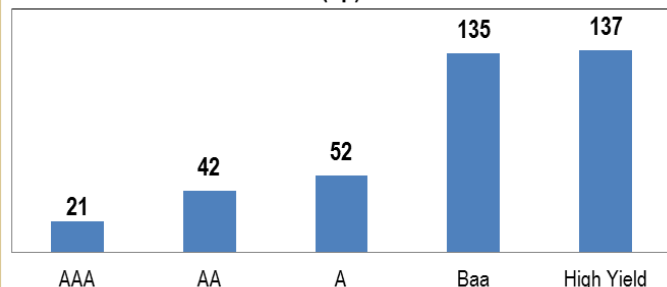
Source: Barclays Capital

2014 Q2

Credit Subsector Excess Returns (bp)



Credit Sector Quality (bp)

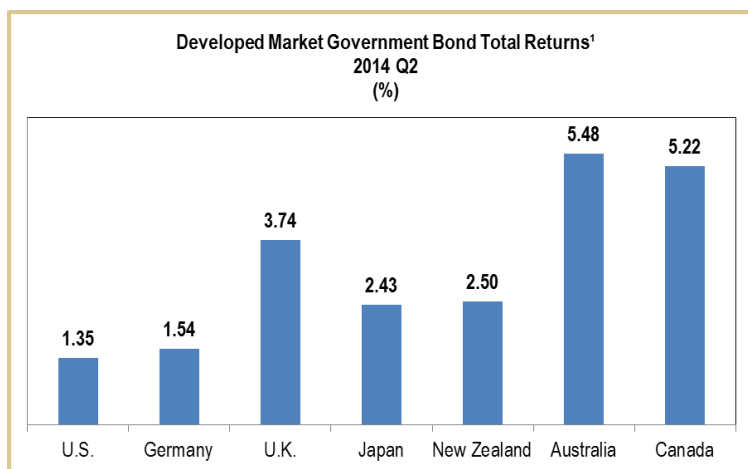


Source: Barclays Capital

spreads remained firm during the month and credit bonds benefited from good liquidity. For this same reason, lower rated tranches outperformed their AAA counterparts. Performance within the ABS sector was also solid. Secondary trading volumes were robust throughout the quarter while investor inquiries for higher yielding ABS tightened spreads between 5-10 bp as dealer inventories declined. In the credit sector, the option-adjusted spread (OAS) tightened 7 bp resulting in 81 bp of excess return. Utilities led the way while finance and industrials also outperformed. In a reversal of the first quarter trend, long-maturity finance actually outperformed +119 bp despite the continued flattening of the Treasury yield-curve.

As expected in this “risk-on” environment, lower quality issues outperformed their higher-rated counterparts. Two-year Treasury yields rose 4 bp to 0.46%, while intermediate and longer-maturity yields declined. As a result, the yield curve, as measured by the 2-year/30-year yield differential, flattened 24 bp to end the quarter at +290 bp.

The flattening of yield curves was a global phenomenon as all non-dollar developed market curves flattened during the quarter. Stronger-than-expected economic data in the U.K. pushed short to intermediate U.K. government yields higher by 5 to 15 bp. As a result, yield differentials versus the U.S. widened by 12 to 15 bp. Currency performance was led by the Canadian dollar which reversed its first quarter slide by gaining 3.5%; the British pound also added 2.7% while the Euro trailed -0.5%.



Source: Barclays Capital

¹U.S. Dollar, Unhedged

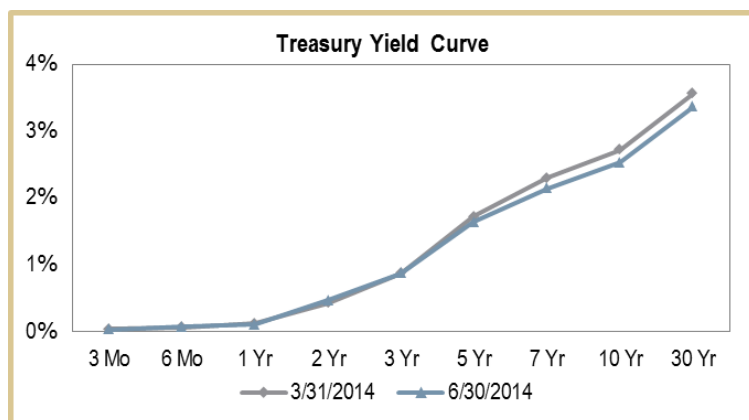
Outlook

The U.S. economy began the year with a weaker-than-expected real GDP of -2.9%, though some of the more timely economic indicators are pointing to a second half rebound. The ISM manufacturing index in the second quarter was nearly 3 points higher than the first quarter average, signaling a rebound in manufacturing activity. U.S. auto sales in June totaled 16.9 million annualized, the highest reading dating back to January of 2006. Nonfarm payrolls in June came in stronger-than-expected adding 288,000 jobs with upward revisions to the prior two months. The 12-month average currently stands at 208k, the fastest pace in eight years and the unemployment rate ticked down to 6.1%. A stronger labor market bodes well for improved consumer sentiment and personal consumption going forward. Expectations are for GDP growth of 3% in the second half of this year.

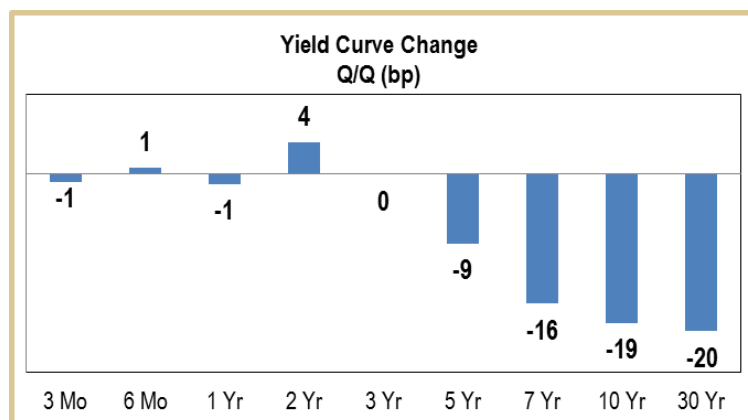
Mortgage originations have slowed down and while a total tapering of \$25B so far has had some impact, the positive technical persists in the MBS sector. However, with short-dated volatility at historical low levels and with the Fed nearing the end of its asset purchase program, we expect the basis to eventually come under pressure. The CMBS sector continues to recover with property performance improving as the economy grows.

In addition, the sector is currently cheap to corporates, and should remain well bid as absolute yield bogeys for investors will either keep spreads steady to tighter. Furthermore, selective lower rated ABS tranches offer incremental yield and have potential to tighten as they are legitimate upgrade candidates as credit enhancement builds as the deal seasons. Threat to the securitized performance though could be the current historically tight swap spreads which can widen if benchmark rates abruptly rise. Corporate bond spreads across the credit spectrum are back to pre-crisis levels. Our risk/reward analysis points to a modest underweight position as 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.

The explosive growth of the Federal Reserve's and other central banks balance sheets has increased future inflation risks. In the U.S. and U.K., inflation indicators have started to "perk-up" while it remains benign across much of the world due continued economic slack. Given our expectations of an improving U.S. economic outlook and the current low interest rate environment we have positioned our portfolios with an underweight to duration.



Source: Bloomberg



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For additional information, please contact:
Lynda DiBari, Director · (212) 487-5104
Marcus Smith, Vice President · (713) 292-2114