Market Review & Outlook
3rd Quarter 2013

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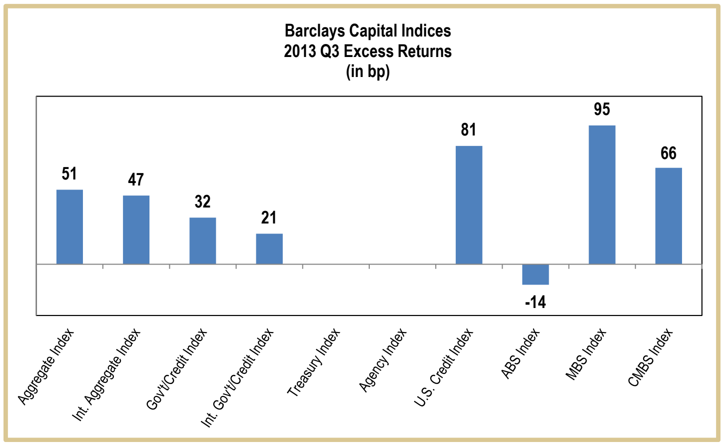
Highlights

- *Despite contentious rhetoric from Congress and the White House, a resolution on the budget and debt ceiling is likely over the next few weeks with the likelihood of a default by the U.S. remaining low.*
- *Low inflation and a still high unemployment rate warrant an accommodative monetary policy.*
- *Global economic growth unlikely to soon return to pre-financial crisis levels as developed economies face sluggish growth, and large emerging economies slow down due to structural rather than cyclical factors.*

Review

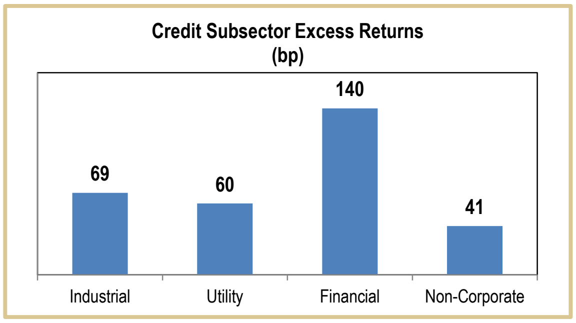
In the third quarter, the broad fixed income market as represented by the Barclays Capital Aggregate Index posted a total return of 0.57%. Interest rates rose (10-year Treasury yield peaked at 3%) as global capital markets adjusted to the prospects for a tapering in the Federal Reserve's QE3 bond purchase program. In a surprising move, the FOMC decided not to taper and 10-year Treasury's yield subsequently fell 16 bp the day of the announcement. For the quarter, most spread sectors outperformed duration-equivalent Treasuries.

The securitized sector rebounded strongly following a dismal first half. The outperformance was mostly attributable to the agency mortgage-backed securities (MBS) sector as spreads tightened following the Fed's non-taper announcement, with lower coupons the biggest beneficiaries. Overall, the agency mortgage-backed securities (MBS) sector outperformed duration-equivalent Treasuries helped by convexity demand and continued limited issuance. The commercial mortgage-backed sector (CMBS) outperformed Treasuries by +66 bp. Spreads tightened modestly throughout the quarter. On an encouraging note, there was strong demand for the $11+ billion in new issue CMBS with certain tranches more than three times oversubscribed. Seasoned CMBS kept pace with the primary market due to the on-going search for yield. For this same reason, the CMBS credit curve also flattened. Despite improving sentiment in the ABS market and strong demand for new issues, liquidity conditions and fund redemptions pushed spreads wider. The sector lagged Treasuries, its worst quarterly performance since Dec'11.

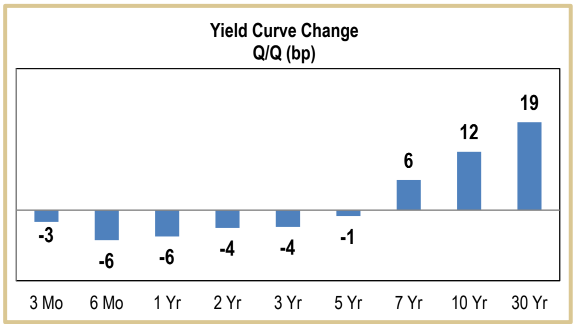


Source: Barclays Capital

2013 Q3



Source: Barclays Capital

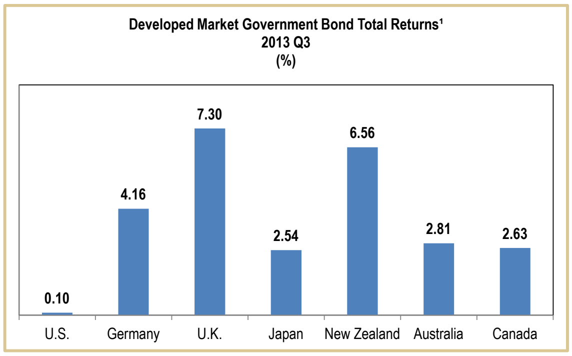


Source: Bloomberg

In the credit sector, the option-adjusted (OAS) tightened. Financials were the standout performer for the quarter adding +140 bp over duration-neutral Treasuries; the industrial and utilities sectors also posted positive excess returns. The credit curve flattened significantly as long maturity issues outperformed their intermediate counterparts by more than 2 to 1.

Quality-based performance reflected the "risk-on" environment: Aaa-rated +39 bp, Aa-rated +41 bp, A-rated +95 bp, Baa-rated +88 bp, and high yield +194 bp. While the change in interest rates for the quarter appears fairly muted, intra-quarter, the 10-year Treasury at one point was 52 bp higher in yield from the beginning of the quarter. Two-year Treasury yields fell, while 30-yr Treasury yields rose. The yield curve, as measured by the 2-year/30-year yield differential, steepened to 337 bp.

Most developed country bond markets underperformed the U.S. as their economies improved. Interest rate spread differentials versus the U.S. for intermediate maturities widened by 6 to 55 bp for Australia, the United Kingdom, Canada, Germany and New Zealand. Japan was the only notable exception as the unprecedented stimulus measures by the Bank of Japan pushed Japanese government yields sharply lower. Following a weak tone earlier this year, improving economic prospects for foreign developed markets provided a strong bid for their currencies. The Japanese yen, Canadian dollar and Australian dollar appreciated against the U.S. dollar, while the euro, British pound and New Zealand dollar rose sharply.



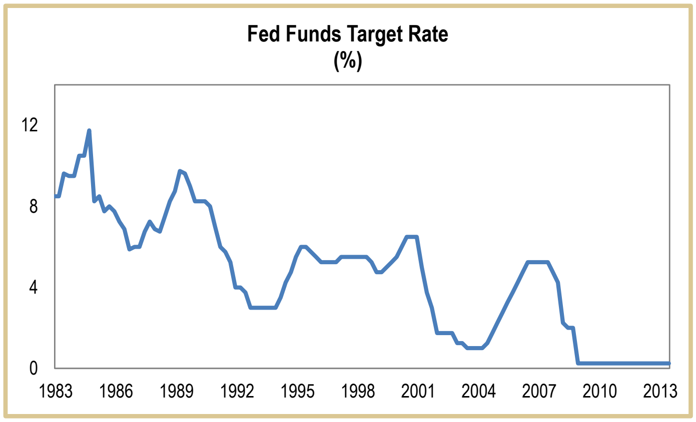
Source: Barclays Capital
¹U.S. Dollar, Unhedged

Outlook

The impasse in Washington over passing a federal budget and raising the debt ceiling has taken center stage as the partial government shutdown has prevented the release of economic data from various governmental agencies.

Prior to the curtailment of government data releases, there was a mostly positive but mixed picture for the U.S. economy. While the weekly jobless claims figures have dropped to the lowest levels in 6 years, employment gains have been subdued with the average monthly gains dropping from 195,000 in the first half of the year to just 136,000 as the second half unfolds. Small business confidence is near pre-financial crisis highs, while an index that measures the services sector of the economy is at 8 year highs. Consumer confidence, however, has recently dropped sharply from its June high. Despite contentious rhetoric from Congress and the White House, the likelihood of a default by the U.S. remains very low, and a resolution on the budget and debt ceiling is likely over the next few weeks. The appointment of Janet Yellen to take over as Chairman of the Federal Reserve early next year is likely to provide stability on the monetary policy front in terms of continuity of policy. However, the question regarding the timing of a reduction in the Fed's bond purchase program remains. An important point is that irrespective of timing, "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 sharp increase in Treasury yields is unlikely to be sustained. The strength in the housing market, an important contributor to the economic recovery, has waned with the steep rise in mortgage rates; home mortgage activity is down 55% from year-ago levels, while housing starts are almost 10% lower from the 1 million rate reached at the end of the first quarter. Higher interest rates will act as a self-stabilizing mechanism by bringing down growth expectations. Economic growth is also slowing down in the large emerging economies such as China, Brazil and India due to structural rather than cyclical factors. These economies were the primary drivers of global growth following the financial crisis. Consequently, the sluggish growth in developed countries will not be sufficient to lift global growth back to the 4+% growth rates seen before the financial crisis.



Source: Bureau of Economic Analysis and Federal Reserve

Mortgage option-adjusted spreads (OAS) look fair, however, the unprecedented nature of the Fed's quantitative easing program, the large scale of its portfolio holdings and monthly portfolio activity, and how it has impacted markets has made it difficult to evaluate how the process will unwind. As a result, we remain cautiously underweight with a bias to buy opportunistically. Although increased broad market volatility has led to some weakness in CMBS we expect the sector to recover as markets stabilize. We continue to find CMBS spreads attractive. Moreover, the Fed's dovish stance at the September FOMC meeting is a bullish signal for the sector. 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 with the building-up of credit enhancement as these deals season. In the credit sector, we maintain our positive bias as valuations remain attractive from a historical perspective. Technicals continue to be strong despite the record issuance in September ($208 billion in U.S. new issuance was priced, 17% higher than the previous record), and evidenced by the robust demand and performance of the record breaking $49 billion of issuance by Verizon Communications Inc. Credit selection will become more imperative moving forward as companies continue to re-leverage their balance sheets through stock buybacks and mergers/acquisitions.

While the Chinese government has taken steps such as increased infrastructure spending and tax breaks for small businesses to avoid a hard landing for the economy, there are greater risks now from the massive shadow banking system (said to be equivalent in size to 60% of China's GDP), and rising levels of corporate and local government debt. The credit explosion in China has greatly increased the country's debt service ratio in the economy to dangerous levels. Europe has emerged from its long recession with the first positive GDP print for the eurozone following six consecutive quarters of contraction. The United Kingdom has had two consecutive quarters of expansion following fears of a triple dip recession at the beginning of the year. However, growth outlooks in Europe are subdued, and economic growth differentials continue to favor the U.S. which should serve to underpin the U.S. dollar.

Lastly, while we have reduced spread sector allocations, we continue to have an overall overweight to spread sectors.

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