



### Highlights

- As a result of speculation that the Fed would change their “forward guidance”, volatility surged during the 3<sup>rd</sup> quarter.
- Given more timely economic indicators, growth expectations are to moderate (2.5% - 3%) for the balance of the year.
- Our portfolios are positioned with neutral duration due to global economic slowdown, stronger U.S. dollar and geopolitical tensions.

### Review

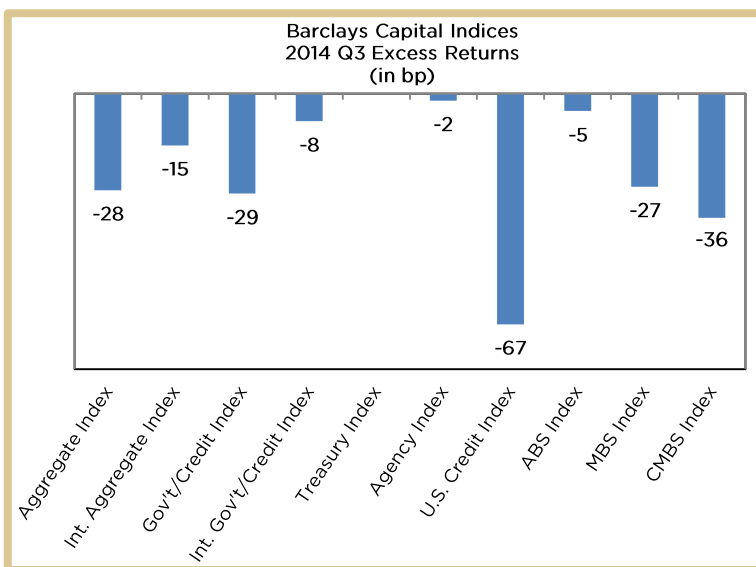
In the third quarter, the broad fixed income market as represented by the Barclays Capital Aggregate Index posted a modest .17% return, as volatility surged on speculation that Federal Reserve would change their “forward guidance” for the Federal Funds Rate. All major spread sectors underperformed duration-equivalent Treasuries.

The securitized sector registered a weak 3<sup>rd</sup> quarter, lagging Treasuries. Performance was a reversal from the strong 2<sup>nd</sup> quarter as wider swap spreads and a spike in volatility hurt all major subsectors within the securitized universe. The residential mortgage-backed sector (MBS) underperformed Treasuries, while ABS and CMBS lost -5 bp and -36 bp, respectively. MBS performance also suffered due to convexity losses, concentrating in the belly of the coupon stack. The GNMA sector was the biggest laggard. The commercial mortgage-backed sector (CMBS) lagged its duration-equivalent Treasuries, its worst quarterly performance since the 2<sup>nd</sup> Quarter of 2013, as heavy new issue supply weighed on the sector.



Peter A. Heine

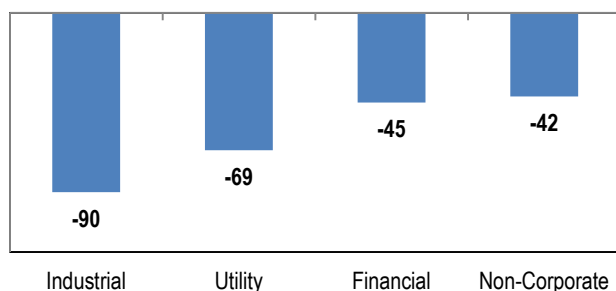
*Managing Director  
Head of Fixed Income*



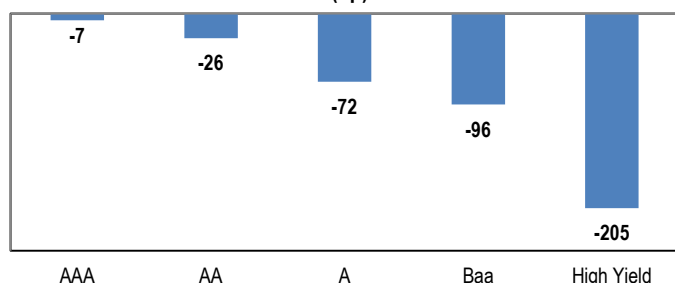
Source: Barclays Capital

2014 Q32

Credit Subsector Excess Returns  
(bp)



Credit Sector Quality  
(bp)

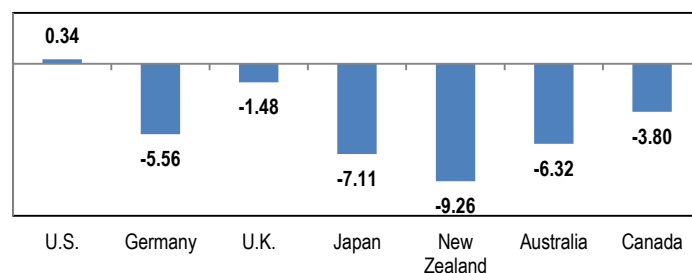


Seasoned tranches outperformed their new issue counterparts, while lower rated tranches outperformed their AAA counterparts. Despite the spread widening, there was no evidence of distressed selling. Activity was rather subdued within the asset-backed sector (ABS) with modest spread widening due to broad market sentiment. The auto sub-sector was the best performer, registering 0 bp of excess return, while the Credit Card and Utility sectors posted -10 bp and -8 bp respectively. In the credit sector, the option-adjusted spread (OAS) widened 11 bp, as record corporate issuance weighed on spreads. Industrials took the brunt of the widening +13 bp and delivered -90 bp of excess return while Utilities and Financials posted -69 bp and -45 bp, respectively.

As to be expected in a “risk-off” environment both the credit curves and quality curves steepened; Aa-rated -26bp, A-rated -69 bp, Baa-rated -91 bp and high yield -205 bp. Given the markets speculation of a change in Federal Reserve monetary policy the yield curve continued to flatten as short and intermediate yields rose 11 to 17 bp, while 10-year and 30-year yields actually decreased 4 to 16 bp. The yield curve, as measured by the 2-year/30-year yield differential, flattened 27 bp to end the quarter at +263 bp.

The flattening of yield curves continued to be a global phenomenon as all non-dollar developed market curves flattened on declining inflation expectations. German 10-year Bunds fell below 1% as the ECB has signaled a quantitative easing policy to spur Eurozone economic growth. Currency performance was led by U.S. dollar as it strengthened against all major currencies.

**Developed Market Government Bond Total Returns<sup>1</sup>**  
2014 Q3  
(%)



Source: Barclays Capital

<sup>1</sup>U.S. Dollar, Unhedged

## Outlook

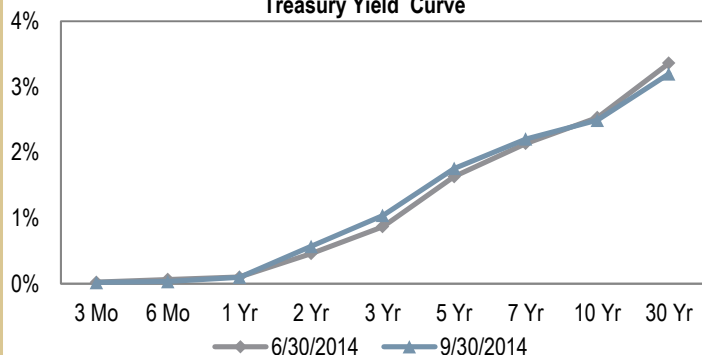
The U.S. economy rebounded sharply (+4.6%) in the second quarter following the weather-induced slowdown experienced in the first quarter. Expectations are for growth to moderate to 2.5 to 3.0% range for the balance of the year as some of the more timely economic indicators are starting to show. The ISM manufacturing and non-manufacturing indices while still elevated do indicate some moderation in the pace of growth. September nonfarm payrolls came in stronger-than-expected (+248,000) and revision to the prior two months added an additional 69,000 jobs; the unemployment rate fell 5.9%, the first time it has dipped below 6% since 2008. While the jobs picture has improved, wage growth is still lagging, up just 2.0% on a year/year basis. A stronger labor market bodes well for improved consumer sentiment and personal consumption going forward, though the housing market continues to be an area of concern as tight credit conditions weigh on activity with purchase mortgage applications down 11% on a year/year basis.

There has been a slight but meaningful shift in mortgage originations during the quarter and while a total tapering of \$35B so far has had no corresponding widening in the basis, the demand-supply technicals should eventually worsen in the coming months. Moreover, 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. Additionally, currently cheap to corporates even after spread widening across investment grade and high yield corporate bonds, the sector 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. Though corporate bond spreads widened marginally in the third quarter they still remain near 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.

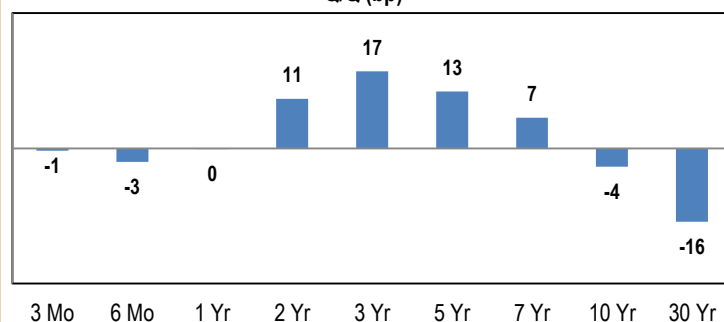
Given the weakness in the Eurozone and Japan, a slowing Chinese economy coupled with a stronger U.S. dollar and geopolitical tensions we expect the Federal Reserve to delay rate hikes until the second half of 2015, as such we have positioned our portfolios with neutral duration relative to our benchmarks.

**Treasury Yield Curve**



Source: Bloomberg

**Yield Curve Change Q/Q (bp)**



Source: Bloomberg

For additional information, please contact:  
Donna Sims Wilson, President · (713) 292-2108  
Lynda DiBari, Director · (212) 487-5104  
Marcus Smith, Vice President · (713) 292-2114