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Quarterly Review

Fixed Income Market Update

March 31, 2014

FIXED INCOME MARKET SECTOR RETURNS

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 YTD
EMD-LC 22.97%	EMD-HC 10.25%	EMD-LC 15.22%	EMD-LC 18.11%	Treasury 13.74%	High Yield 58.21%	CMBS 20.40%	TIPS 13.56%	EMD-HC 17.44%	High Yield 7.44%	EMD-HC 3.73%
EMD-HC 11.62%	EMD-LC 6.27%	EMD-HC 9.86%	TIPS 11.63%	Agency 9.26%	Bank Loans 44.87%	EMD-LC 15.68%	Treasury 9.81%	EMD-LC 16.76%	Bank Loans 6.15%	High Yield 2.98%
High Yield 11.13%	Bank Loans 5.69%	High Yield 11.85%	Treasury 9.01%	MBS 8.34%	EMD-HC 29.82%	High Yield 15.12%	Credit 8.35%	High Yield 15.81%	CMBS 0.23%	Credit 2.91%
TIPS 8.46%	TIPS 2.84%	Bank Loans 7.33%	Agency 7.90%	TIPS -2.35%	CMBS 28.45%	EMD-HC 12.24%	EMD-HC 7.35%	CMBS 9.67%	ABS -0.27%	TIPS 2.21%
Bank Loans 5.60%	Treasury 2.79%	MBS 5.22%	MBS 6.90%	Credit -3.08%	ABS 24.72%	Bank Loans 9.97%	MBS 6.23%	Bank Loans 9.43%	Agency -1.38%	EMD-LC 1.90%
Credit 5.24%	High Yield 2.74%	CMBS 4.73%	EMD-HC 6.16%	EMD-LC -5.22%	EMD-LC 21.98%	Credit 8.47%	CMBS 6.02%	Credit 9.39%	MBS -1.41%	MBS 1.58%
MBS 4.70%	MBS 2.61%	ABS 4.70%	CMBS 5.57%	EMD-HC -12.03%	Credit 16.04%	TIPS 6.31%	ABS 5.14%	TIPS 6.98%	Credit -2.01%	Treasury 1.34%
CMBS 4.10%	Agency 2.33%	Agency 4.37%	Credit 5.11%	ABS -12.72%	TIPS 11.41%	Treasury 5.87%	High Yield 4.98%	ABS 3.66%	Treasury -2.75%	Bank Loans 1.30%
Treasury 3.54%	ABS 2.09%	Credit 4.26%	ABS 2.21%	CMBS -20.52%	MBS 5.89%	ABS 5.85%	Agency 4.82%	MBS 2.59%	EMD-HC -5.25%	CMBS 1.29%
Agency 3.33%	Credit 1.96%	Treasury 3.08%	Bank Loans 1.88%	High Yield -26.18%	Agency 1.53%	MBS 5.37%	Bank Loans 1.82%	Agency 2.16%	TIPS -8.61%	Agency 1.02%
ABS 3.00%	CMBS 1.82%	TIPS 0.41%	High Yield 1.87%	Bank Loans -28.75%	Treasury -3.57%	Agency 4.36%	EMD-LC -1.75%	Treasury 1.99%	EMD-LC -8.98%	ABS 0.54%

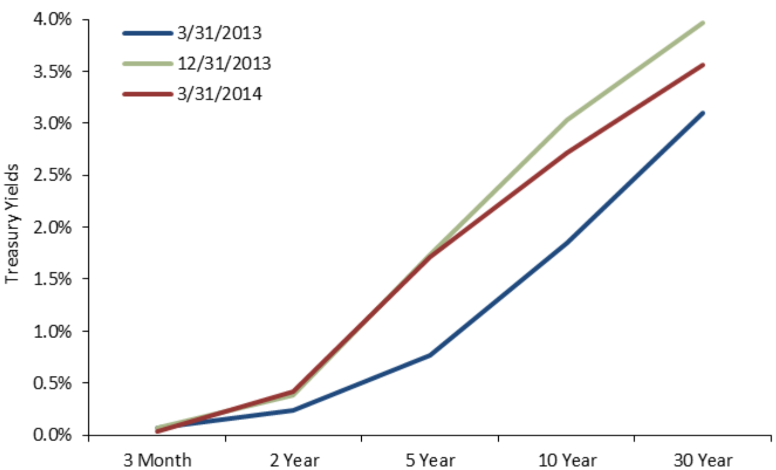
Source: Barclays Capital, JPMorgan, Credit Suisse

US TREASURY

Treasury Yield Curve

- Despite consensus expectations for further increases in rates, Treasury yields fell sharply across the curve in the early weeks of the first quarter with the five-year down -25 bps and the long end down -37 bps in January after disappointing US economic data. Later in the quarter, market consternation over FOMC/Janet Yellen's communications on monetary policy brought rates back up. While maintaining some consistency with continuing its $10B/month taper, the relatively hawkish tone of the FOMC surprised the markets, pushing the five-year Treasury up by 21 bps and largely erasing the move down earlier in the quarter. A majority of Fed governors indicated they believed the Fed Funds rate would rise to 1% in 2015, implying a rate hike in early 2015, earlier than market expectations.

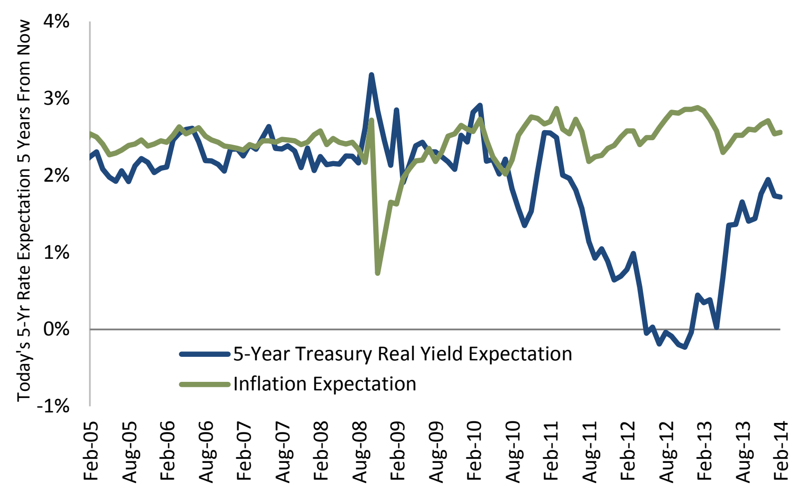
US Treasury Yield Curve



Treasury Rate Expectations

- Inflation and real yield levels remain low by historical standards, but are expected to normalize over the next five years. With tapering underway, fixed income investors are pricing in the end of accommodative policy. Using the five-year/five-year forward Treasury rate as a guide, one can see how the markets have dramatically increased expectations for five-year real yields to near 2% five years from now. However, inflation expectations still continue to be relatively stable, highlighting the lack of fear over inflation pressures driving rates up.

Treasury Rate and Inflation Expectations



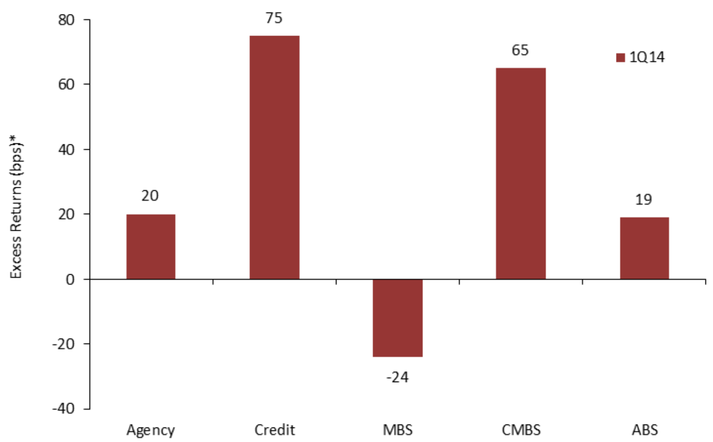
Source: Bloomberg, JPMorgan, Federal Reserve Bank of St. Louis

INVESTMENT GRADE OVERVIEW

Excess Returns

- All investment grade sectors produced positive nominal returns for the quarter on the back of falling rates. Credit, with its longer duration profile, led all sectors with a 291 bps return, essentially double all other sectors. In excess return terms (versus duration neutral Treasuries), credit's return advantage was tighter, besting CMBS by only 10 bps with the two sectors the clear leaders for the quarter. Agency MBS was the only sector to end the quarter with a negative excess return.

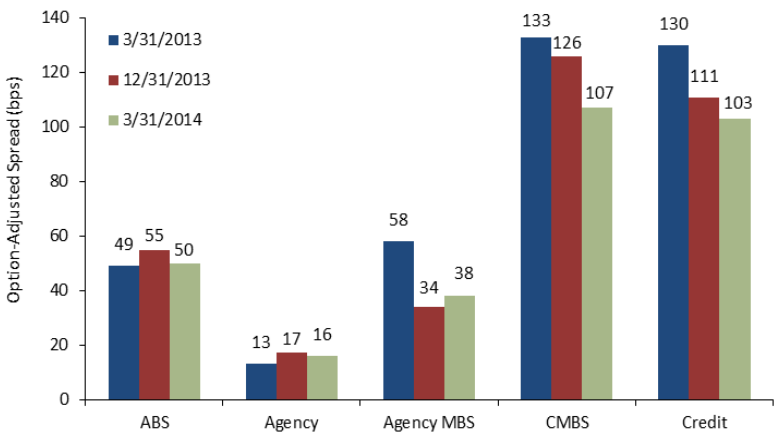
Excess Returns



Spreads

- Spreads began the year modestly higher across the investment grade universe, save CMBS, before riding the risk-on wave that characterized February. In February alone, higher beta sectors, such as CMBS and credit, tightened 15 bps and 9 bps, respectively. March witnessed continued grinding in of spreads, although agency MBS spreads widened slightly by 3 bps.

Option-Adjusted Spreads

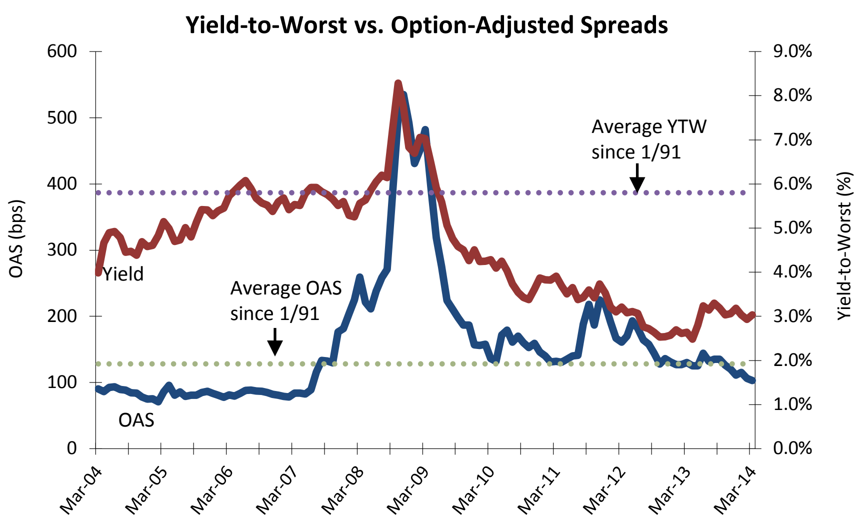


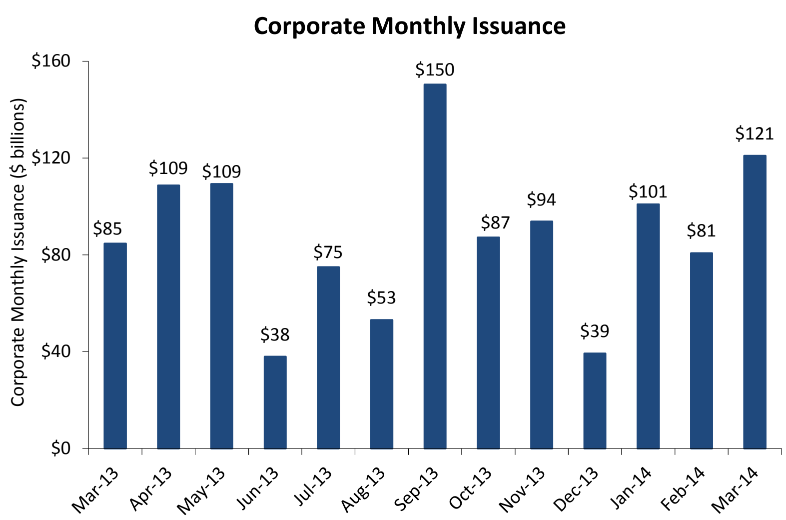
*Excess returns versus duration-neutral Treasuries
Source: JPMorgan, Barclays Capital

INVESTMENT GRADE CREDIT

Spreads & Issuance

- Investment grade credit produced a strong 2.91% return in the first quarter with the long duration bucket up 6.3%. Credit continued the strong run seen in late fourth quarter of 2013. A majority of the performance came in January despite modestly wider spreads as the sharp drop in rates pushed the sector higher. February and March witnessed tighter spreads with new issuance benefiting from oversubscriptions by investors.
- Spreads are at their tightest levels since June 2007 but remain 31 bps wide of their all-time low. In first quarter, industrials out-performed financials and utilities with spreads tightening 9 bps.
- The non-corporate component of credit, which includes emerging market sovereign debt, rebounded after a difficult 2013 with a 4.1%s return in the first quarter.
- Despite concerns over US economic growth and geopolitical tensions arising out of Ukraine, issuance was surprisingly robust for the quarter as over $300B hit the primary market. Total quarterly issuance was the highest since the first quarter of 2012. January and March were the leading months with $101B and $121B in new issuance, respectively. As noted, robust demand from investors helped take down the debt as strong fundamentals and appetite for carry continue to attract investors to credit.





Source: JPMorgan, Barclays Capital, SIFMA

INVESTMENT GRADE: SECURITIZED SECTORS

Securitized Sector Observations

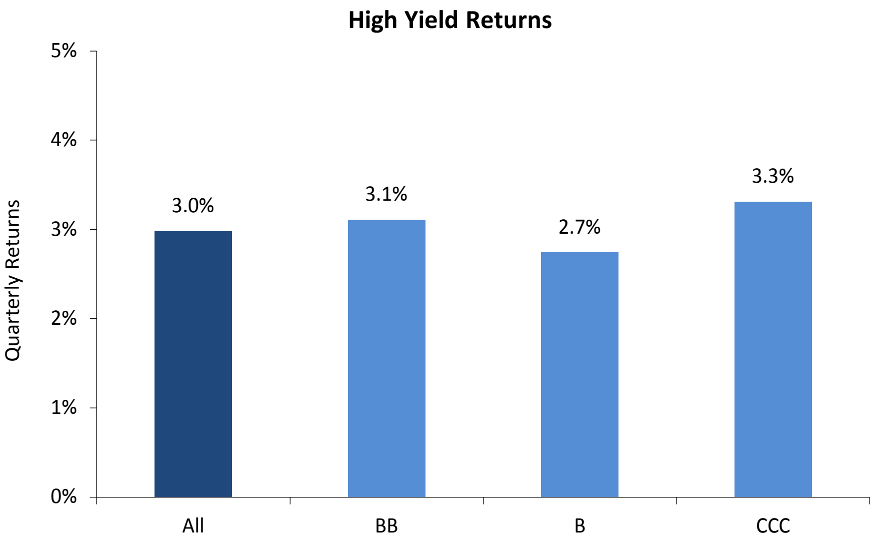
- **Agency MBS**
  - Reduced appetite for agency MBS on the heels of the Fed's tapering program weighed on the agency MBS sector in the first quarter of 2013. The Fed's continued reduction of agency MBS purchases has brought its monthly buys to $25B, versus the $40B average in 2013. To be sure, higher rates have impacted the supply of new paper which should help offset the reduction in Fed activity in the sector.
  - Hybrid ARMS issues were the winners in the first quarter, generating a positive 37 bps in excess return while fixed rate issues lagged at -25 bps.
- **Non-Agency MBS**
  - Non-agency MBS continued to put up strong returns on the back of a solid 2013. Most sectors generated a 2-3% return over the quarter, with the single outlier being Alt-A Hybrid issues, the outperformer with a 5% quarterly return.
  - A slight negative story arising out of the first quarter, however, was slowing housing activity in the US. With higher mortgage rates since last summer, existing home sales are down 15% from July 2013 and mortgage purchase applications are showing weakness as well.
- **CMBS**
  - CMBS produce a 1.29% total return in the first quarter, with a majority of it generated in January and February before trailing off in March. Lower-quality CMBS issues once again were the top performers, with BBB-rated issues producing 186 bps, besting AAA-rated issues by 50 bps.
  - New issuance was particularly slow in the first two months of the year leading to a 33% decline for the quarter versus the first quarter of 2013. While March did see a solid uptick in activity and forward supply is robust, expectations are for total issuance in 2014 to remain close to 2013's $80B.
- **ABS**
  - Credit card-backed securities outpaced auto-backed issues in the first quarter with a 0.60% return versus auto's 0.43% return. First quarter issuance of $54.6B was over $7B more than first quarter 2013, highlighting continued interest from investors for higher yielding short-duration options.

Source: JPMorgan, Barclays, SIFMA, BlackRock

HIGH YIELD

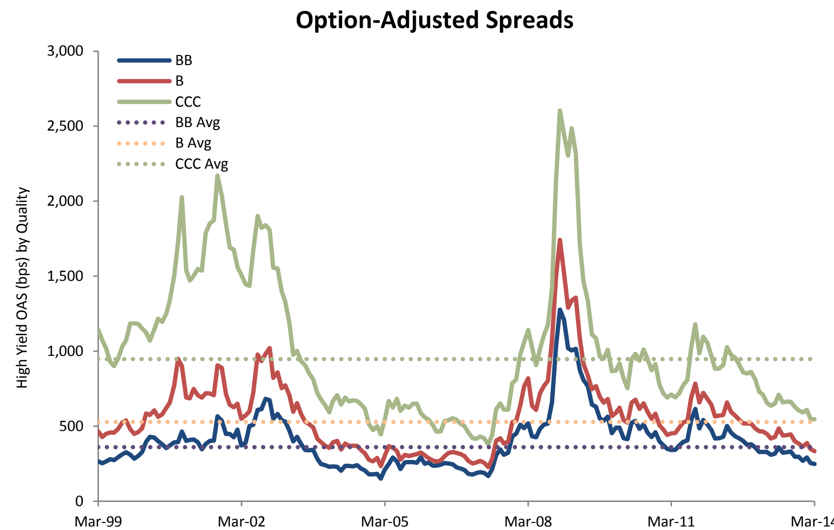
Returns

- After a strong 2013 in which high yield posted a 7.4% return, 2014 began with a bang in the sector with a 2.9% return for the first quarter. Primary drivers of returns were spread tightening and falling Treasury rates, the latter helping higher quality issues keep pace with higher-yielding, low-quality issues. February was an especially strong month for high yield with a 2.0% total return as spreads fell -41 bps for the sector.



Spreads

- The initial 22 bps widening of high yields spreads in January was offset by falling Treasury yields. February was a risk-on month as spreads fell sharply before grinding tighter in March by 5 bps. At 358 bps, high yield spreads have reached their lowest levels since June 2007, and sit 167 bps tighter to their average. CCC-rated issue spreads fell -45 bps during the first quarter bringing them nearly 400 bps inside their long-term average of 940 bps.
- Current spreads are pricing in a 1.0% default rate which is in line with near-term default expectations.



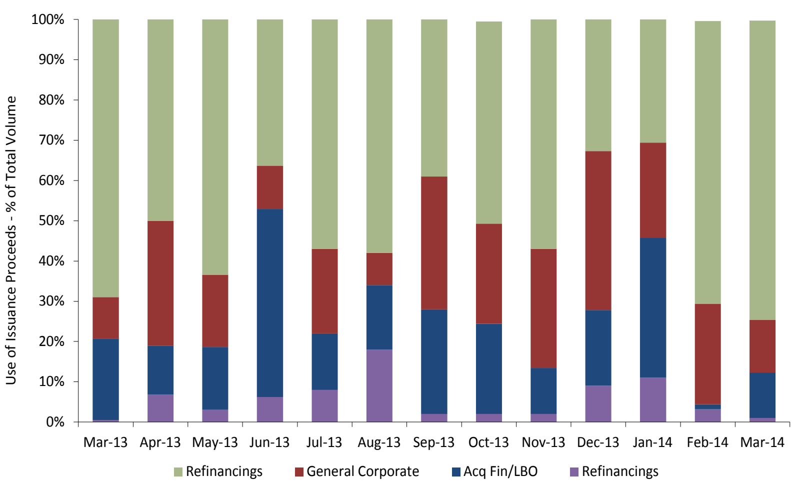
Source: JPMorgan, Barclays Capital

HIGH YIELD (CONTINUED)

Flows & Issuance

- The positive trend of high yield mutual fund inflows seen in late 2013 continued into the first quarter of 2014 as $3.4B in new assets came into the sector from retail investors.
- The record-setting issuance pace from 2013 was not maintained at the start of 2014, but issuance was strong nonetheless. Companies brought $88B in new issues to the primary market in the first quarter, about $40B off the total in the first quarter of 2013.
- While January experienced a sharp uptick in acquisition finance/LBO issues (35% of total), issuance turned solidly more conservative in February and March with 70% of new deals for re-financings.

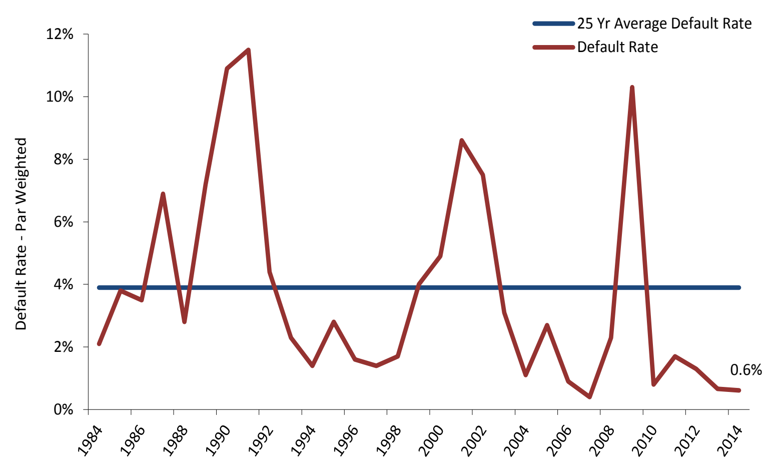
Use of Issuance Proceeds



Defaults

- Defaults moved lower over the course of the quarter to a post-crisis low of 0.6% and 60 bps lower relative to last March. Five high yield bond defaults totaling $1.6B occurred in the first three months of the year; most of this occurred in February which saw $1.1B in defaults.
- One seemingly eminent default that did not occur in March was that of Energy Futures Holdings (TXU) which chose not to file Chapter 11 bankruptcy in the last month of the quarter. Expectations are for a missed coupon payment to occur in early April, making it the largest high yield default on record and the second-largest default on record including investment-grade bonds. The effect of the missed payment will push bond defaults to 1.22% in April. To be sure, TXU bonds have been trading at distressed levels as the markets have been expecting this event for some time.

Default Rate – Par Weighted



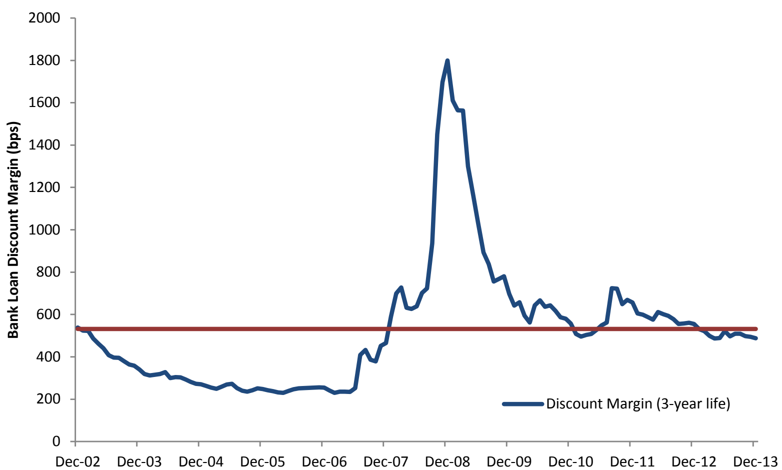
Source: JPMorgan, Barclays Capital

BANK LOANS

Returns & Yields

- Bank loans returned 1.3% in the first quarter. Falling rates worked against the bank loan sector as it lagged longer duration credit sectors such as investment grade credit and high yield. Discount margins (3-year life) fell -15 bps to 473 bps, the lowest level December 2007's 465 bps level. Yields (3-year life) fell to their lowest levels in history in January before moving modestly higher to finish the quarter at 5.14%.
- Smaller issues (<$100 million) outperformed larger, more liquid issues (>$500M) by 100+ bps in the quarter while second lien loans finished ahead of first lien loans by 140 bps.

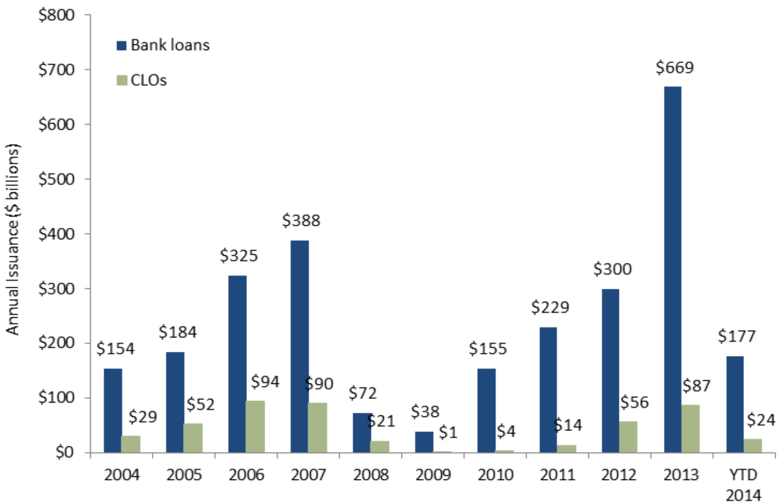
Discount Margin (3 Yr Life)



Issuance & Flows

- Issuance in the first quarter was extremely robust with $176.5B coming to market marking the third-highest quarterly volume on record. February and March had particularly large volumes of over $63B, making them the sixth- and seventh-largest on record, respectively. Refinancing or re-pricings were the primary drivers of issuance. Acquisition financing started out strong with a third of new issues in January before trailing off through the final two months. Dividend deals, however, actually increased as a percentage of issuance from 1% in January to 9% in March.
- Inflows into bank loan mutual funds continued a consecutive positive streak of 21 months and 93 weeks. However, average monthly inflows have fallen to $2.7B over the last six months from an average of $6B in the first three quarters of 2013.

New Issuance



Source: JPMorgan, Credit Suisse

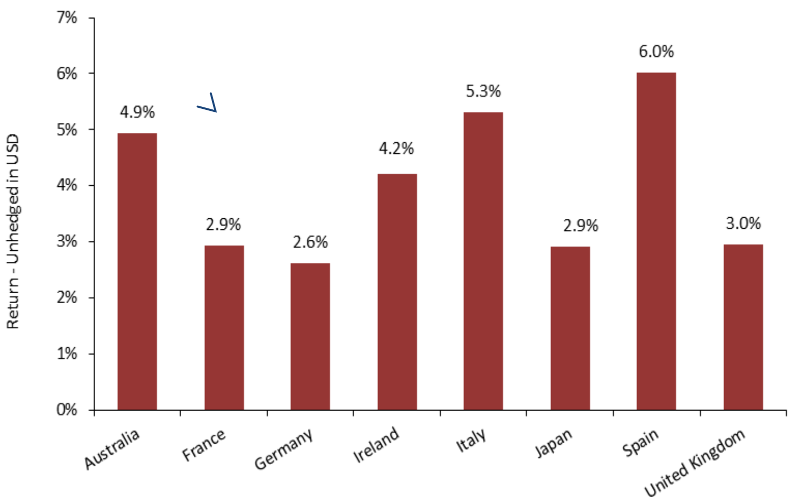
Summit Strategies Group

INTERNATIONAL AND EMERGING MARKET DEBT

International – Developed

- Italy, Spain, and Ireland again produced strong returns in the first quarter, continuing the trend seen in 2013. Italy and Spain in particular have seen their 10-year yields drop dramatically over the last year with each now around the 3.3% level. A credit upgrade in January helped maintain the positive momentum in Ireland.
- Major market currency returns were mixed over the quarter. Within developed Europe, the euro remained stable versus the dollar even with events emanating out of Ukraine while the Japanese yen appreciated about 2% versus the dollar.

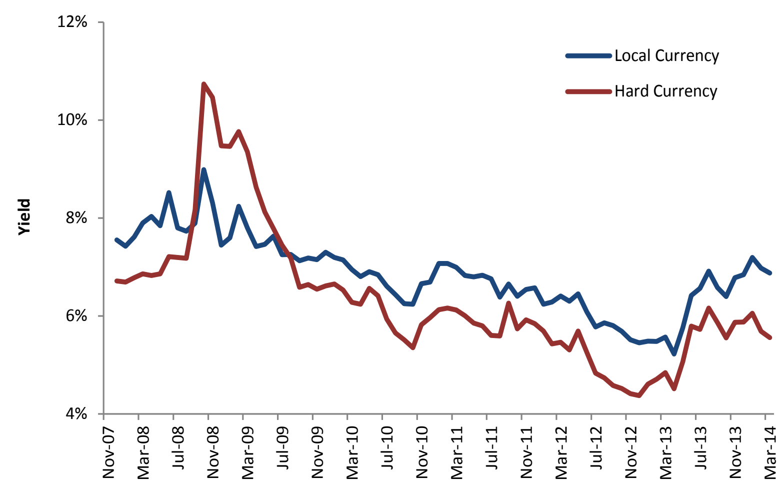
Year-to-Date Returns



Emerging Market Debt

- After a difficult 2013, hard currency was up 3.7% on the back of falling Treasury rates and local currency finished with a 1.9% return in unhedged US dollar terms. Initially Chinese growth concerns and the initiation of tapering in the US weighed on EMD, but sentiment toward EMD improved as the quarter wore on, even as tension in Ukraine increased. In local markets, Europe, hurt by -9.0% return in Russia, was the worst performer after leading Asia, LATAM, and MidEast/Africa in 2013. Indonesia and Brazil bounced back from a difficult 2013 to posts returns of 13.3% and 7.7%, respectively.
- Outflows from US/European retail EMD fund remained steady in the first quarter with approximately $13B in asset losses. On a positive note, EMD funds experienced its first inflow of $531M in over 13 weeks in March.

Local Currency and Hard Currency Yields



Source: JPMorgan, Citi, Colchester Global Investors