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Quarterly Review

Fixed Income Market Update

December 31, 2013

YEAR END SNAPSHOT

A year to forget for fixed income finally ended with a dose of certainty when the Fed decided in December to formally initiate $10 billion in tapering of its current quantitative easing program starting in January 2014. This helped to end the endless market speculation over the timing of the reduction in monetary stimulus. Additional forward guidance on the future for the federal funds rate kept expectations for rate hikes pushed out until 2015 at minimum. Sectors such as emerging market debt and US TIPS were the hardest hit by the tapering fears which began mid-year; EMD fell under pressure as investors withdrew en masse and countries struggled to protect their currencies. TIPS were hit with a double whammy of lower inflation expectations and higher real rates. Higher carry domestic sectors, such as high yield, bank loans, and non-agency MBS, were able to avoid the downdraft felt by higher quality, longer duration fixed income sectors.

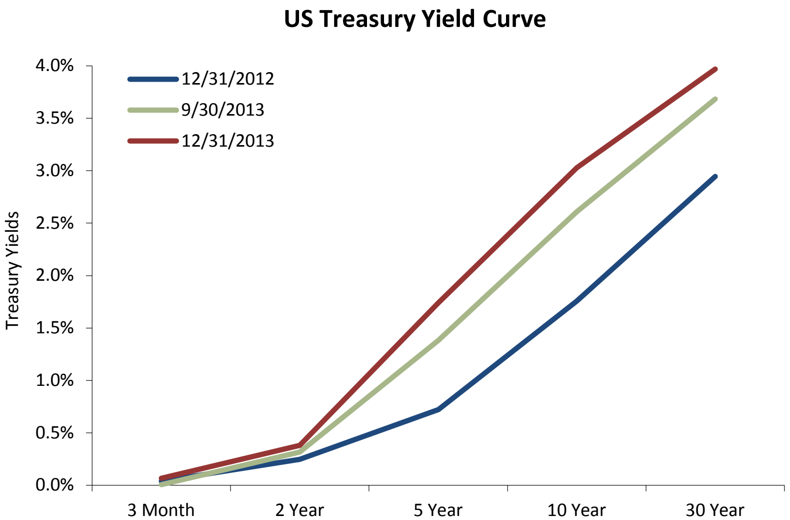
January	February	March	April	May	June	July	August	September	October	November	December	Year-to-Date
High Yield 1.34%	Credit 0.70%	High Yield 1.02%	EMD-LC 3.43%	Bank Loans 0.23%	Bank Loans -0.55%	High Yield 1.90%	Bank Loans 0.04%	EMD-LC 4.40%	EMD-HC 2.77%	High Yield 0.51%	High Yield 0.54%	High Yield 7.44%
Bank Loans 1.12%	Treasury 0.53%	Bank Loans 0.85%	EMD-HC 2.92%	High Yield -0.58%	ABS -0.57%	EMD-HC 1.21%	ABS -0.21%	EMD-HC 2.61%	EMD-LC 2.75%	Bank Loans 0.48%	Bank Loans 0.53%	Bank Loans 6.15%
EMD-LC 0.72%	High Yield 0.51%	CMBS 0.29%	High Yield 1.81%	ABS -0.63%	MBS -0.96%	Bank Loans 1.07%	MBS -0.29%	TIPS 1.45%	High Yield 2.51%	ABS 0.21%	EMD-HC 0.51%	CMBS 0.23%
CMBS -0.15%	Bank Loans 0.39%	TIPS 0.28%	Credit 1.80%	CMBS -0.87%	Agency -1.03%	TIPS 0.73%	CMBS -0.41%	MBS 1.41%	Credit 1.44%	CMBS 0.11%	ABS -0.22%	ABS -0.27%
ABS -0.25%	Agency 0.37%	MBS 0.12%	CMBS 0.89%	Agency -1.02%	Treasury -1.10%	Credit 0.71%	Agency -0.44%	High Yield 0.99%	Bank Loans 0.80%	Agency -0.01%	Credit -0.25%	Agency -1.38%
Agency -0.37%	MBS 0.34%	Treasury 0.10%	Treasury 0.89%	MBS -1.53%	CMBS -1.45%	CMBS 0.51%	Treasury -0.49%	CMBS 0.92%	CMBS 0.71%	Credit -0.27%	CMBS -0.29%	MBS -1.41%
MBS -0.50%	ABS 0.30%	Agency 0.06%	TIPS 0.80%	Treasury -1.71%	High Yield -2.62%	Agency 0.01%	High Yield -0.61%	Credit 0.83%	MBS 0.68%	Treasury -0.33%	MBS -0.47%	Credit -2.01%
TIPS -0.68%	TIPS 0.02%	Credit 0.01%	Bank Loans 0.75%	Credit -2.36%	Credit -2.85%	MBS -0.09%	Credit -0.81%	Agency 0.72%	TIPS 0.55%	MBS -0.62%	EMD-LC -0.55%	Treasury -2.75%
Treasury -0.81%	CMBS 0.00%	ABS -0.01%	Agency 0.50%	EMD-HC -3.57%	TIPS -3.58%	Treasury -0.11%	TIPS -1.45%	Treasury 0.70%	Treasury 0.48%	TIPS -1.09%	Agency -0.56%	EMD-HC -5.25%
Credit -0.87%	EMD-HC -0.31%	EMD-LC -0.52%	MBS 0.53%	TIPS -4.36%	EMD-LC -4.13%	ABS -0.19%	EMD-HC -2.56%	ABS 0.56%	Agency 0.41%	EMD-HC -1.70%	Treasury -0.91%	TIPS -8.61%
EMD-HC -1.34%	EMD-LC -0.32%	EMD-HC -0.62%	ABS 0.40%	EMD-LC -6.52%	EMD-HC -4.91%	EMD-LC -0.56%	EMD-LC -4.09%	Bank Loans 0.29%	ABS 0.33%	EMD-LC -3.64%	TIPS -1.47%	EMD-LC -8.98%

Source: Barclays Capital, JPMorgan, Credit Suisse

US TREASURY

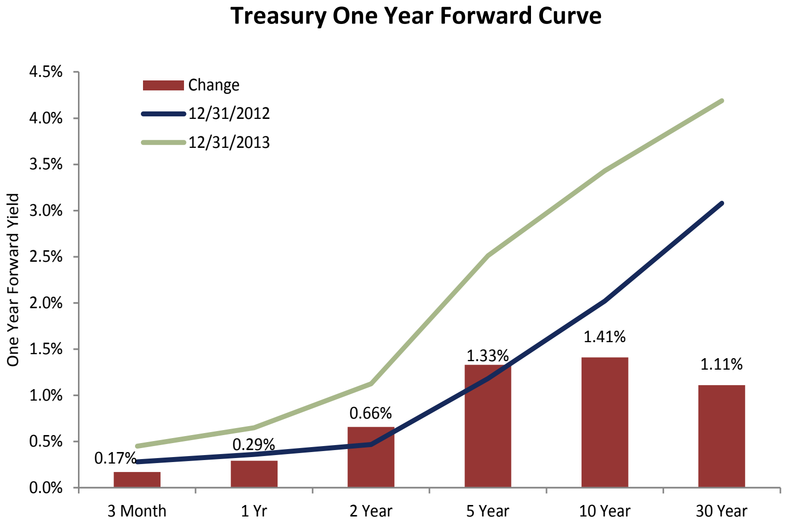
Treasury Yield Curve

- Treasuries lagged domestic fixed income sectors with a -0.75% bps return in the fourth quarter as rates rose across the curve; for the year, Treasuries were down -2.75%, making it the third worst calendar year in 40 years. Initially, rates were held lower by the US government shutdown with the 10-year hitting a low of 2.50% in mid-October. However, solid payroll data in the delayed October report prompted rates to steadily move higher as expectations for a December taper grew. A strong ISM manufacturing reading and the Fed's subsequent $10 billion taper in December pushed rates to finish near year-to-date highs. For the year, the 5-year and 30-year were each up 102 bps while the 10-year increased by 127 bps.



Forward Curves

- One year forward rates changed quite dramatically over the course of 2013 with the initial catalyst being rampant speculation over tapering and culminating in the confirmation in December of the start of tapering in January 2014. Most of the impact to forward rates was felt in the belly of the curve as the short end remained bounded by the Fed's commitment to maintaining the current federal funds rate past their current unemployment target of 6.5%.



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

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INVESTMENT GRADE OVERVIEW

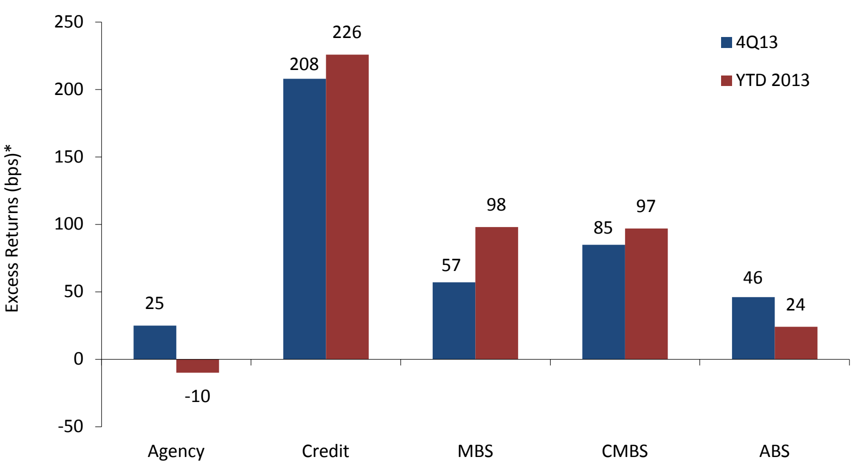
Excess Returns

- Despite negative absolute returns for all sectors except CMBS in 2013, nearly all investment grade sectors were able to generate positive fourth quarter and year-to-date excess returns versus duration neutral Treasuries. Leading all sectors was investment grade credit which saw 92% of its total 2013 excess return of 226 bps generated in the fourth quarter alone. All the securitized sectors – ABS, CMBS, MBS – were able to produce positive excess returns with CMBS leading the group in the fourth quarter and equaling MBS for 2013. Agency debt was the sole outlier for the year as it trailed with a modest -10 bps excess return.

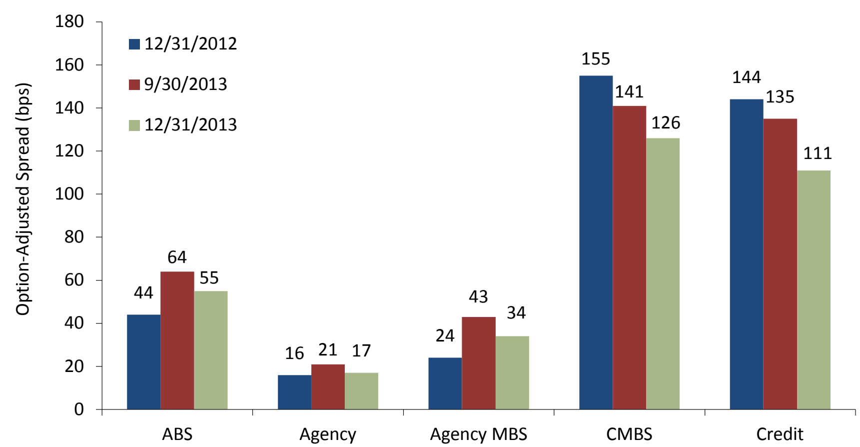
Spreads

- Spreads for all investment grade sectors were tighter for the quarter with credit and CMBS spreads experiencing the most at -15 bps and -24 bps, respectively. Credit's year-ending 111 option-adjusted spread was driven by financials' -46 bps drop for the year, most of which came in the fourth quarter. The option-adjusted spread for CMBS finished the year at its lowest year-end level since 2006.

Excess Returns



Option-Adjusted Spreads



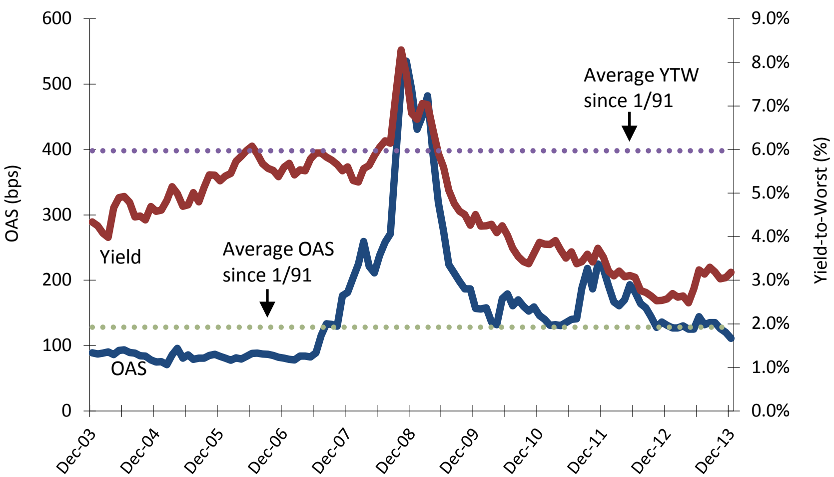
*Excess returns versus duration-neutral Treasuries
Source: JPMorgan, Barclays Capital

INVESTMENT GRADE CREDIT

Spreads & Issuance

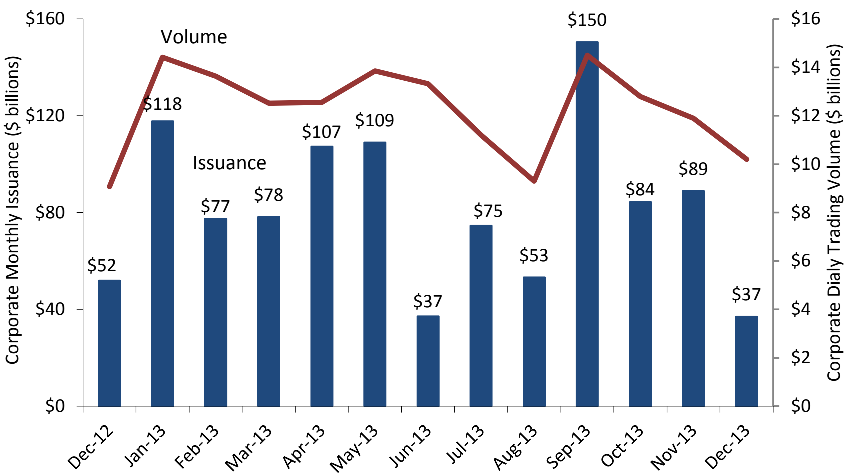
- Credit spreads wrapped up the year 20 bps inside the starting OAS level from the beginning of the year. Despite tighter spreads, it was not enough to offset the rise in Treasury rates which caused a -2.01% annual total return. The fourth quarter provided a majority of the 226 bps in excess return for the year; spreads grinded tighter by 24 bps in the fourth quarter, helped by better US growth expectations, demand for yield, and a continuation of strong corporate fundamentals.
- During the fourth quarter, industrials outperformed both financials and utilities on an excess return basis although each were very strong at 237 bps, 223 bps, and 235 bps, respectively.
- The non-corporate component of credit, which includes emerging market debt, dragged on the sector in 2013; EMD came under pressure due to rising rates in the US and mutual fund outflows .

Yield-to-Worst vs. Option-Adjusted Spreads



- Issuance totaled $210B in the fourth quarter, bringing the full-year issuance total to $1.0T. Issuance slowed in the last quarter of the year by $60B versus the same time period in 2012. However, 2013's overall issuance was largely in line with 2012's total.
- Despite regulations affecting bank's ability to trade securities for their own desks, monthly trading volumes averaged $12B per month in 2013, a five-year high.

Corporate Monthly Issuance & Daily Trading Volume



Source: JPMorgan, Barclays Capital, SIFMA

INVESTMENT GRADE: SECURITIZED SECTORS

Securitized Sector Observations

- **Agency MBS**
  - Agency MBS ended the quarter down -0.42% and -1.41% for the year. The sector was buffeted by external factors in the fourth quarter which included rising rates, the naming of Mel Watt as Director of the Federal Housing Finance Agency, and consternation over an expected tapering decision in December. Surprisingly, the latter issue actually provided a level of certainty for investors and spreads moved tighter in the second half of December.
  - Spreads moved tighter throughout the quarter, finishing -37 bps inside their widest level, seen in early June, and -16 bps tighter for the year. Fixed rate MBS issues under-performed hybrid MBS securities on an absolute basis during the fourth quarter. However, fixed rates generated 101 bps excess return for the year while hybrids lagged with a -16 bps excess return.
- **Non-Agency MBS**
  - Non-agency MBS wrapped up a solid year with especially strong performance in October following the resolution to the US government shutdown. For the quarter the sector was up 5.0% and 16% for the year. In particular, higher-yielding subprime and option-ARM issues were strong performers. Floating rate paper also continued to attract higher interest from investors versus fixed rate issues. Housing continues to improve which bodes well for the sector, especially given the lack of new supply of non-agency MBS.
- **CMBS**
  - CMBS managed to eke out a positive 0.23% return for 2013, despite a -0.29% drop in the fourth quarter. Lower quality CMBS issues once again were the top performers with BBB-rated issues producing 158 bps in excess return while AAA-rated issues produced 83 bps during the fourth quarter. The disparity was more pronounced over the year with BBBs generating 431 bps in excess return versus AAA's 52 bps.
  - Issuance for the year hit $80B which was just over double all of 2012's issuance and the highest since the financial crisis.
- **ABS**
  - The ABS sector was able to avoid the carnage brought on by higher rates in 2013, posting a modestly negative 0.27% return for the year. The largest cohort within ABS – auto-backed paper – led the ABS subsectors with an annual return of 0.71% while credit cards and utility-backed issues returned -0.84%% and -2.13%, respectively.

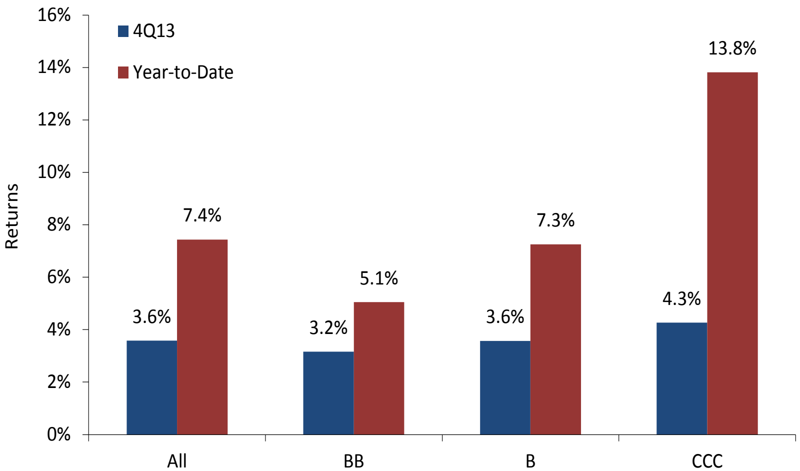
Source: JPMorgan, Barclays Capital, SIFMA, BlackRock

HIGH YIELD

Returns

- High yield finished the year with coupon-plus returns of 7.4% as its carry advantage and full absorption of rising rates through falling spreads helped the sector avoid a negative year. The fourth quarter alone provided nearly 50% of the annual return with the sector up 3.6%, most of it arising in October.
- Lower quality issues again led with a 4.3% return in the fourth quarter and outpaced BB- and B-rated issues by over 600 bps for the year.

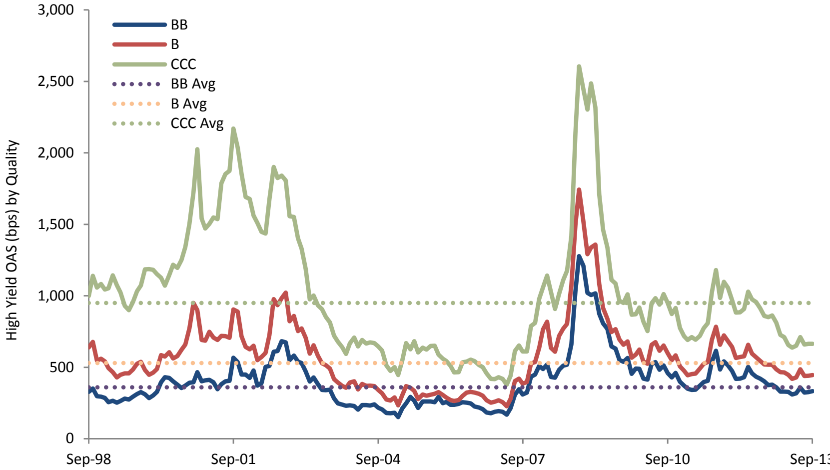
High Yield Returns



Yield, Spread & Price

- High yield spreads moved sharply lower in the first month of the fourth quarter, falling -45 bps in October. They continued to move tighter in November and finished an additional -20 bps narrower in December, bringing the quarter's move to -79 bps. This was by far the strongest move in spreads for the year as it represented 61% of the year's -129 bps decline.
- CCC spreads fell -221 bps for the year and now sit only 322 bps wide of BB spreads; this is only 100 bps outside of the tightest BB-CCC spread difference seen in May 2006.
- At 384 bps, high yield spreads are pricing in a 1.4% default rate which is in line with expectations. The current one-year default rate of 0.7% implies a spread of 340 bps for the high yield market, which leaves a modest amount of room for further spread compression.

Option-Adjusted Spreads



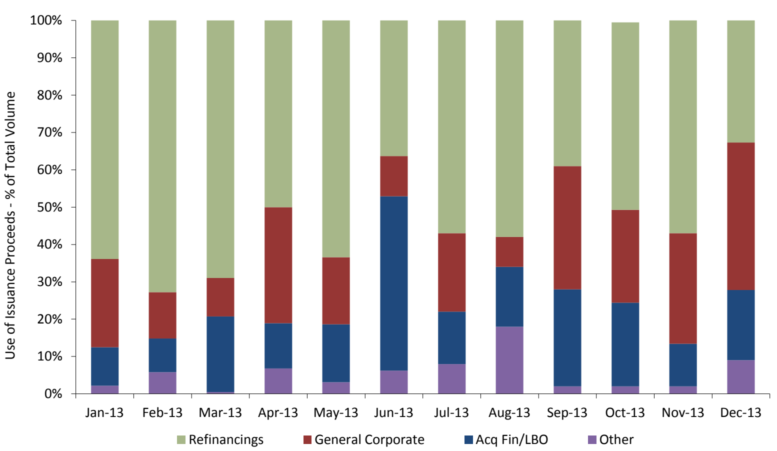
Source: JPMorgan, Barclays Capital

HIGH YIELD (CONTINUED)

Flows & Issuance

- Flows into high yield were negative for the year as -$4.9B flowed out of high yield mutual funds. While certainly a reversal from the last few years of record inflows, the outflows were less than the record outflow of -$8.8B seen in 2005. To be sure, the trend for flows in the second half of the year was positive as $9.4B came into high yield funds in the third and fourth quarter helping to offset the large -$15.9 outflow in the second quarter.
- The record setting $399B in issuance in 2013 still maintained a relatively moderate profile with refinancings making up 54% of issuance. Lower-quality deals only made up 18.8% of issuance versus a high of 36% in 2007. The makeup of issuance did turn more aggressive in the second half of the year with refinancings accounting for 49% of deals versus 59% in the first six months.

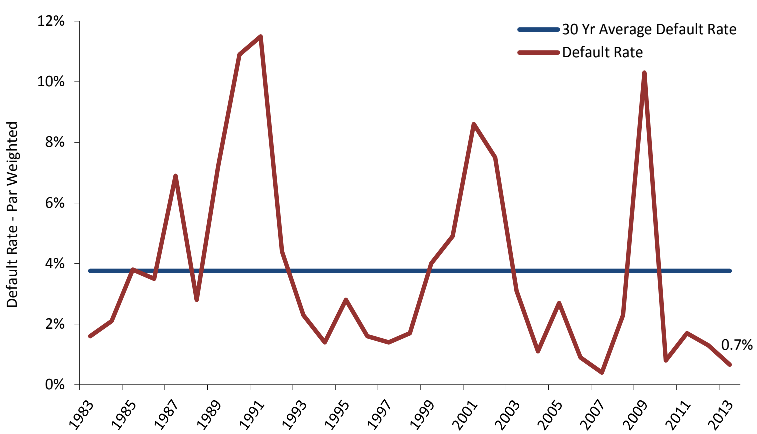
Use of Issuance Proceeds



Defaults

- Defaults in 2013 affected $7.9B in high yield bonds which left the default rate below 1% on a par-weighted basis. While the number of defaulting issuers (20) has been fairly steady the last four years, the volume of defaults has ticked down from its high of $94.6B in 2009. Both upgrade and downgrade volumes increased in 2013 but the upgrade/downgrade ratio ended the year at a 1.4 level, well-above a recent low of 0.3 in 2008.

Default Rate – Par Weighted



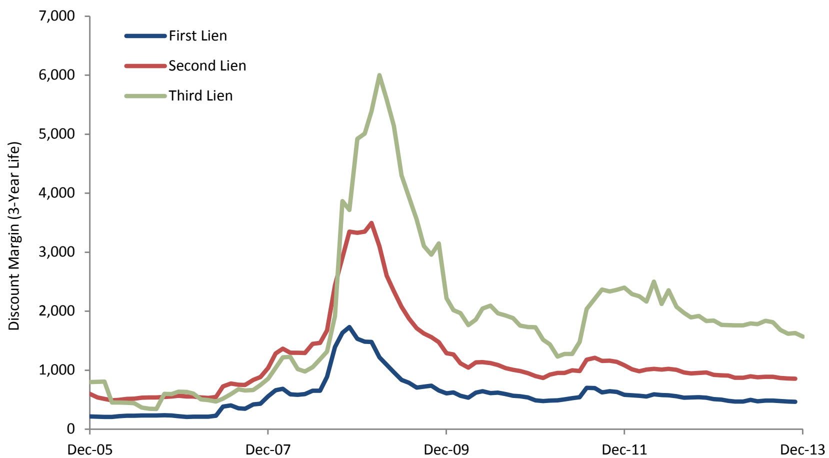
Source: JPMorgan, Barclays Capital

BANK LOANS

Returns & Yields

- Bank loans returned 1.8% in the fourth quarter, bringing year-to-date returns to 6.2%. CCC issues outperformed with a 10.9% return versus BB's 4.2% and B's 7.1% annual return. Discount margins (3-year life) fell -9 bps to 488 bps during the quarter and yields (3-year life) finished the quarter at 5.26%. Yields are now only 6 bps wide of their 15-year tight.
- The return dispersion between smaller issues (<$100 million) and larger, more liquid issues (>$1 billion) was 321 bps for the year. Lower seniority (third lien) outperformed first lien and second lien issues by 1005 bps and 366 bps, respectively. Loans with full covenants and covenant-lite issues performed in line with each other in 2013.

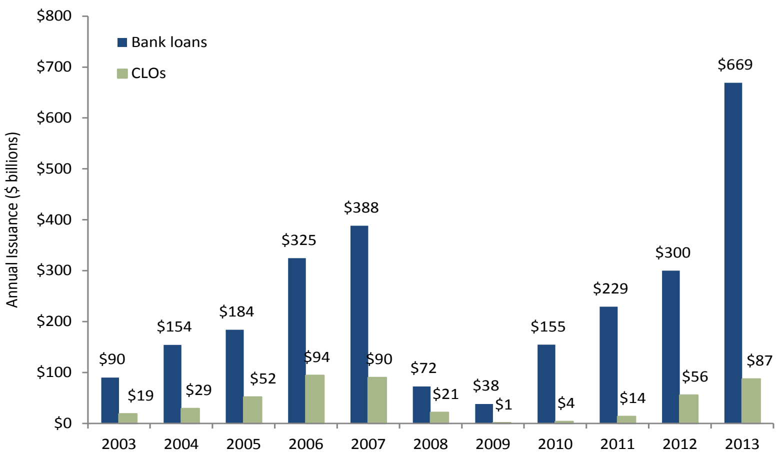
Discount Margin (3 Yr Life) by Seniority



Issuance & Flows

- Strong demand from investors led to a fourth straight year of increased issuance, ultimately setting an annual record of $669B in institutional loan volume. Such high issuance levels can imply a reduction in credit standards but 71% of the new issuance was for refinancing/repricing purposes and lower quality issuance remained contained. To be sure, cov-lite deals did represent 51% of total issuance and acquisition financing made up 29% of deals in the final seven months.
- Inflows into bank loan mutual funds in 2013 totaled a record $62.9B, over three times the previous record set in 2010. Inflows have been positive for 81 consecutive weeks and look unlikely to abate given rising rate concerns and credit fundamentals. CLO issuance hit $87.1B in 2013, trailing only 2006's $94.1B and 2007's $90.0B for the highest annual total issued.

New Issuance



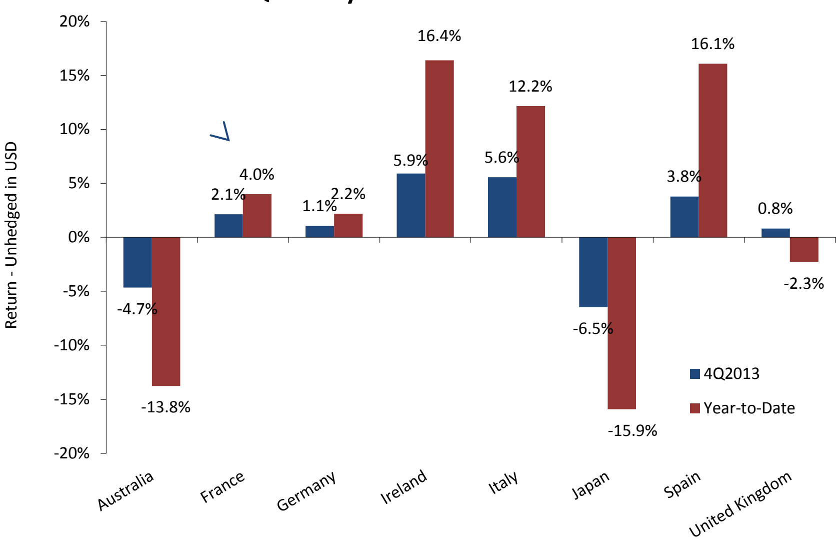
Source: JPMorgan, Credit Suisse

INTERNATIONAL AND EMERGING MARKET DEBT

International – Developed

- Peripheral Europe's outperformance was the surprise of 2014 as the concern over a Eurozone crisis eased. Spreads of Italy and Spain's 10-year yields dropped 99 bps and 170 bps, respectively, versus the German 10-year yield. Ireland's bond market benefited from its exit from the EU/IMF program in December and was a top performer.
- Australia significantly underperformed on a drop in demand for commodities and fears of a strong Australian dollar negatively impacting the local economy. Japan's massive quantitative easing program negatively impacted the Yen as it fell over 20% versus the US dollar.

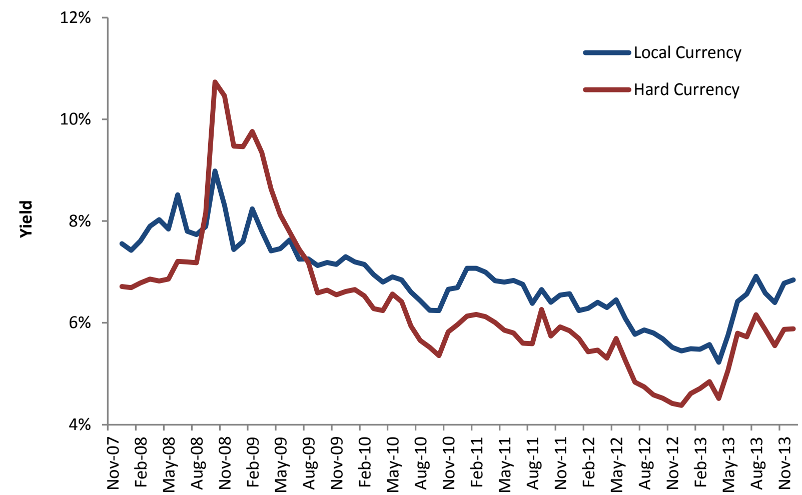
Quarterly & Year-to-Date Returns



Emerging Market Debt

- The fourth quarter could not come fast enough as emerging market debt market never recovered from its downturn after the Fed's surprise tapering talk back in May. Hard currency finished down -5.3% while local fell -9.0%. Local currency index yields rose 139 bps over the year while hard currency yields increased 150 bps. Currency detracted from local returns to the tune of -870 bps. Europe was the best performer as it managed to avoid the major drawdowns driven by currency weakness as was seen in Brazil, Turkey, Indonesia, and South Africa.
- US/European retail outflows reduced total EMD inflows to $9.7B for the year, a far cry from 2012's record $97.5B. Local currency recorded a positive flow of $11B while hard currency funds saw $1.4B withdrawn over 2013.

Local Currency and Hard Currency Yields



Source: JPMorgan, Citi

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