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Quarterly Review

Fixed Income Market Update

June 30, 2014

FIXED INCOME MARKET QUARTERLY OVERVIEW

Market behavior in the second quarter of 2014 was a far cry from a year ago, when the "taper tantrum" drove rates higher and risky assets down. Instead, limited volatility and low trading volumes defined the second quarter despite ongoing tension between Ukraine and Russia and the rise of ISIS in northern Iraq. Market participants largely shrugged off geo-political events as the equity markets reached all-time highs and spreads tightened. US fixed income experienced positive returns as the yield curve flattened sharply and spread sectors saw further reductions in their risk premiums. Offsetting storylines counter-balanced one another over the quarter: a dovish Fed versus a more hawkish Bank of England; a return to positive inflows into emerging market debt versus the asset flows out of bank loan funds; and weak 1Q US GDP numbers versus an improvement in the US labor picture and manufacturing sector. The juggernaut of global liquidity was increased yet again as the ECB announced easing measures with the introduction of new targeted LTROs and a negative deposit rate on excess reserves, hoping to jumpstart lending and stave off deflation. Yields in Europe fell to all-time lows, providing another impetus for investors to gravitate to the US for higher relative yields.

January	February	March	April	May	June	Year-to-Date
TIPS 1.98%	EMD-LC 3.92%	EMD-LC 2.81%	TIPS 1.35%	EMD-HC 3.10%	EMD-LC 1.00%	EMD-HC 8.66%
Credit 1.68%	EMD-HC 3.03%	EMD-HC 1.37%	EMD-HC 1.24%	TIPS 2.12%	High Yield 0.84%	EMD-LC 5.99%
MBS 1.56%	High Yield 2.02%	Bank Loans 0.37%	Credit 1.19%	EMD-LC 2.08%	Bank Loans 0.60%	TIPS 5.83%
Treasury 1.36%%	Credit 1.09%	High Yield 0.24%	MBS 0.92%	Credit 1.41%	EMD-HC 0.36%	Credit 5.70%
Agency 0.88%	CMBS 0.58%	Credit 0.12%	EMD-LC 0.89%	MBS 1.20%	TIPS 0.30%	High Yield 5.46%
CMBS 0.82%	TIPS 0.45%	CMBS -0.10%	High Yield 0.63%	Treasury 0.94%	MBS 0.26%	MBS 4.03%
Bank Loans 0.71%	MBS 0.34%	ABS -0.14%	Treasury 0.55%	High Yield 0.92%	CMBS 0.18%	Bank Loans 2.77%
High Yield 0.70%	Agency 0.31%	Agency -0.17%	Agency 0.54%	Agency 0.67%	Credit 0.08%	Treasury 2.72%
ABS 0.44%	Treasury 0.27%%	Treasury -0.29%%	CMBS 0.48%	CMBS 0.65%	ABS 0.04%	CMBS 2.62%
EMD-HC -0.68%	ABS 0.24%	MBS -0.32%	ABS 0.34%	Bank Loans 0.61%	Agency -0.03%	Agency 2.21%
EMD-LC -4.63%	Bank Loans 0.22%	TIPS -0.47%%	Bank Loans 0.23%	ABS 0.39%	Treasury -0.14%	ABS 1.31%

Source: Barclays Capital, JPMorgan, Credit Suisse

US TREASURY

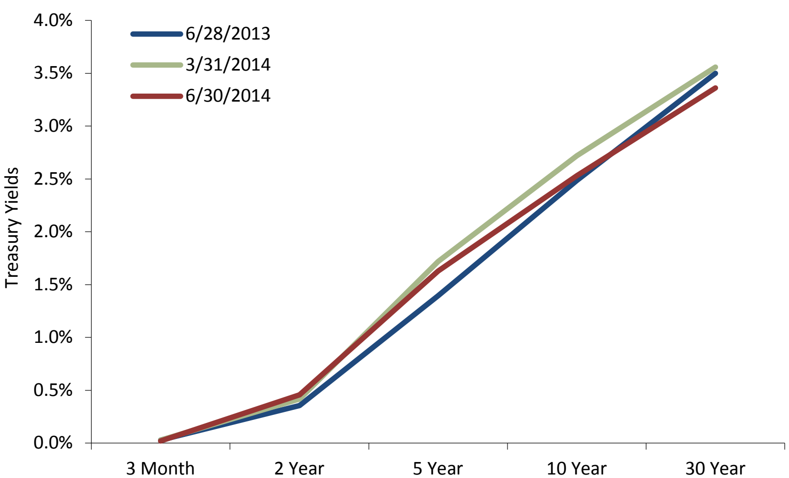
Treasury Yield Curve

- The surprise move down in Treasury yields continued into the second quarter with Treasuries posting a 1.4% quarterly return. Market pundits pointed to various reasons for the drop in yields: short covering; relative higher yields to the Eurozone, LDI long duration buyers, and expectations for ECB monetary actions. Most of the fall in yields came in April and May via a bull-flattening as longer-term yields fell over 20 bps. Better-than-expected payroll numbers in early June saw a sharp move up in yields before retreating to a modest move higher for the month.
- For the quarter, the 30-year Treasury was down -20 bps while the 2-year was actually up 4 bps. The 2-30's curve flattened significantly, from 314 bps to 290 bps.

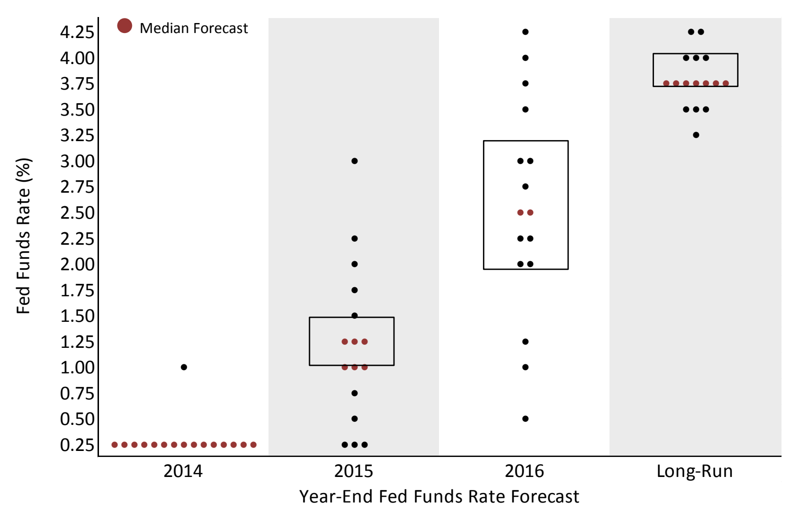
Fed Funds Rate

- Many investors are looking to the Federal Reserve's so-called "dot plot" of Fed Funds rate forecasts for insight into changes in monetary policy. The data highlights individual forecasts of the future Fed Funds rate by Federal Reserve Board Members and regional Federal Reserve Bank Presidents. As seen below, the median expectation of survey participants (which includes non-voters) is for a 2015 year-end exit rate of between 1% and 1.25% before moving to 2% to 3% by the end of 2016.
- These forecasts are higher than the implied figures from Eurodollar futures as Janet Yellen's dovish views have held sway over investors. For the long run and as indicated by the flattening 5-30's curve, investors have started to buy into lower potential US growth. In fact, the Fed's own potential GDP forecast range is down from 2.3-2.5% a year ago to between 2.1-2.3% as of June.

US Treasury Yield Curve



Fed Funds Expectations at June 2014 FOMC Meeting



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

INVESTMENT GRADE OVERVIEW

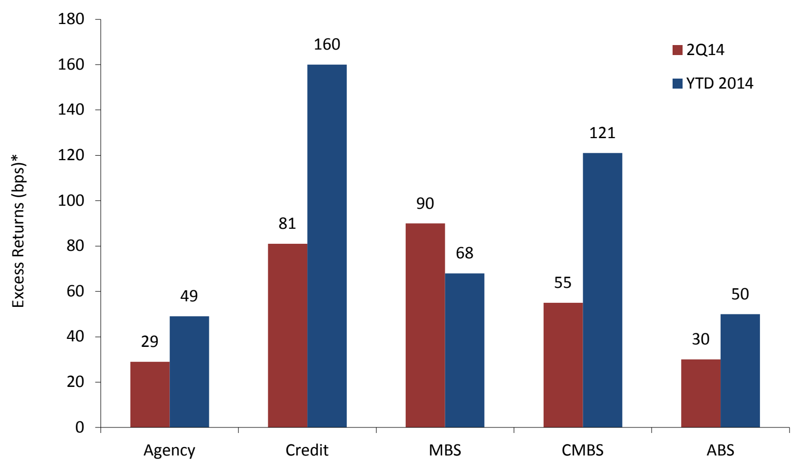
Excess Returns

- Excess returns (versus duration-neutral Treasuries) were strong across investment grade sectors in the second quarter with spreads tighter for all sectors. After trailing other sectors in the first quarter with a negative excess return, the agency MBS sector topped the group with 90 bps in excess return. Investment grade credit once again posted a robust excess return, marking the fourth straight quarter to exceed 70 bps. With the bull flattening of the Treasury yield curve, credit benefited from its longer duration profile and the fall in Treasury rates.

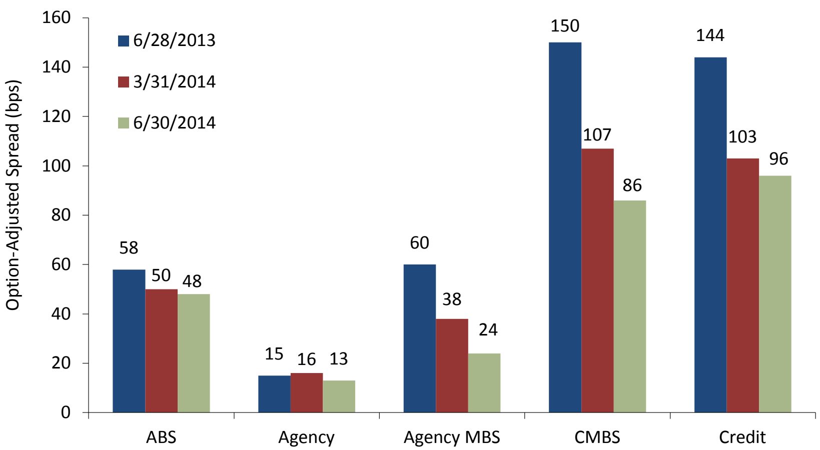
Spreads

- Option-adjusted spreads tightened throughout the quarter, helped by a significant lack of volatility. Since the taper tantrum in the second quarter of 2013, investment grade sectors have experienced a robust reduction in risk premiums, especially CMBS, agency MBS, and credit.
- Credit and CMBS are now at the tightest levels seen since June of 2007, but still 45 bps and 30 bps wide of their tightest levels seen in the last 24 and 14 years, respectively.

Excess Returns



Option-Adjusted Spreads

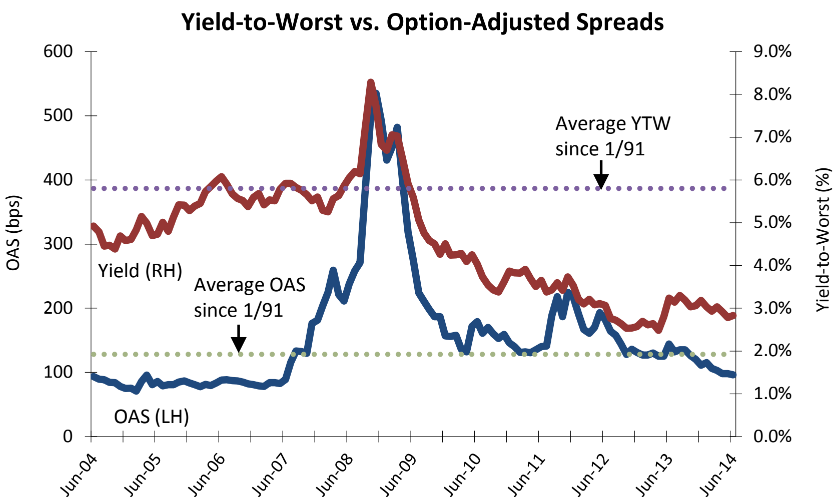


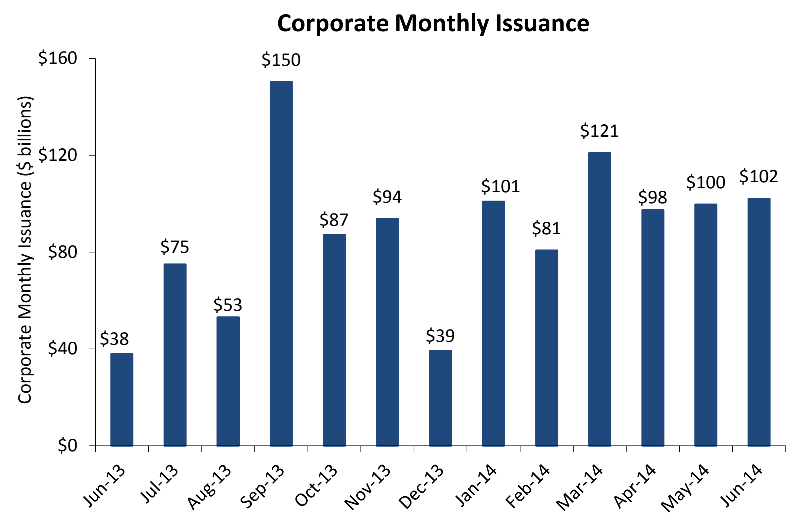
* Excess returns versus duration-neutral Treasuries
Source: JPMorgan, Barclays Capital

INVESTMENT GRADE CREDIT

Spreads & Issuance

- Investment grade credit produced a strong 2.7% return in the second quarter with the long duration bucket up 5.0%. This outperformance was primarily driven by the price return, given falling rates, which totaled 1.68%. On an industry basis, utilities surpassed industrials and non-corporates with a 3.4% quarterly return while financials lagged with a 2.2% return.
- Spreads are at their tightest levels since June 2007 but have not reached the all-time tights seen in mid-1997. At that time, credit spreads touched 51 bps which is still 44 bps through current levels. To be sure, yields in 1997 were 6.6% or 377 bps higher than current levels.
- Second quarter corporate bond issuance maintained first quarter's robust level. Total issuance was $70B higher in the second quarter of 2014 versus the same time period in 2013, when corporate issuance dropped because of concerns over Fed tapering and higher rates. 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**
  - Despite the ongoing tapering program by the Fed, agency MBS's 2.4% second quarter return was its best quarterly return since 2Q 2010. Helping to drive returns higher was a period of low volatility and expectations of the extension of the Fed's principal reinvestment program even if rates are hiked.
  - Fixed rate issues were the winners in the second quarter, generating a 2.4% return versus Hybrid ARM's 0.5%. Lower coupon issues outperformed high coupons given their longer durations and carry advantage.
- **Non-Agency MBS**
  - Non-agency MBS continued to put up strong returns of roughly 3.0%, building on a solid first quarter. Alt-A hybrid and alt-A fixed rate issues finished with year-to-date returns of 6.6% and 4.6%, respectively. With loss-adjusted yields of between 4-6%, low defaults, and an improving housing market, the non-agency MBS sector remains an attractive sector given the low level of yields.
- **CMBS**
  - CMBS continued to attract strong interest from investors, helping the sector generate a 1.3% return in the second quarter as spreads fell by -21 bps. Across the quality spectrum, returns were positive with lower-quality issues outperforming higher quality issues. Barclays announced its intent to include agency CMBS within the Barclays Aggregate and Barclays CMBS indices, which helped provide technical price support for the securities ahead of their July 1 inclusion.
  - New issuance picked up in June after slower activity in April and May of $4.5B and $5.2B in new private label issuance, respectively. The $10B of issuance in June was the second highest monthly total post-crisis.
- **ABS**
  - Credit card-backed securities outpaced auto-backed issues in the second quarter with a 0.98% return versus auto's 0.48% return. Second quarter issuance of $59B brought year-to-date issuance to $114B, which is $20B more than issuance in the first six months of 2013. ABS remains attractive as a higher yielding/lower duration option for investors.

Source: JPMorgan, Barclays, SIFMA, BlackRock

HIGH YIELD

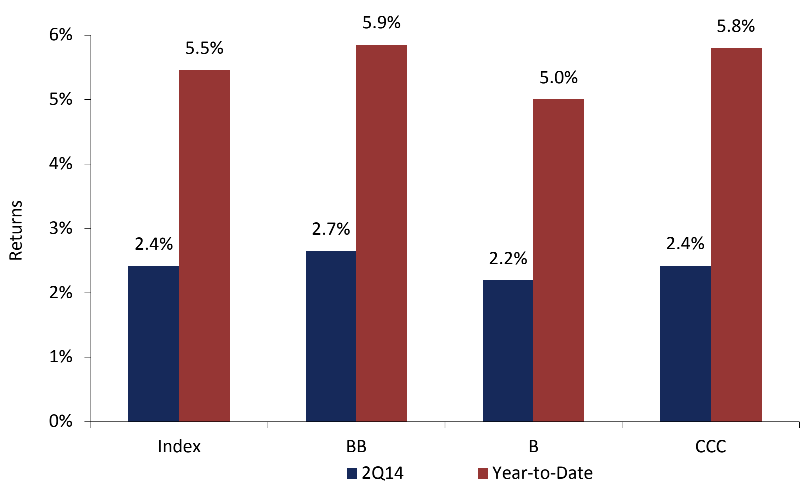
Returns

- Investors were rewarded for their continued interest in high yield as the sector put up strong returns in the second quarter on the back of falling spread levels and lower Treasury rates. The 2.4% return over the quarter marked the fourth straight quarter the market has produced at least 225 bps in nominal returns. In addition, high yield has produced a positive quarterly return in 11 of the last 12 quarters.

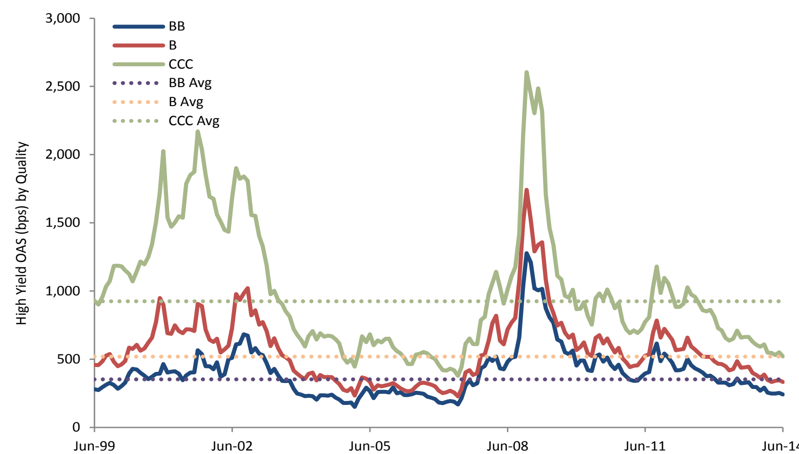
Spreads

- Although high yield spreads leaked out seven bps in May, the overall trend for the quarter was continued tightening with spreads falling -14 bps in both April and June. Interestingly, B-rated issues experienced no spread tightening while BB- and CCC-rated issues compressed by -7 bps and -25 bps, respectively.
- At 337 bps, high yield spreads have reached their lowest levels since June 2007, and sit 185 bps inside their average but still remain 102 bps wide of their all-time tight. In the previous credit cycle before the financial crisis, spreads remained below 400 bps for 37 straight months; the current cycle has seen spreads under 400 bps for only five consecutive months.

High Yield Returns



Option-Adjusted Spreads



Source: JPMorgan, Barclays Capital

HIGH YIELD (CONTINUED)

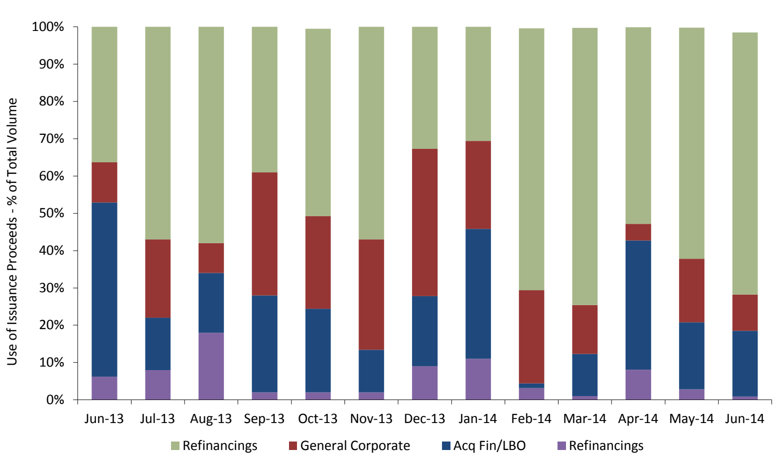
Flows & Issuance

- High yield mutual funds remained a choice destination for investors with year-to-date inflows topping $7B. Low Treasury rates and a search for yield has helped support the high yield market.
- Issuance totaled $207B at the end of the quarter which is in line with the level of issuance in the first six months of 2013. An uptick in LBO/acquisition financing in April was driven by a $16.7B multi-tranche, multi-currency acquisition financing deal by Numericable Group SA and Altice SA. This was the largest transaction in history, eclipsing TXU's $7.5B LBO financing in 2007. May and June issuance reflected the larger trend of companies terming out their debt as refinancings accounted for over 60% of issuance.

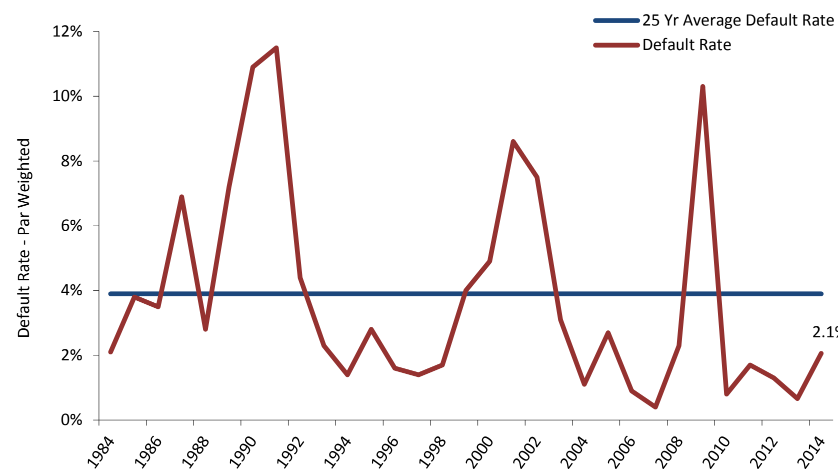
Defaults

- The default rate breached 2% in April on the heels of the Chapter 11 filing of Energy Futures Holdings (TXU) which saw $16.6B in high yield bonds affected. This marked the second-largest bond default in history. Excluding the TXU default, the par-weighted default rate finished the quarter at 0.70%.
- Year-to-date default volumes total $21.5B which exceeds all of 2013 by $13B. However, given the size of the TXU default, the number of defaults totals only 9, versus the 21 experienced in all of 2013.

Use of Issuance Proceeds



Default Rate – Par Weighted



Source: JPMorgan, Barclays Capital

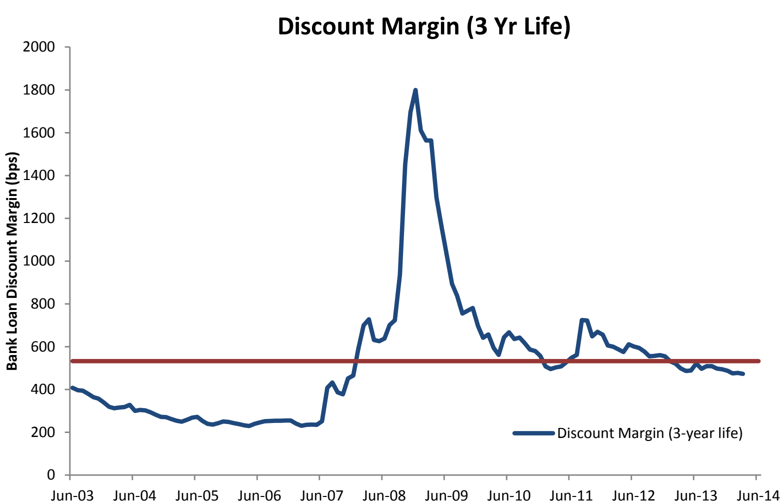
BANK LOANS

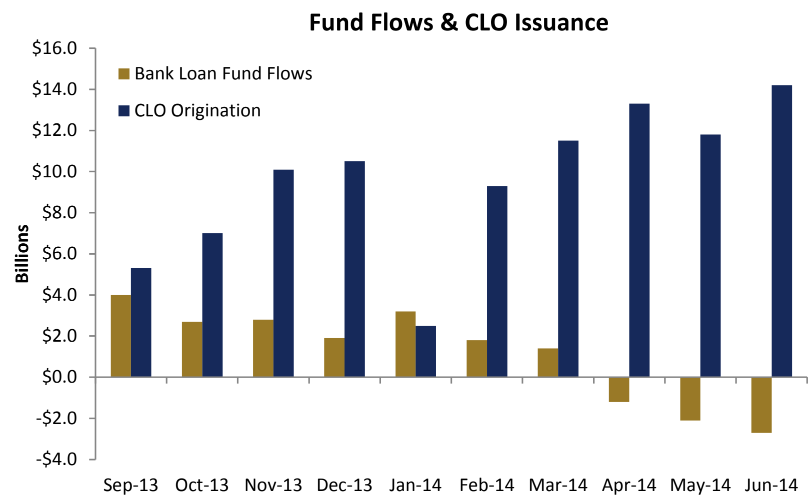
Returns & Yields

- Bank loans returned 1.5% in the second 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 458 bps, the lowest level since November 2007's 452 bps level. Yields (3-year life) breached the 5.0% level, ending the quarter at 4.9%, their lowest level in history.
- Higher carry helped smaller issues (<$200 million) outperform larger, more liquid issues (>$500 million) by 50 bps in the quarter. Second lien loans also finished ahead of first lien loans by 80 bps.

Issuance & Flows

- Total bank loan issuance was $127.5B in the second quarter, a $50B drop from first quarter's pace. Still, loans experienced their 7th straight quarter of $100B+ in issuance. Cov-light volume has averaged 65% of issuance this year, nearly 20% higher than in 2013. With an elevation in M&A activity, acquisition-related financing has accounted for 31% of the total volume this year.
- With Treasury yields falling to recent lows, investors' appetite for floating rate bank loans took a breather in June, ending an impressive 95 week period of fund inflows. June experienced the 3rd and 4th largest weekly withdrawals on record. However, helping to offset the heavy withdrawals by retail investors was the strong appetite from CLO vehicles. CLO origination of $39B marked the highest on record, topping the second quarter of 2007's $32.8B.





Source: JPMorgan, Credit Suisse

INTERNATIONAL AND EMERGING MARKET DEBT

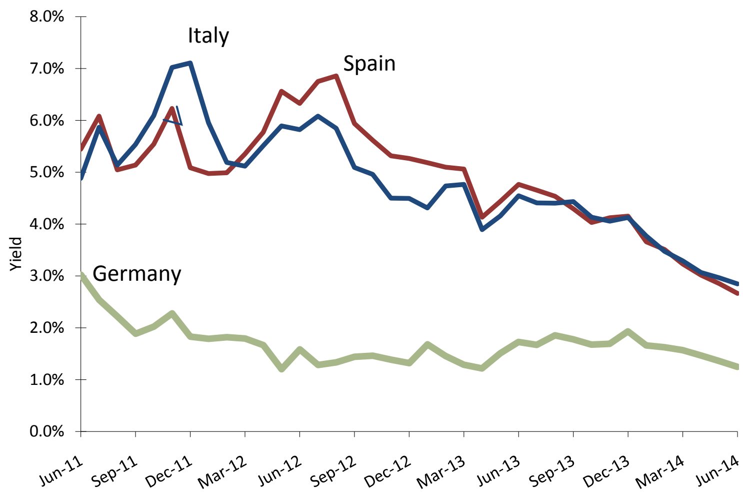
International – Developed

- In June, the ECB announced easing measures meant to stimulate the economic activity, lending, and inflation in the Eurozone; included in the actions were a negative interest rate on excess deposits from banks and a targeted LTRO program which will allow banks to borrow at 0.25% for four years. Combined with weak overall growth and benign inflation, these actions helped push yields across Europe to record lows.
- The divergence in central bank monetary policies was in full effect in the second quarter. The Bank of England's Governor, Mark Carney, commented that rates could rise sooner than expected, sending the British Pound higher. Japan, meanwhile, is maintaining its massive QE program as it seeks to achieve its 2% target inflation rate.

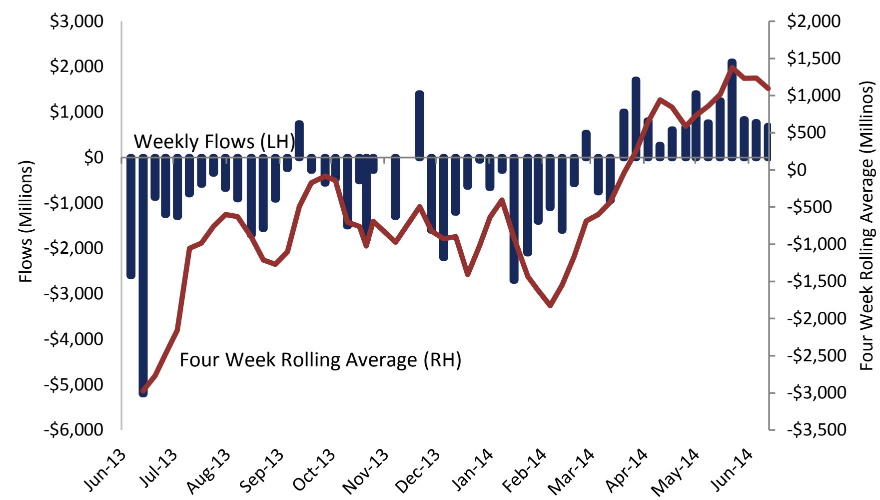
Emerging Market Debt

- Emerging market debt continued to shake off its poor showing in 2013 with solid gains made in the second quarter. Falling Treasury rates, decreased tension in Ukraine, and ECB easing helped hard currency return 4.8% and local currency finish with a 4.0% return in unhedged US dollar terms. In local markets, the LATAM region led with a 6.1% return with Brazil, Colombia, and Peru performing well. Asia just sneaked out a positive quarter as Indonesia underperformed ahead of elections and Thailand suffered from a military takeover. In Europe, Russia rebounded sharply with a 6% return.
- Flows turned the corner for EMD literally as the second quarter started and continued thereafter. Over $3.5B was added to EMD funds each month of the quarter, bringing year-to-date flows back into positive territory.

Ten-Year Bond Yields



EMD Mutual Fund Flows



 Source: JPMorgan, Citi, Colchester Global Investors