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Quarterly Review

Fixed Income Market Update

December 31, 2014

FIXED INCOME MARKET QUARTERLY OVERVIEW

The fourth quarter witnessed a continuation of the major global macro themes initiated in the third quarter and earlier. Market psyche was damaged by a further collapse in oil prices and diverging global growth and monetary policy expectations. Production cuts by Saudi Arabia and other OPEC members to contain the decline in oil prices did not materialize as they surprised markets by maintaining current oil production levels. Combined with US shale production continuing to grow and Libyan production coming back online, OPEC's decision exacerbated the supply glut overhanging the market. Along with slowing global growth, the supply/demand imbalanced pushed Brent prices down over 40% in the fourth quarter. The impact of the fall in oil severely hurt Russia as its currency fell significantly and local rates had to be raised sharply to counter the capital outflows. Outside of oil, markets watched as the divergence in central bank monetary policies between Japan and Europe in one camp and the US and UK in the other grew wider. The ECB started a limited buying program only to see it forced to quell growing angst among investors over the inadequacy of such moves, leading to an increase in expectations for quantitative easing via sovereign bonds. The growing divergence in monetary policy and policy expectations further exacerbated the strong US dollar trend. While developed sovereign markets enjoyed solid gains as global rates fell, sectors such as high yield and local emerging market debt experienced spread widening and pressure from dollar strength, respectively.

January	February	March	April	May	June	July	August	September	October	November	December	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 0.40%	High Yield 1.58%	ABS -0.15%	EMD-HC 1.71%	Treasury 0.81%	MBS 0.15%	Credit 7.53%
Credit 1.68%	EMD-HC 3.03%	EMD-HC 1.37%	EMD-HC 1.24%	TIPS 2.12%	High Yield 0.84%	TIPS 0.03%	Credit 1.44%	MBS -0.16%	EMD-LC 1.56%	Credit 0.68%	Treasury 0.14%	EMD-HC 7.43%
MBS 1.56%	High Yield 2.02%	Bank Loans 0.37%	Credit 1.19%	EMD-LC 2.08%	Bank Loans 0.60%	Credit -0.04%	Treasury 1.05%	Agency -0.29%	High Yield 1.19%	CMBS 0.67%	Credit 0.01%	Agency 6.14%
Treasury 1.36%%	Credit 1.09%	High Yield 0.24%	MBS 0.92%	Credit 1.41%	EMD-HC 0.36%	Bank Loans -0.04%	MBS 0.94%	Bank Loans -0.52%	Credit 1.06%	MBS 0.65%	CMBS -0.14%	MBS 6.08%
Agency 0.88%	CMBS 0.58%	Credit 0.12%	EMD-LC 0.89%	MBS 1.20%	TIPS 0.30%	Agency -0.15%	EMD-HC 0.84%	CMBS -0.52%	Treasury 0.97%	Bank Loans 0.46%	ABS -0.22%	Treasury 5.05%
CMBS 0.82%	TIPS 0.45%	CMBS -0.10%	High Yield 0.63%	Treasury 0.94%	MBS 0.26%	ABS -0.16%	Agency 0.62%	Treasury -0.55%	MBS 0.97%	Agency 0.39%	Agency -0.36%	CMBS 3.86%
Bank Loans 0.71%	MBS 0.34%	ABS -0.14%	Treasury 0.55%	High Yield 0.92%	CMBS 0.18%	Treasury -0.16%	CMBS 0.54%	Credit -1.41%	CMBS 0.92%	ABS 0.25%	Bank Loans -1.10%	TIPS 3.64%
High Yield 0.70%	Agency 0.31%	Agency -0.17%	Agency 0.54%	Agency 0.67%	Credit 0.08%	CMBS -0.24%	EMD-LC 0.48%	EMD-HC -1.81%	TIPS 0.85%	TIPS 0.26%	TIPS -1.13%	High Yield 2.45%
ABS 0.44%	Treasury 0.27%%	Treasury -0.29%%	CMBS 0.48%	CMBS 0.65%	ABS 0.04%	MBS -0.59%	TIPS 0.44%	High Yield -2.09%	Agency 0.69%	EMD-HC 0.09%	High Yield -1.45%	Bank Loans 2.06%
EMD-HC -0.68%	ABS 0.24%	MBS -0.32%	ABS 0.34%	Bank Loans 0.61%	Agency -0.03%	EMD-LC -1.06%	ABS 0.32%	TIPS -2.50%	ABS 0.51%	High Yield -0.73%	EMD-HC -2.31%	ABS 1.88%
EMD-LC -4.63%	Bank Loans 0.22%	TIPS -0.47%%	Bank Loans 0.23%	ABS 0.39%	Treasury -0.14%	High Yield -1.33%	Bank Loans 0.23%	EMD-LC -5.11%	Bank Loans 0.29%	EMD-LC -1.31%	EMD-LC -5.93%	EMD-LC -5.72%

Source: Barclays Capital, JPMorgan, Credit Suisse

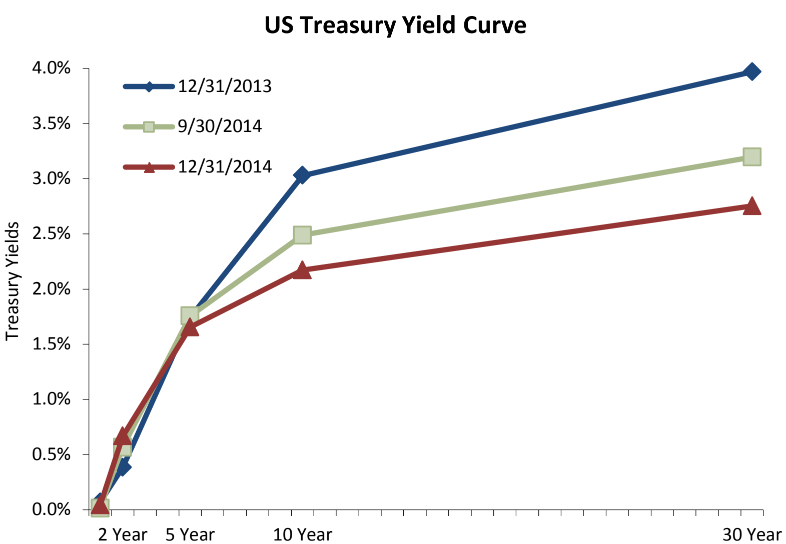
US TREASURY

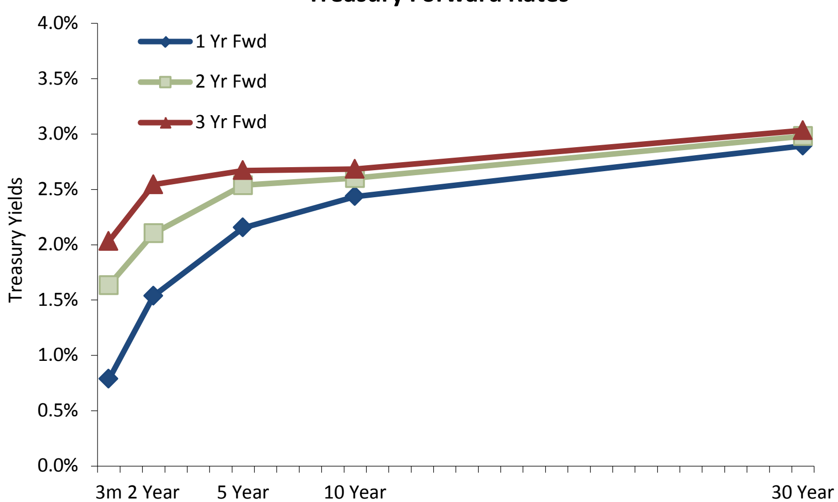
Treasury Yield Curve

- Despite the end of the third round of quantitative easing during the fourth quarter, the US Treasury yield curve continued the unexpected flattening on falling inflation expectations (1.7% over 10 years at year-end compared to 2.3% at 6/30/14), which helped push the return for long Treasuries above 25% for the year. The 30-year yield fell 45 bps from the previous quarter-end and 122 bps from year-end 2013. The 5-30 spread declined to 110 bps at year-end 2014 from 225 bps at year-end 2013.
- Due to lower developed market yields, especially within the Eurozone and Japan, many investors favored the higher relative yields of the US. The elevated foreign inflows helped to provide a technical bid in the absence of the Fed purchasing program.

Treasury Forward Rates

- With the well telegraphed end of the third round of Quantitative Easing in October and the removal of the phrase "considerable time" from December FOMC guidance by the Federal Reserve, markets are increasingly expecting a lift-off of interest rates during 2015, with 1-year forward rates anticipating 3-month Treasuries to yield 0.79% at the end of 2015.
- Despite the significant difference in the 1-year and 3-year forward rates for the 3-month Treasury (0.79% compared to 2.03%), forward prices for long Treasuries remain consistent across the same time periods. This would indicate that the market is continuing to expect low inflation and growth in the long term.





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

INVESTMENT GRADE OVERVIEW

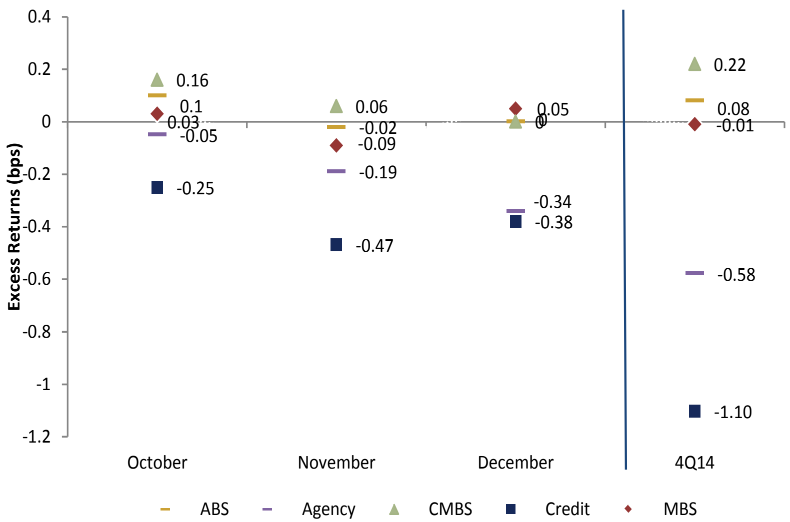
Excess Returns

- Excess returns (versus duration-neutral Treasuries) continued their trend of relative underperformance from the third quarter. Investment grade credit suffered the sharpest fall (-110 bps) for the quarter, representing the worst relative performer in each month. ABS and CMBS were the only sectors to generate positive excess during the quarter, with CMBS having positive excess during each month and ABS only generating negative performance during November.

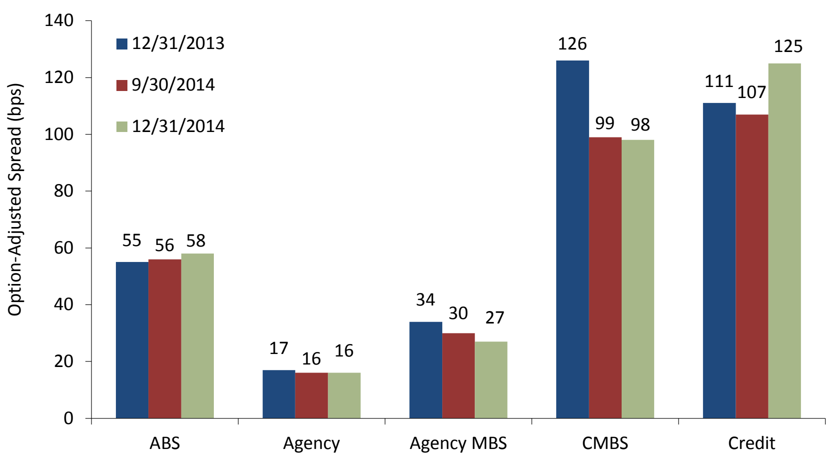
Spreads

- Option-adjusted spreads were relatively unchanged across all sectors during the quarter except in the credit sector. The increase in credit spreads was almost solely driven by the energy sell-off, with spreads for investment grade energy increasing to 211 bps as of 12/31 from 149 bps on 9/30.
- The worst-performing investment grade subsector was energy services, with spreads increasing by 136 bps over the quarter, making it the highest spread of investment grade sectors at 312 bps.

Excess Returns*



Option-Adjusted Spreads



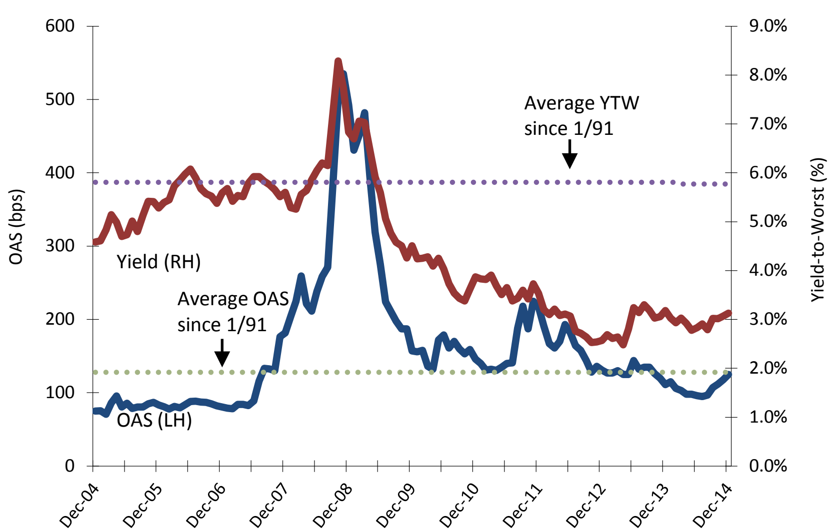
* Excess returns versus duration-neutral Treasuries
Source: JPMorgan, Barclays Capital

INVESTMENT GRADE CREDIT

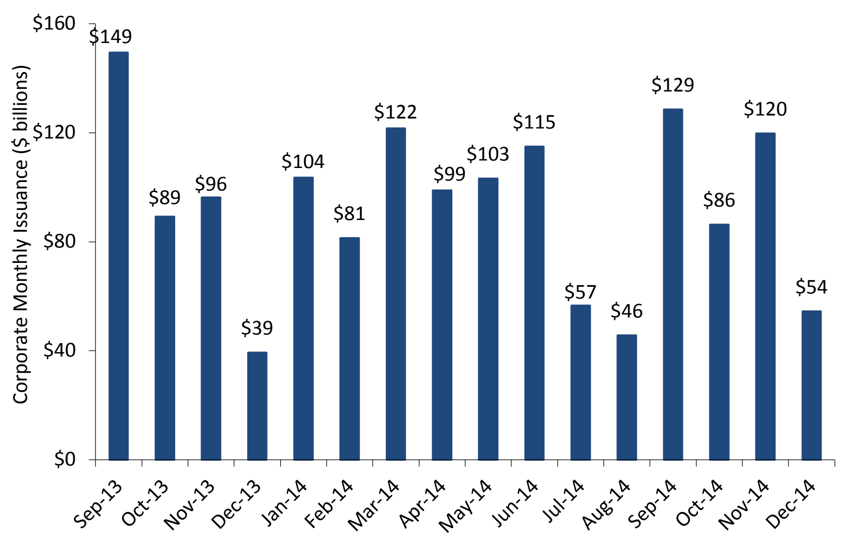
Spreads & Issuance

- Investment grade credit rebounded off its flat return in the third quarter to produce a 1.8% nominal return in the last three months of 2014. Falling rates were the primary driver as spreads widened. For the year, investment grade credit managed a 7.5% total return, which more then recouped the negative return in 2013. The long duration bucket was up over 16% for the year with the bull flattening of the curve.
- The utilities sector was the clear winner among sub-sectors, posting a 3.4% and 11.5% return for the fourth quarter and year, respectively. A longer overall duration helped utilities relative to financials and industrials. The industrials sector was impacted by the fall in oil prices in the fourth quarter. Oil field service issues were down -5.8% over the quarter.
- Issuance of $263 billion in the fourth quarter helped make 2014 the largest on record. Over $1.1 trillion in new issues were brought to market. November's $121 billion in issuance was the third-highest for the year, but December's $56 billion was the second-lowest as markets dealt with implications of falling oil prices. To be sure, strong issuance levels continues to be met by equally robust demand from retail investors, insurance companies, and pensions.

Yield-to-Worst vs. Option-Adjusted Spreads



Corporate Monthly Issuance



Source: JPMorgan, Barclays Capital, SIFMA

INVESTMENT GRADE: SECURITIZED SECTORS

Securitized Sector Observations

- **Agency MBS**
  - The sector was buffeted by the market's risk-off tone and prepayment concerns as 10-Year Treasury rates fell sharply over the quarter. Current coupon issues outperformed higher coupon issues by over 100 bps, given the latter's sensitivity to refinancing activity. Fixed rate issues outperformed floating rate issues by nearly 400 bps.
  - The Fed ended its purchases of agency mortgage-backed securities as expected in late October. To be sure, the Fed will still reinvest principal and interest payments from its existing portfolio, providing a $20 billion per month technical bid in the sector.
- **Non-Agency MBS**
  - The sector essentially shrugged off the volatility of the global macro environment and falling energy prices to post a respectable 0.84% quarterly return per Citigroup's Non-Agency RMBS index. For the year, the sector was up 9.32%, easily besting other spread sectors such as investment grade credit and high yield.
- **CMBS**
  - CMBS led all other Barclays Aggregate major sectors with 23 bps and 108 bps in excess return for the fourth quarter and 2014, respectively. Higher-yielding BBB-rated issues and longer duration AAA-rated issues outperformed AA- and A-rated issues over the year.
  - New issuance totaled $19.8 billion in the fourth quarter, bringing full year issuance to $89.9 billion, a post-financial crisis high. Delinquencies continue to trend down from their peak of 10% to under 6% currently.
- **ABS**
  - The shortest duration sector of the Barclays Aggregate major sectors did not experience the sizable returns seen in longer duration sectors. ABS posted a 0.6% quarterly return and a 1.9% 12-month return. For the year, credit card-backed issues outperformed auto-backed issues by over 100 bps.
  - Issuance ended the year at $222.7 billion, the highest since $268.6 billion in 2008.

Source: JPMorgan, Barclays, SIFMA, BlackRock

HIGH YIELD

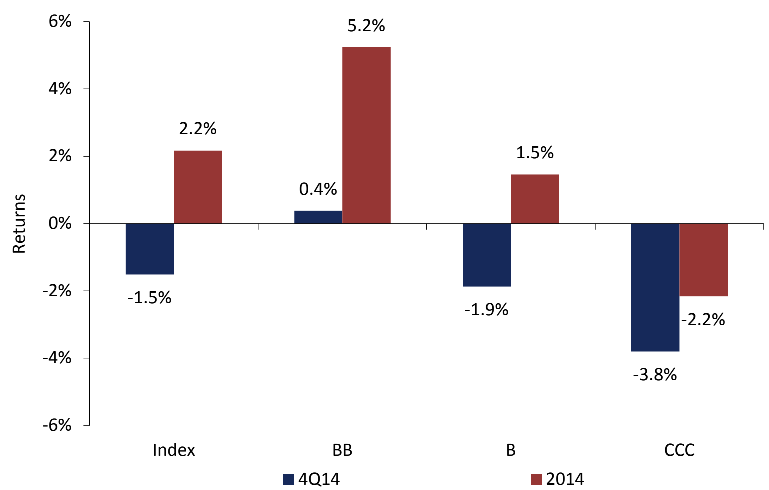
Returns

- High yield investors suffered another setback in the fourth quarter as energy-related high yield bonds sold off dramatically in concert with oil prices. Substantial spread widening overcame declining Treasury rates with CCCs (lower interest rate sensitivity, higher credit risk) suffering the most. The energy segment was hardest hit, down -10.6% in the fourth quarter. CCC-rated exploration and production (E&P) companies and oil field service companies suffered the most.
- Despite the spread widening headwinds in the second half of the year, coupon payments combined with falling interest rates helped produce a positive 2.2% return for 2014.

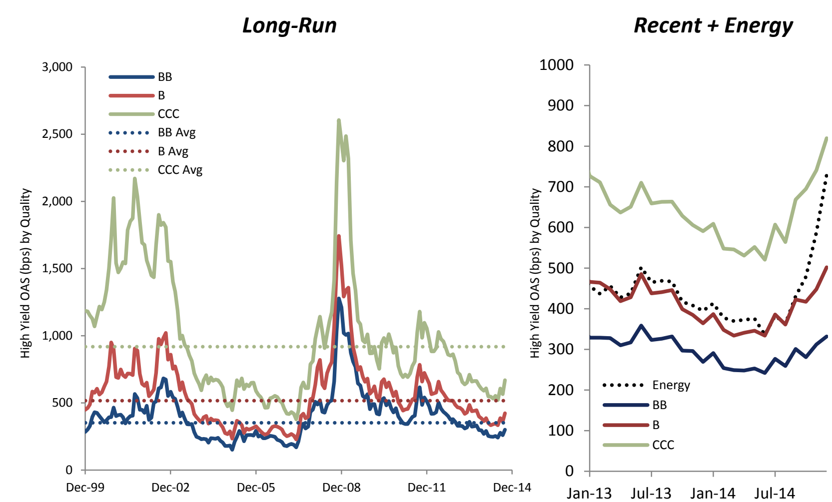
Spreads

- High yield spreads gapped 59 bps wider in the fourth quarter with the majority due to energy-related credits. As would be expected with oil sliding nearly 42%, energy related credits saw spreads widen almost 300 bps. Overall, BB-rated issues widened only 31 bps, B-rated issues rose 79 bps, and CCC-rated issues suffered the most, up 151 bps.
- At 483 bps, high yield option-adjusted spreads have reached their highest levels since June 2013. Spreads sit 36 bps inside their average and 146 bps wide of their recent tight in June 2014. Spreads have been tighter than the current level 55% of the time over the last 20 years.

High Yield Returns



Option-Adjusted Spreads



 Source: JPMorgan, Barclays Capital

HIGH YIELD (CONTINUED)

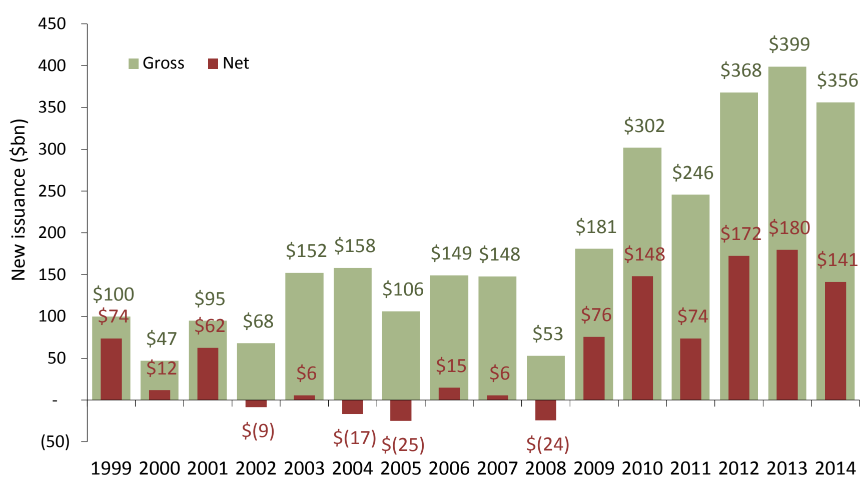
Flows & Issuance

- High yield mutual funds suffered again in the fourth quarter with over $1.3 billion in outflows. Flows were a positive $5.6B in October and November before turning sharply negative in December as the selloff in energy spooked investors. For the year, mutual funds saw a record $21 billion in outflows.
- Issuance totaled $70 billion in the fourth quarter, a marginally slower pace than third quarter. Issuance, however, slowed sharply in December to only $7 billion. Both net new issuance (-46%) and refinancing activity (-44%) slowed quarter-over-quarter as spreads rose and demand diminished. Net issuance for 2014 was $141 billion, a decrease of $38 billion from 2013.

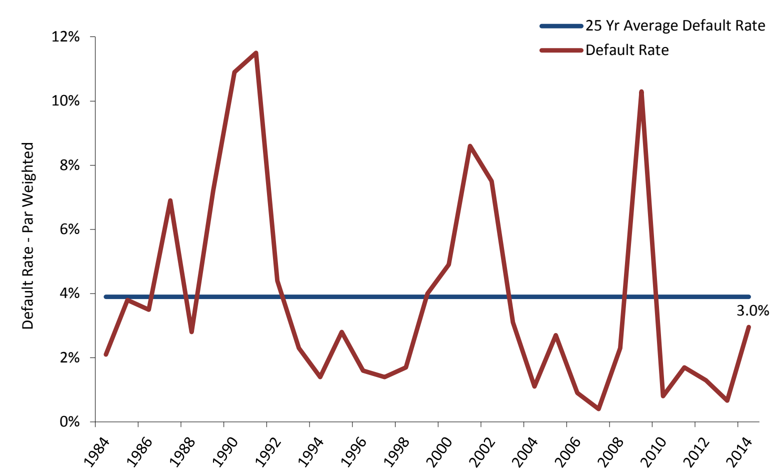
Defaults

- The one-year default rate (par weighted) rose to nearly 3% in the fourth quarter. The second quarter default of Energy Futures Holdings (TXU) – $16.6 billion in high yield bonds affected and second largest bond default in history – continues to dominate the default rate. The fourth quarter added the third-largest default on record in the form of Caesar's Entertainment's nearly $13 billion in high yield bonds.
- 2014 defaults totaled $37 billion, easily exceeding 2013's total of $8 billion and the highest volume since 2009. However, given the size of the defaults by TXU and Caesar, the number of defaults totals only 17, versus the 21 experienced in all 2013 and the lowest total since 2007.

Gross and Net New Issuance



Default Rate – Par Weighted



Source: JPMorgan, Barclays Capital

BANK LOANS

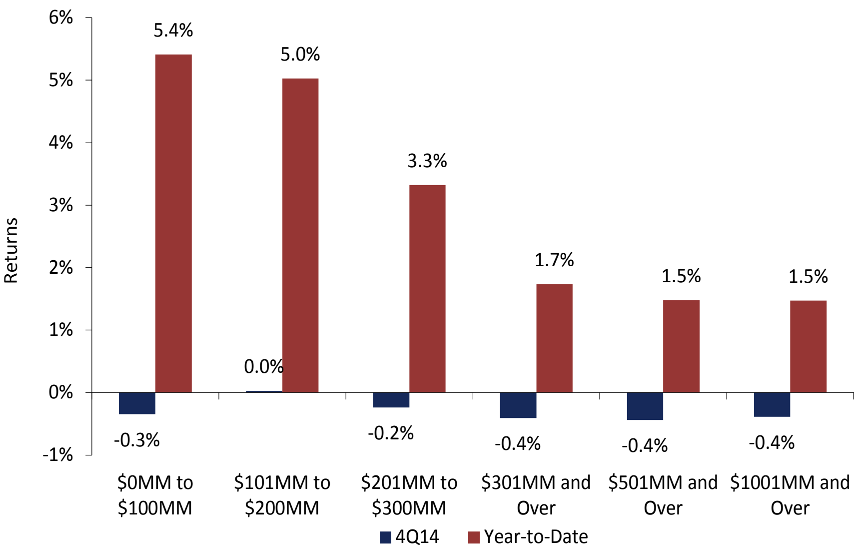
Returns & Yields

- Falling rates over the quarter were a tailwind for most fixed income sectors, but bank loans saw no benefit due to their short duration, ending the quarter down -0.49%. It was also a tough year for loans as the sector produced a 1.9% return, lagging other fixed-rate sectors. Smaller issues (<$300 million) generated a positive return, outperforming larger, more liquid issues (>$500 million) by over 180+ bps during 2014.
- As with high yield, energy was the focal point of under-performance with a quarterly return of -10.3%. Fortunately for bank loans, however, energy only comprised 4.4% of the CS Leveraged Loan Index versus the 13.3% of the Barclays Corporate High Yield Index.

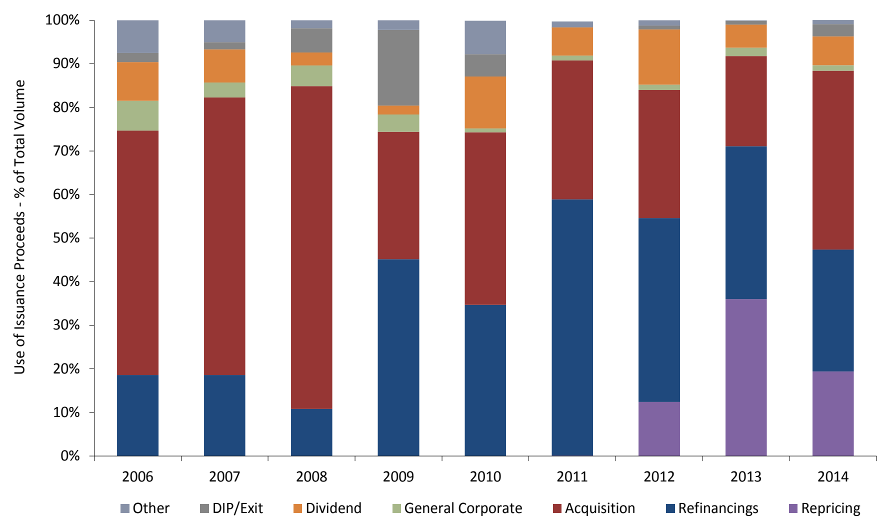
Issuance & Flows

- Issuance declined over the course of the fourth quarter as the market adjusted to expectations for lower rates and outflows continued. Issuance of only $16 billion in December was a far cry from the year's peak of $65 billion in February. Still, total issuance of $467 billion represented the second-highest total on record. Acquisition-related financing represented an increasing majority of issuance in the fourth quarter, accounting for 74% of the total.
- Investor appetite for floating rate bank loans continued to languish as outflows totaled $12.6 billion in the fourth quarter. However, mitigating the impact of fund outflows was the continued strength in CLO issuance which topped $30.6 billion. CLO issuance for the year reached an all-time record high of $131.4 billion in 2014.

Returns by Issue Size



Use of Issuance Proceeds

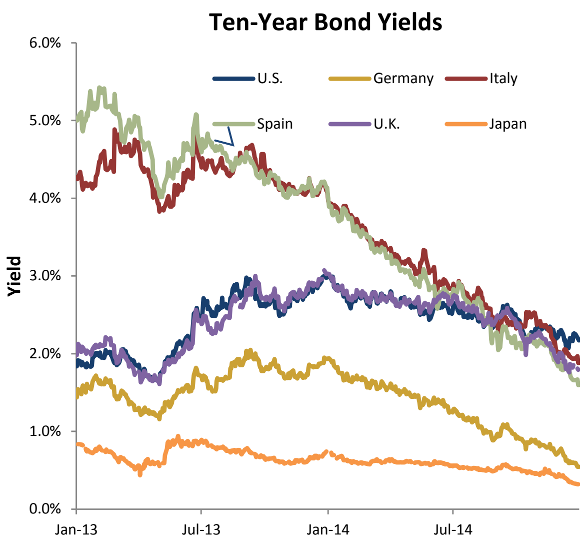


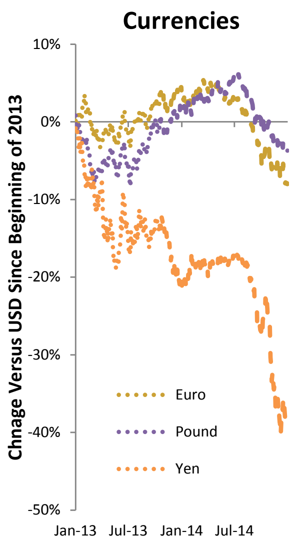
Source: JPMorgan, Credit Suisse

INTERNATIONAL AND EMERGING MARKET DEBT

International – Developed

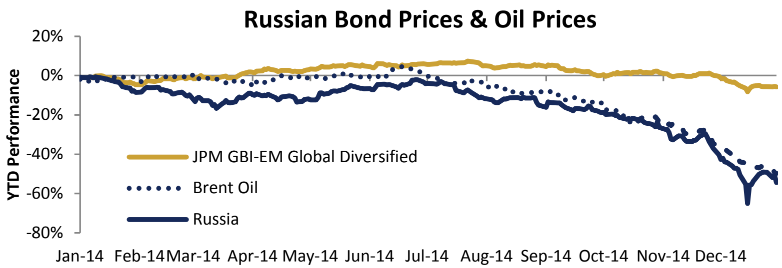
- The fourth quarter witnessed further divergence in central bank monetary policies. The euro, along with euro-area yields, slid as expectations the ECB would announce government bond quantitative easing hit a fever pitch. In a surprise move, the Bank of Japan crushed the yen by stepping up its quantitative easing program by 33%. While a continuation of accommodative policy was expected by the ECB and Bank of Japan, the US found itself even more isolated when UK rates and the pound were pulled lower by the Euro-zone and a more dovish Bank of England's outlook for rates.
- The impetus for the divergence in policy remains rooted in varied economic outlooks. The Euro-zone is suffering from weak growth/deflationary pressures, a situation in which Japan has been mired for decades. In contrast, job gains and steady economic growth continue in the US and UK.

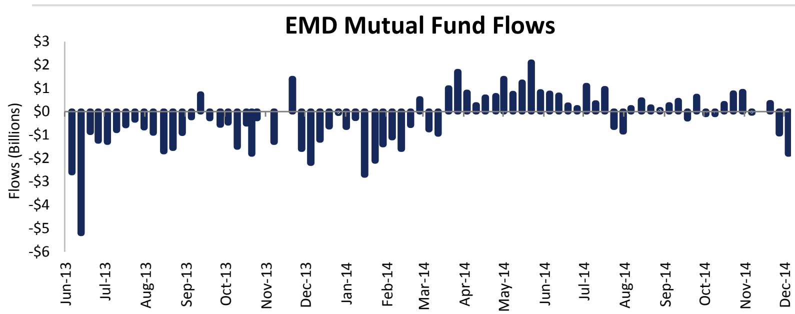




Emerging Market Debt

- Local currency emerging market debt slipped -5.7% in the fourth quarter on falling oil and commodity prices and a stronger US dollar. Russian bonds were the biggest impediment to performance, falling nearly 44% as the ruble was hit by falling oil prices and an economy slowed by sanctions.
- After starting the fourth quarter well, flows into emerging market debt mutual funds turned sharply negative toward the end of the year as oil continued to fall. Mutual funds in Europe and the US subtracted $2.3 billion. Net flows for 2014 were a positive $1.2 billion, however.
- Oil prices pressured the finances in many oil export dependent countries. In an extreme example, Venezuela saw a 2018 maturity bond fall in price from $76 to $44. The 12/31 price implies a yield to maturity of 50%.





Source: JPMorgan, Citi