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Quarterly Review

Fixed Income Market Update

September 30, 2014

FIXED INCOME MARKET QUARTERLY OVERVIEW

The complacency that had developed in markets amid persistent low volatility came to an end in the third quarter as exogenous events and fundamental factors weighed on market sentiment. While July started much as the second quarter ended, numerous events jostled markets throughout the month including sanctions on Russia, the continuing ISIS threat, Israeli ground offensive in Gaza, and the downing of Malaysian Airlines Flight 17 in Ukraine. Further, oil and other commodities driven by global growth expectations were hit hard as markets downgraded the growth potential of both Europe and emerging markets. The market weakened alongside growing geo-political tensions before staging a bit of a relief rally in August even as European core rates fell to all-time lows on further concerns over economic growth and deflation and expectations of more substantial action by the ECB. The rally was short-lived as markets fell sharply in September with spreads widening, US dollar strength, and the uncertainty over the Scottish independence referendum. To cap off the quarter, Bill Gross, co-founder of PIMCO and "Bond King," stunned the markets and his former firm by announcing his resignation and move to Janus Capital.

January	February	March	April	May	June	July	August	September	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 8.02%
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%	Credit 5.67%
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%	MBS 4.22%
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%	High Yield 3.49%
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%	TIPS 3.67%
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%	Treasury 3.06%
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%	Bank Loans 2.43%
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%	CMBS 2.38%
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 2.40%
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 1.32%
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%	EMD-LC -.01%

Source: Barclays Capital, JPMorgan, Credit Suisse

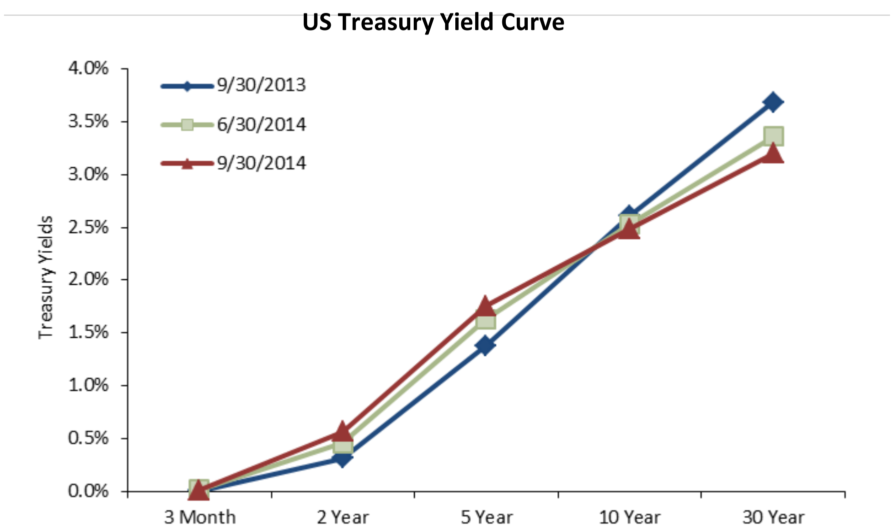
US TREASURY

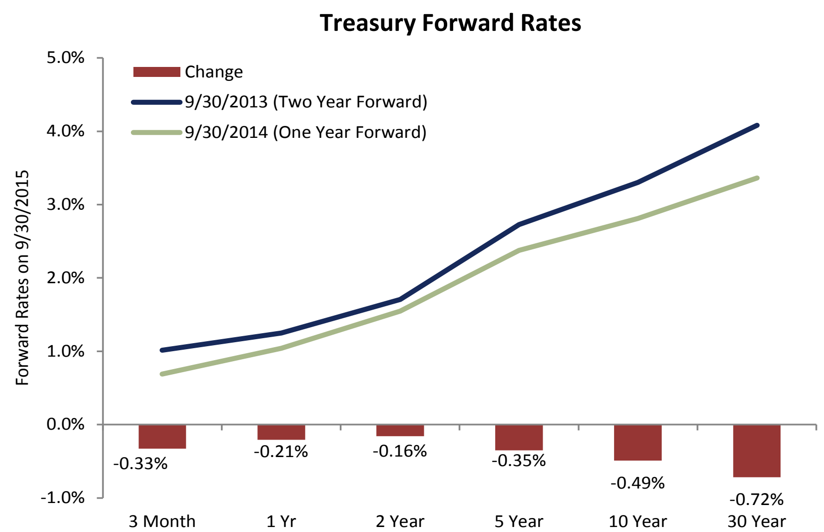
Treasury Yield Curve

- Rate moves in the third quarter were mixed across the yield curve. Short rates rose 11-13 bps while long duration bonds fell -16 bps. Over the past 12 months, the 2-30's curve has flattened significantly, from 337 bps to 263 bps.
- In July, the front-end of the curve rose on Janet Yellen's comments that Fed Funds rate could be at 1% by the end of 2015. August saw a steep drop in longer-term rates after a disappointing job report and increasing tensions overseas. By the end of the month, the 10-year Treasury fell to 2.33% before it began a steady rise all the way to 2.65% by mid-September. A rally ensued thereafter as rates fell with the 10-year settling at 2.49%.

Treasury Forward Rates

- In mid-September, the Federal Reserve decided to maintain its guidance on interest rates, stating rates would remain low for a "considerable time." On a long-term basis, the Fed noted they expected the fed fund rates to be at 3.75% by the end of 2017.
- Future rate expectations for 9/30/2015 have changed meaningfully since the third quarter of 2013. Essentially, the market maintains a 2015 "liftoff" date for the start of monetary policy normalization, albeit later in the year. However, more noticeable is the limited expected increase in long-term rates which highlights the markets' lower projections for inflation pressures and economic growth.





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

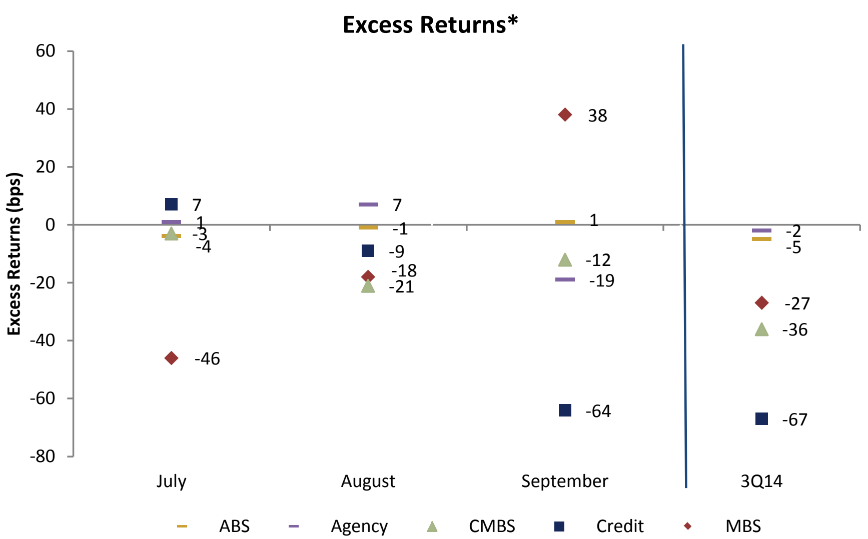
INVESTMENT GRADE OVERVIEW

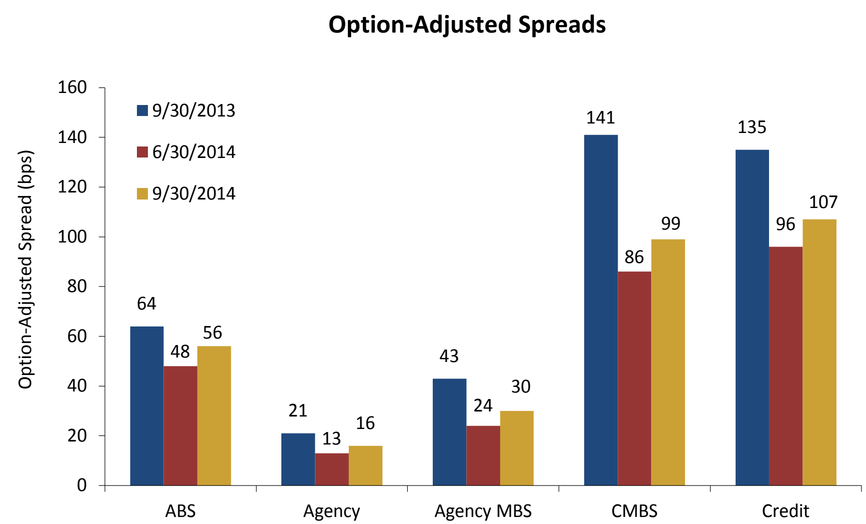
Excess Returns

- Excess returns (versus duration-neutral Treasuries) were decidedly negative in the third quarter, a sharp reversal from returns in the second quarter. Investment grade credit suffered the sharpest fall at -67 bps for the quarter with nearly all of it coming in the final month of the quarter. CMBS was the only sector to generate negative excess returns in all three months of the quarter, while Agency and ABS sectors were the best performers. Agency MBS fell early on before besting all other sectors in a difficult September.

Spreads

- Option-adjusted spreads finished the quarter wider across the board. Spreads started July fairly tame for most sectors although agency MBS did gap out 8 bps in July, representing an outlier. Despite Treasury rate volatility, spreads were only marginally wider during August. September was more eventful, especially for investment grade credit which saw spreads pop 10 bps, representing 90% of the spread widening for the quarter.





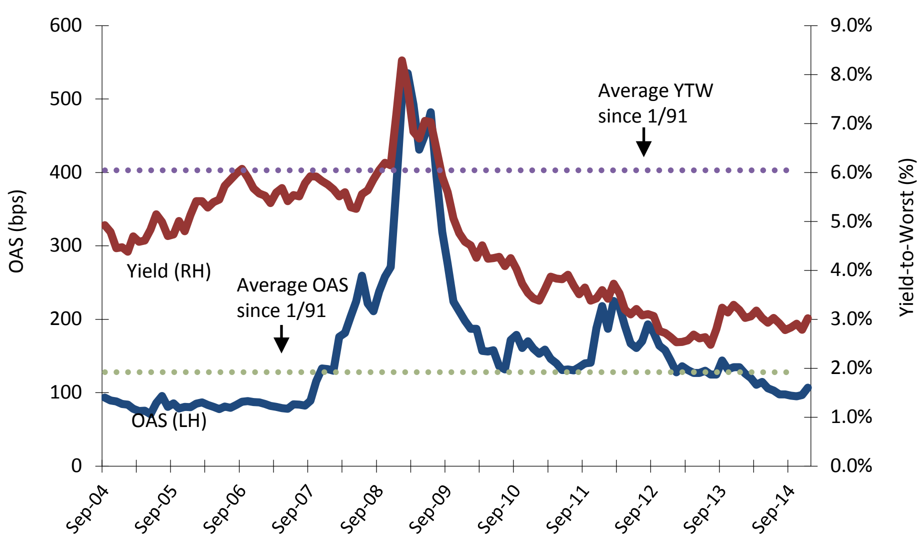
* Excess returns versus duration-neutral Treasuries
Source: JPMorgan, Barclays Capital

INVESTMENT GRADE CREDIT

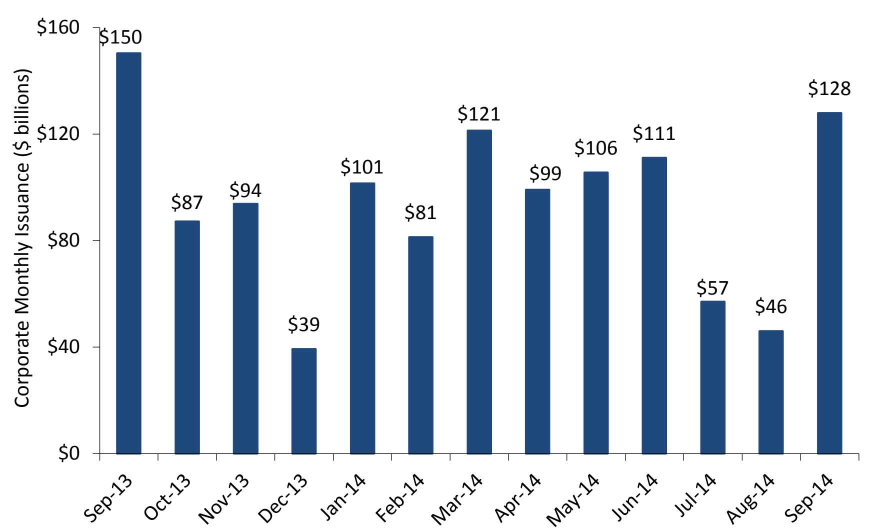
Spreads & Issuance

- Investment grade credit's flat return for the third quarter was a far cry from the second quarter's 2.7% return. On an industry basis, utilities was the only positive sector with a 0.45% return, besting both industrials and financials. On the back of a sharp fall in oil prices, the energy sub-sector was the clear underperformer, falling nearly -100 bps; oil field service bonds alone were down nearly -2.5%.
- Overall, spreads widened 11 bps for the sector with most of this occurring in the latter half of the quarter. The industrials sub-sector drove most of the increase in spread.
- A typical summer lull in July and August saw issuance fall to the lowest monthly levels of the year before a surge in September. For the quarter, issuance totaled $231B, which trailed both the first and second quarter's $304B and $315B, respectively. Still, issuance through the first three quarters is ahead of the pace set in 2013 by about $28B. Strong issuance levels continues to be met by equally strong 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**
  - Mortgages began the quarter in the red as a combination of factors forced spreads wider in July; these included relatively tight valuations and the coming end of QE asset purchases. August witnessed a recovery as the sector generated 94 bps in return. September performance was slightly negative, but relative to other sectors during the tough month, sector performance was quite good as dipped just -16 bps.
  - For the quarter, fixed rate issues lagged hybrid ARMs as the former generated -28 bps in excess returns while the latter posted a positive 35 bps in excess returns.
- **Non-Agency MBS**
  - On a relative basis, non-agency MBS had a good quarter with returns flat over the three-month period. Returns for the year have been solid, ranging from 6% for prime fixed paper and 9% for Alt-A hybrid issues.
  - Investors seeking yield have continued to gravitate to the sector with prime paper generating cash flow yields of 5%. With the market shrinking to below $1 trillion in size, market technicals should continue to be supportive.
- **CMBS**
  - CMBS was one of the laggards in investment grade fixed income as it generated a -0.23% quarterly return. Spreads widened by 13 bps over the quarter, with a majority of that arising in August. Both non-agency and agency CMBS (a new addition to the Barclays Aggregate index) trailed in excess return terms with non-agency down -33 bps and agency -47 bps. Lower quality issues, such as BBB-rated issues, outperformed AAA-rated issues during the quarter.
  - New issuance picked up from the slower rate seen in the second quarter with $12.7B in new non-agency CMBS issuance in the third quarter. Issuance is down roughly 20% from last year's pace through the third quarter.
- **ABS**
  - ABS was one of the better performers for the quarter as it just missed generating a positive excess return. While autos were flat in excess return terms, credit card issues dragged on the sector as the sub-sector posted a -10 bps excess return for the quarter.
  - At $197B, issuance is up 22% from the same year-to-date period in 2013.

 Source: JPMorgan, Barclays, SIFMA, BlackRock

HIGH YIELD

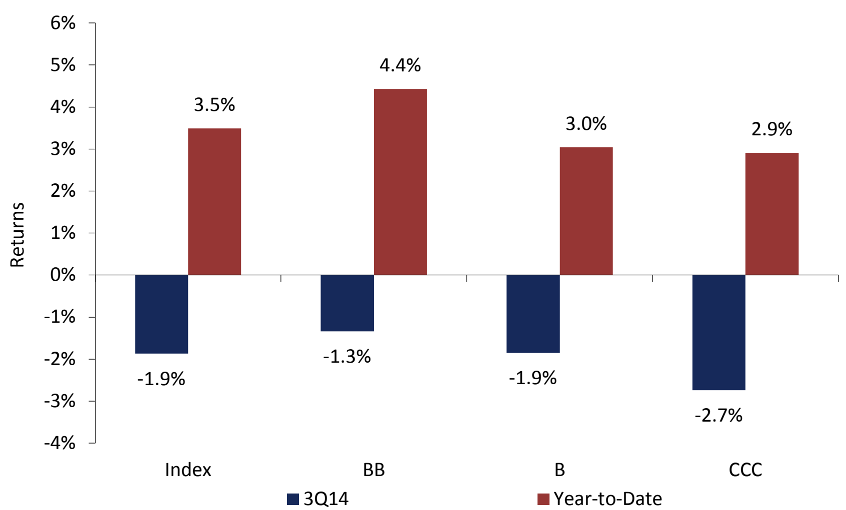
Returns

- High yield investors suffered a setback in the third quarter as high yield bonds sold off in sympathy with equities. Spread widening overcame declining Treasury rates with CCCs (lower interest rate sensitivity, higher credit risk) suffering the most. The 1.9% decline over the quarter was the worst since the third quarter of 2011. Despite the setback, high yield has produced a positive quarterly return in 10 of the last 12 quarters.

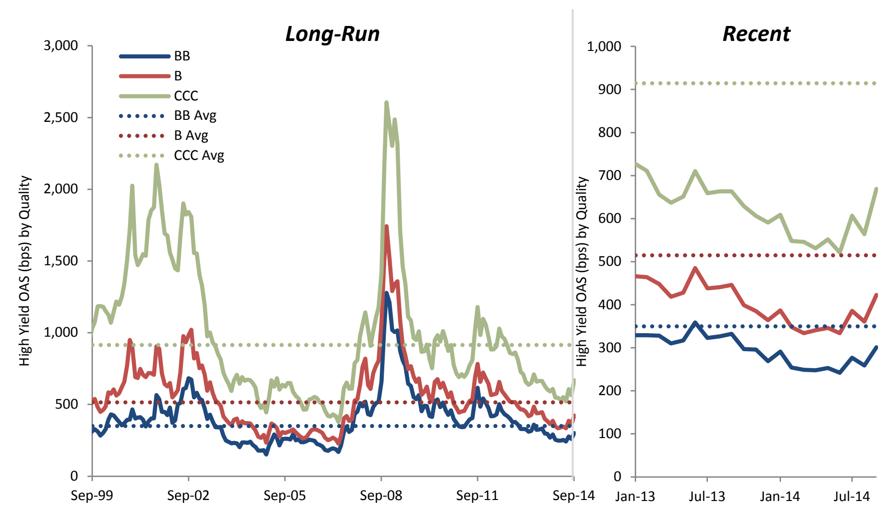
Spreads

- High yield spreads gapped 87 bps wider in the third quarter with the majority of the move (61 bps) occurring in September. As would be expected in an equity driven selloff, CCC-rated securities suffered the most with spreads nearly 150 bps wider on the quarter. Comparatively, BB-rated issues widened only 59 bps and B-rated issues lost 89 bps. Even though higher rated high yield did better, the disparity between investment grade was stark with the lowest investment grade tier (BBB) only widening 15 bps.
- At 424 bps, high yield spreads have reached their highest levels in a year. While spreads still sit 96 bps inside their average, they are 189 bps wide of their all-time tight. Spreads have been tighter than the current level 44% of the time over the last 20 years.

High Yield Returns



Option-Adjusted Spreads



 Source: JPMorgan, Barclays Capital

HIGH YIELD (CONTINUED)

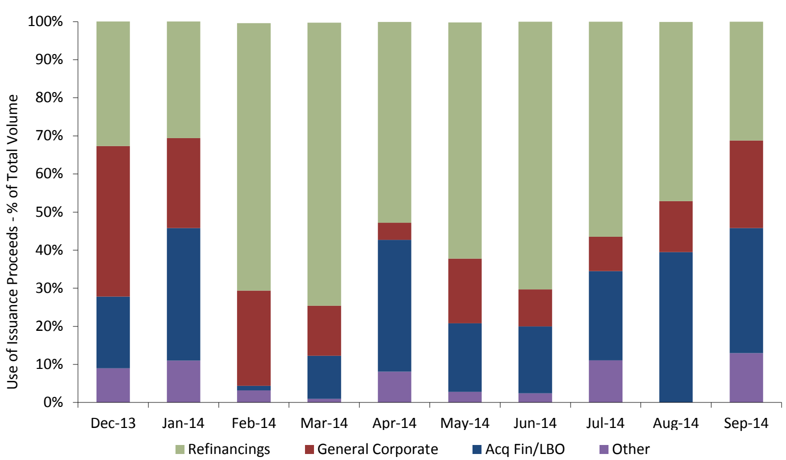
Flows & Issuance

- High yield mutual funds suffered significantly in the third quarter with over $20B in outflows. This reversed what had been a positive trend through the second quarter. The third quarter selloff reminded investors of the dangers in reaching for yield amid continued low Treasury rates.
- Issuance totaled $76B in the third quarter, a slower pace than the first half of 2014. Both net new issuance (-28%) and refinancing activity (-44%) slowed quarter-over-quarter as spreads rose and demand diminished. The majority of the issuance occurred in September, which featured 83 bonds totaling $44B.
- Acquisition finance issuance steadily increased during the quarter, representing 30% of all new deals. However, this is still well-below the high of 52% seen in 2007.

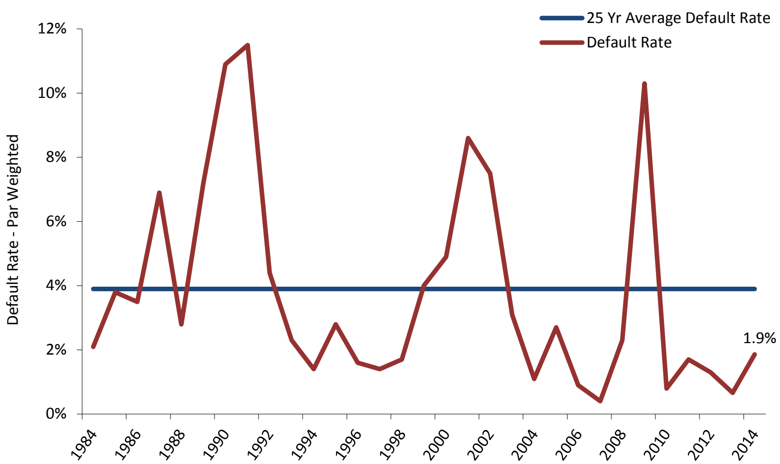
Defaults

- The one-year default rate (par weighed) slipped back below 2% in the third quarter. The second quarter default of Energy Futures Holdings (TXU) – $16.6B in high yield bonds affected and second largest bond default in history – continues to dominate the default rate. Excluding the TXU default, the par-weighted default rate finished the third quarter at 0.5%.
- Year-to-date default volumes total $22.5B which exceeds all of 2013 by $14.5B. However, given the size of the TXU default, the number of defaults totals only 12, versus the 21 experienced in all of 2013.

Use of Issuance Proceeds



Default Rate – Par Weighted



Source: JPMorgan, Barclays Capital

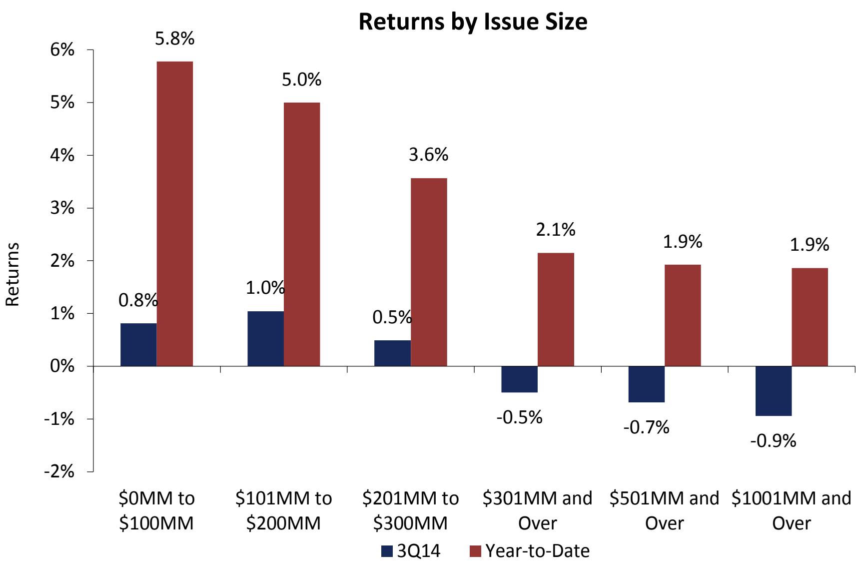
BANK LOANS

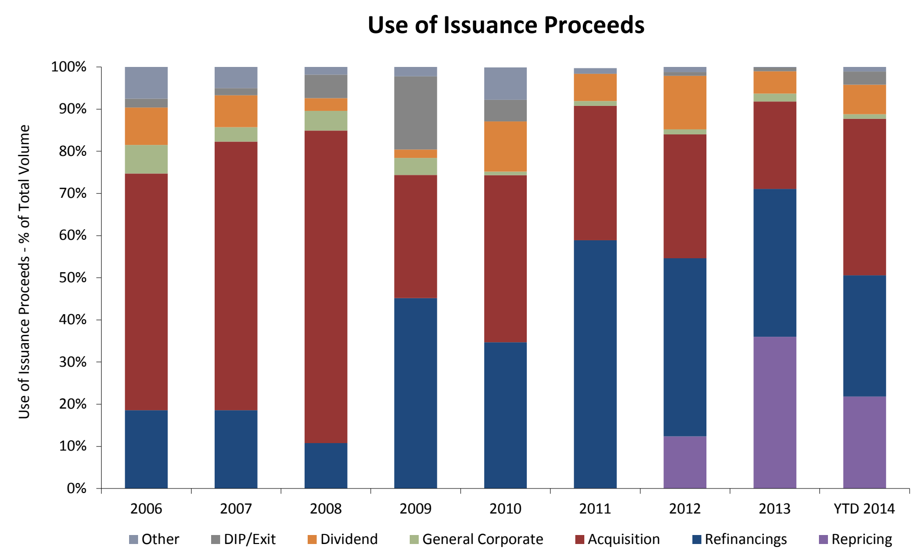
Returns & Yields

- Bank loans slipped in the third quarter, falling 0.33% but besting their high yield debt brethren. Beyond general risk-off sentiment arising from various geo-political events worldwide, loans suffered from a string of outflows. Discount margins (3-year life) rose 52 bps, the largest quarterly move since third quarter 2011. Yields (3-year life) rose to 5.7%, its highest level in nearly two years.
- Higher carry helped smaller issues (<$300 million) generate a positive return, outperforming larger, more liquid issues by over a 100 bps.

Issuance & Flows

- Total bank loan issuance was $104.2B in the third quarter, a $20B drop quarter-on-quarter and $70B less than the first quarter's level. Still, loans experienced their eighth straight quarter of $100B+ in issuance. Cov-light volume has averaged 66% of issuance this year, 16% higher than in 2013. With an elevation in M&A activity, acquisition-related financing has accounted for 37% of the total volume this year.
- Investors' appetite for floating rate bank loans continued to languish as outflows totaled -$8.9B in the third quarter. Outflows have now been experienced in 23 of the last 25 weeks. The heavy withdrawals by retail investors was offset, however, by strong appetite from CLO vehicles. CLO origination for the year totals $101.6B, surpassing the previous record of $94.1B in 2006.



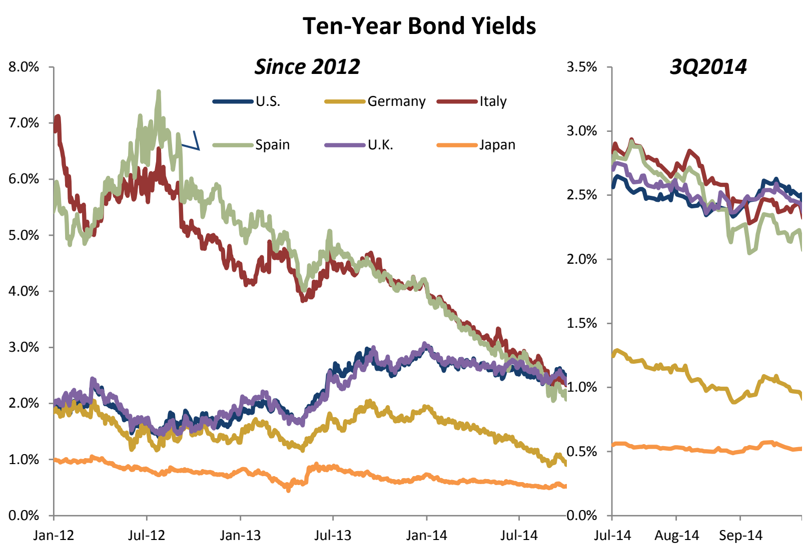


Source: JPMorgan, Credit Suisse

INTERNATIONAL AND EMERGING MARKET DEBT

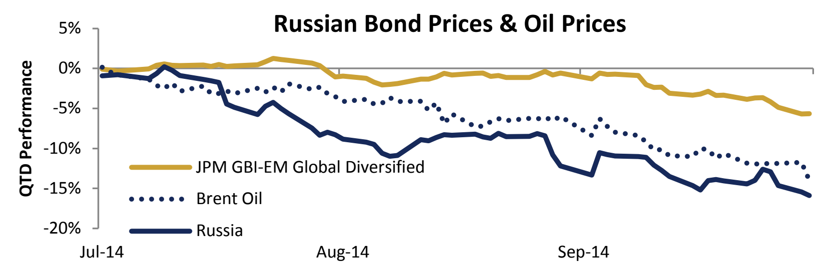
International – Developed

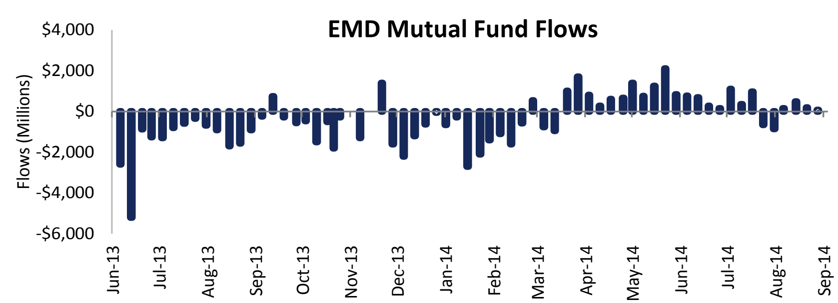
- The third quarter saw the divergence in central bank monetary policies continue to grow. The euro, along with euro-area yields, slid on ECB accommodation including plans to start buying covered bonds and asset-backed securities in the fourth quarter. Japan, in the midst of a quantitative easing program targeting 2% inflation, saw the yen hit a six-year low against the dollar. In contrast, quantitative easing in the US will wrap-up in October. In the UK, Bank of England's Governor Carney noted rates were getting closer to rising, despite economic growth not prompting wage growth.
- 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 Japan has been mired in 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 third quarter on weaker growth forecasts, falling commodity prices, a slowing China, and a stronger US dollar. Russian bonds were the biggest impediment to performance, falling nearly 16% as the Ruble was hit by falling oil prices and an economy slowed by sanctions. Brazil (elections, economy) and Turkey (inflation, slow growth) were also laggards, falling nearly 9% each.
- After a rough first quarter (-$12B) and a rebound in the second quarter (+$13B), flows into emerging market debt mutual funds were muted in the third quarter. Over the course of the quarter, mutual funds in Europe and the US added about $3B. This brings year-to-date net flows to a positive $3.5B.
- Outside of indices, Argentina was pushed into a technical default after refusing to abide by a ruling in the US requiring full repayment of holdout creditors from its 2005 restructuring.





Source: JPMorgan, Citi, Colchester Global Investors