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MARKET COMMENTARY

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The Economy

The world keeps getting flatter. In addition to items of specific domestic importance, the things that may drive sentiment in US fixed income and equity markets on any given day could include Spanish government bond yields, Chinese manufacturing or German unemployment. And while European headlines and "Fedspeak" are driving the current conversation, the horizon remains clouded with the uncertainty of the US election, regulatory flux and visions of a fiscal cliff.

The noise level has risen, and during the second quarter of 2012 the financial markets reacted with a flight from risk. The S&P 500 fell 2.75% during the second quarter, but is still up 9.49% year-to-date. The ten-year Treasury ended the quarter at 1.65% versus 2.20% on March 31, 2012, and 1.88% on December 31, 2011. The US Dollar trade-weighted index rose 2.4% in the second quarter and remains higher by 1.5% for the year. Commodities, as measured by the CRB Index, remained in a bear market that began in early 2011. They fell 7.9% in the second quarter and are down 7% YTD. The CRB index remains at levels similar to late 2004.

In general, scanning the incoming economic data in the second quarter, the world seems to be in the midst of a global slowdown. Eurozone manufacturing activity as measured by its Purchasing Managers Index stands at 45.1 in June and has been indicating contraction since August of 2011. Unemployment across the EU has risen to a record 11.1%. China's PMI came in at 48.2 in June, and excess inventories of metals in China have been widely reported, another non-government indicator suggesting a slowdown.

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The US is in similar condition. The pace of US nonfarm payroll growth has declined significantly, from +275 thousand in January 2012 down to +80 thousand in June. Private nonfarm payrolls averaged only +91 thousand in the second quarter of 2012, significantly slower than the +226 thousand average of the previous quarter. Real disposable personal income per capita remains stuck at the same levels of May 2007. Retail sales are down two months in a row, and the International Council of Shopping Centers chain store sales index is growing at its slowest pace since 2009. The Institute of Supply Management (ISM) manufacturing survey declined to 49.7 from near 55 in April (its lowest level since 2009). The non-manufacturing sector ISM came in at 52.1, the lowest in more than two years. Headline inflation has continued to slow meaningfully, down to 1.7% in May from 3.9% in September 2011. Inflation expectations, as measured by five-year TIPS breakeven rates, have also declined to 1.7% at quarter end from near 2.2% in March 2012. Corporate earnings warnings have also increased in the second quarter: As of the end of June, 94 companies in the S&P 500 had issued negative guidance versus only 26 positives, the worst ratio since the second quarter of 2001.

Central banks around the globe responded to the slowdown, cutting rates (the ECB, China, Australia, for example) and extending various balance sheet programs (the Fed, the Bank of England). These actions soothed markets and investors, and potentially

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helped ease the slowdown in business activity, but there seems to be a shift in sentiment amongst the central bankers of the world. The annual report of The Bank for International Settlements (BIS), released in June, contained sharp criticism regarding the world's growing dependence on constant central bank liquidity:

» "Any positive effects of easing monetary policy may be shrinking whereas the negative side effects may be growing."

» "…there is a growing risk of overburdening monetary policy."

» "A vicious circle can develop, with a widening gap between what central banks are expected to deliver and what they can actually deliver."

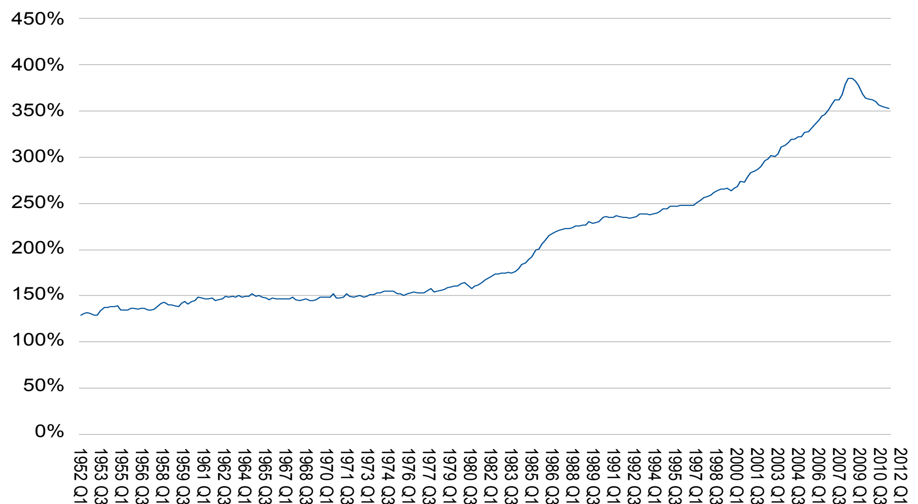
» "…low short- and long-term interest rates may create risks of renewed excessive risk-taking."

» "…aggressive and protracted monetary accommodation may distort financial markets."

The BIS is no small think tank. The BIS, in its own words, is the "bank for central banks." The current board of directors consists of the head of every major central bank, all recognizable names: Bernanke, Draghi, Carney, King, Noyer, Shirakawa, to name a few. That the BIS annual report takes such a strong tone toward the limits of monetary policy should be noted, not only for the self-criticism, but also for the message that is being sent to those government officials who are holding the fiscal policy strings.

Indeed, central bankers have their work cut out for them, but they are only a part of the broader policymaking apparatus. Take the United States, for example. Even after several years of deleveraging, the ratio of total debt-to-GDP remains high by historical standards.

Chart 1: Total Credit Market Debt Outstanding as a % of GDP



Source: Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics.

The total debt/GDP ratio peaked around 385% in the first quarter of 2009 and has now declined to near 350%. (Total debt includes household, non-financial business, financial sector and all government debt.) The financial sector has seen the most deleveraging: Total financial sector credit market debt outstanding is down by $3.4 trillion dollars, a 20% decline since the fourth quarter of 2008. Household debt has declined by roughly $900 billion over the same period, a 6% decline.

At the same time, the Federal Reserve has been aided by a $5.5 trillion increase in federal government debt, about double the amount from 2008, and a $1.1 trillion increase in nominal GDP. But a return to the total debt-to-GDP level of 2000 (around

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265%) suggests a reduction in total debt of $13.6 trillion. Policymakers here and around the world have some hard decisions to make.

Residential Mortgage Market

The second quarter of 2012 proved yet again the resilience of the agency mortgaged-backed securities (MBS) market. Despite the unsettling headlines regarding the continuing European sovereign debt crisis, spreads between the 30-year Fannie Mae current coupon and the ten-year US Treasury ended the quarter just eight basis points (bps) wider than where they began. This is due to a number of factors, such as the perceived superior credit quality of agency MBS, the support of the Federal Reserve and relatively tame prepayment speeds. While overall prepayment speeds remain muted relative to rates, the 30-year mortgage universe has undergone a fairly dramatic change over the past two years (see Table 1). This change has come courtesy of lower rates and a multitude of programs under the Making Home Affordable Act that aim at mortgage modification via principal reduction, second lien forgiveness or rate reduction.

"While overall prepayment speeds remain muted relative to rates, the 30-year mortgage universe has undergone a fairly dramatic change over the past two years."

The two most significant programs launched under the Making Home Affordable Act are the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP). While most estimates put HAMP modifications at roughly one million, the combined efforts of HARP 1.0 and 2.0 are expected to generate up to three million refinancings by the time the program ends on December 31, 2013. In tandem with government sponsored programs, roughly three million creditworthy borrowers with equity in their homes have refinanced the old-fashioned way by taking advantage of lower rates. As a result, the weighted-average coupon (WAC) on the 30-year Fannie Mae universe has decreased 46 bps over the past two years from 5.22% to 4.76%.

Table 1: 30-year Fannie Mae Universe (in $millions)

	June 2012	June 2010	+/-
3.5%	$177,273	$1,374	$175,899
4.0	332,596	121,924	210,672
4.5	379,997	384,595	(4,598)
5.0	271,749	413,600	(141,851)
5.5	241,755	459,179	(217,424)
6.0	158,169	289,380	(131,211)
6.5	52,906	90.188	(37,282)
7.0	16,313	26,326	(10,013)
7.5	3,264	5,063	(1,799)
8.0	1,336	1,984	(648)
8.5	310	600	(290)
9.0	201	301	(100)
9.5	105	159	(54)
10.0	47	75	(28)
	$1,636,021	$1,794,748	$(158,727)

Source: Bloomberg.

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Commercial Mortgage Market

The desire for yield has continued to support demand for commercial real estate investments. It hasn't hurt that the underlying fundamentals have painted a picture where the glass is half-full rather than half-empty.

Demand has been strong, as evidenced by the Federal Reserve Bank of New York's auction of its Maiden Lane III portfolio, announced in April. The auctioned bonds were the senior portions of two CDOs issued in 2007 and 2008 which contained approximately $7.5 billion of securities. The announcement was not a surprise given that Maiden Lane II had successfully sold its remaining securities, but there was a concern that the market would be negatively affected by the significant supply of bonds hitting the market. Those concerns were unfounded, as the market digested the supply with good execution for the Fed.

Commercial real estate valuations show that the market is stabilizing if not improving. For example, the NCREIF National Property Index registered a 2.59% positive gain according to the latest release. While this is slightly less than the 3.0% to 4.0% increases that were achieved quarterly since the second quarter 2010, it was nonetheless the ninth consecutive quarterly increase. The revamped Moody's commercial property price index also showed a far greater recovery of commercial real estate prices. This index now shows a nearly 28% increase since the low observed in early 2010. We believe that pricing is being driven by the need for current return as well as real estate's traditional role as an inflation hedge.

"Commercial real estate valuations show that the market is stabilizing if not improving."

CMBS yields are relatively attractive for fixed income investors in this low-interest rate environment, thanks to a relative scarcity of investable product and muted levels of new issuance volumes. Issuance is projected to be approximately $25 to $30 billion for 2012, basically in line with 2011 levels. In this environment, investors can consider opportunities across the capital stack, from AAA CMBS with coupon floors to higher rated mezzanine tranches that provide additional yield.

Asset-backed Securities (ABS) Market

Supply ramped up sharply during the second quarter of 2012 versus the second quarter of 2011. Auto issuance continued to dominate supply but there was also increased issuance in credit cards, fleet lease, equipment, student loans, and global RMBS. Total ABS issuance year-to-date is approximately $104 billion versus $67 billion for the first half of 2011. Halfway through 2012, we are just $32 billion short of total issuance in 2011.

Issuance has been met with strong demand, with several deals getting upsized and most launching at tighter spreads than initially expected. Additionally, several deals (credit card, prime and subprime auto) were done on reverse inquiry from several large investors. Demand remains particularly strong in subordinated tranches of prime and subprime auto and heavy equipment deals as investors continue to hunt for higher yielding securities.

The collateral story remains positive for most of the subsectors. Collateral performance in the consumer and equipment segments remains strong. According to Fitch, cumulative losses in the prime auto segment hit record lows during the quarter. While delinquencies were modestly higher in June, they remain well below prior year levels. Performance in the subprime auto segment was more mixed. Aggregate delinquencies have been trending higher but annualized net losses were lower on a month-over-month

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and year-over-year basis. In the credit card space nearly all trusts saw lower delinquency and charge-off rates on a month-over-month and year-over-year basis for the May 31st reporting period.

During the quarter, a number of subordinated tranches from older vintage auto and equipment deals were upgraded by one or more ratings agencies. Improved recoveries, tight underwriting standards on 2010 and 2011 vintages and deleveraging of transactions due to the sequential pay structures (resulting in increased credit enhancement levels) were the key drivers of the upgrades.

"The combination of these strong fundamentals has driven overall performance in the ABS sector."

In this season of market uncertainty, the ABS market continued to show the benefits of its collateral and structure. As reported by the Bank of America/Merrill Lynch ABS Index, the asset-backed sector generated a quarterly return of +0.28%, driven by strong performance in manufactured housing, autos, utilities and equipment, and credit cards. More importantly for indexed investors, the asset-backed sector earned 131 basis points of excess returns versus comparable Treasury securities for the first half of 2012.

Corporate Credit Market

"Quality yield" is a rare thing these days, particularly as the underlying government rates of core developed countries continue to grind towards zero thanks to their safe haven status and various forms of quantitative easing. The behavior of the high yield (HY) market last quarter was a case-in-point: as equities sold off and Euro sovereign woes re-emerged, the HY market's commensurate sell-off was very short-lived. The behavior of the riskiest end of the yield spectrum drives home an important market reality: There is tremendous demand for "quality yield" and not a lot of it.

The macro-induced volatility of last quarter served as a double-edged sword for HY technicals. First, yields rose and investors built cash to protect against outflow risk. Second, issuers either pulled deals or sat on the sidelines. New issues tapered off each successive month of the quarter, with the June print at a mere $10.2 billion, or 6.8% of total 2012 supply. While ETFs experienced outflows at the first emergence of renewed macro risk, the stability that higher yields brought to flows is an example of the underlying demand for "quality yield." Against the "risk-off" backdrop in the second quarter, the share-count of a basket of the most liquid high yield ETFs rose 3.9%, while by quarter's end the market yield was unchanged.

A more comprehensive measure of supply-side technicals is the par outstanding balances of the fixed income benchmarks. They are a good proxy for net supply because they incorporate not only gross new issuance but also calls, tenders, and maturing bonds. Based on Bank of America's Merrill Lynch (BAML) Bond indices, the growth of "quality" high yield— single- and double-B— has slowed dramatically from two years ago (see Table 2 below). For those with yield needs, it's a bit sobering to accept that the growth of the investible universe of dollar fixed income is concentrated in Treasurys (currently yielding on average 0.96%) and investment grade (3.31%). The reality is that it's hard to find 5% yielding assets, let alone 8%.

Another source of yield that is being diminished is hybrid capital securities. The U.S. preferred stock index, for example, has a current yield of 5.5%, but this market is on the cusp of dramatic shrinkage. Under Basel III, Trust Preferred securities (TRups) will no long qualify as Tier 1 capital. In early June, the Federal Reserve released its Notice of Proposed Rulemaking (NPR) regarding the implementation of Basel III capital rules for U.S. banks. The NPR specifies that the Fed will follow Basel guidelines for the phase-out of TRups as Tier 1 capital, making them expensive sub-debt. Many U.S. banks view the NPR as the trigger of the regulatory-event par call in most TRups indentures. Since the majority of these securities have high coupons, several banks have stated that they will

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call outstanding TRups. According to Barclays, of the $87 billion TRups outstanding, $61 billion have coupons below 6%, and thus are potentially callable.

Table 2: Size of Dollar Fixed Income Asset Classes, (in $billions)

"The behavior of the riskiest end of the yield spectrum drives home an important market reality: There is tremendous demand for 'quality yield' and not a lot of it."

		Δ Over			
Fixed Income Asset Classes	Current	Q1 2011	YTD	1-yr	2-yr
Treasury Notes and Bonds	$6,896	3.3%	-4.7%	13.6%	35.3%
Agency	$821	-4.4%	-11.9%	-12.8%	-27.7%
Mortgages	$4,712	0.9%	-6.7%	-0.2%	1.3%
IG Corporates	$3,738	2.2%	-4.3%	9.6%	26.9%
HY Corporates	$1,000	-1.8%	4.9%	-5.9%	11.0%
BB	$420	-4.5%	-2.3%	-12.6%	16.4%
B	$401	1.1%	6.1%	-1.8%	12.8%
CCC	$180	-1.6%	22.9%	2.7%	-2.8%
US Preferred Stock, Fixed Rate	$104	-13.8%	-22.1%	-27.4%	-8.0%

Colored numbers represent greater than 1 SD from average of all classes in period.

Source: BAML Index.

Treasury/Rates Market

Price movement in Treasurys in the second quarter of 2012 was similar to the same period last year: the market rallied and yields trended lower as economic data weakened and European concerns continued. The move this year, however, was more of a flattening trend as front end yields have been anchored near record lows. Over the quarter, the two-year was richer (or lower in yield) by only three bps while the five-, ten- and thirty-year fell in yield by 32.5 bps, 56.5 bps, and 58 bps respectively.

The auction schedule was unchanged in the second quarter from the first, with the Treasury auctioning off $501 billion of nominal notes and bonds. The tone out of Europe has led to solid auction statistics for most of the quarter as the flight to quality bid was the dominant theme. April and May had the strongest auction results across the curve. New issue thirty-year bond auctions have been the hardest for the market to digest but May's auction saw strong enough demand for it to come 2.5 bps richer than where it was trading just prior to the auction deadline. The end of June brought about a different result for the two-, five- and seven-year auctions. While these auctions have typically been on the stronger side of late, all three had weaker auction statistics and came at yield levels cheaper (or higher in yield) than where they were trading just prior to auction.

At the June 20th FOMC meeting, the Fed's policy committee announced it would extend "Operation Twist" through the end of the year. The operation will include sales and purchases totaling about $267 billion. The FOMC also reiterated their "late 2014" rate guidance and downgraded their economic outlook. The market seemed to be hoping for more clues on whether "QE3" might be a reality but that will likely have to wait until the August 1st meeting.

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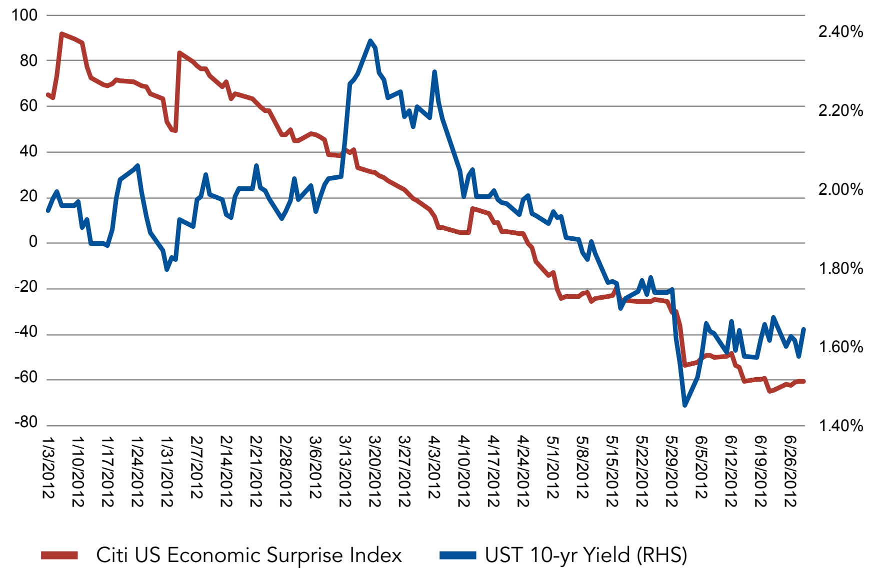
One of the market's favorite charts is the Citigroup Economic Surprise Index, an objective and quantitative measure of how economic news relates to expectations. Chart 2 below graphs the index compared with ten-year Treasury yields. As the Citi index has been steadily declining all year (ie, actual data has generally come in below consensus), ten-year yields have mostly followed suit, with one exception: In the latter part of March some market participants made the painful mistake of anticipating better data only to see yields revert back lower as the economic data continued to weaken and Europe deteriorated. It will be interesting to see if the market makes the same mistake again.

"The market seemed to be hoping for more clues on whether 'QE3' might be a reality but that will likely have to wait until the August 1st meeting."

Chart 2: Citi Economic Surprise Index and the 10-Year Treasury Yield



Source: Citigroup, Bloomberg.

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