RYAN LABS
ASSET MANAGEMENT

BOND MARKET WATCH
OCTOBER 31, 2012

The 4th quarter started off with a continuation of the rally from the 3rd quarter, with credit spreads continuing to tighten in the first half of October. However, with a significant rally stalling in equities, rates not confirming much of a risk-on rally at all, and uncertainty leading up to the election, spreads widened moderately during the second half of October. While credit and securitized investors are still very well aware of the $40 billion a month of agency MBS buying from the Fed, each progressive Fed move seems to be met by less and less enthusiasm from the equity markets. Macroeconomic data has shown some improvement, with the most recent monthly Non Farms Payroll report, the last before the heated presidential election, surprised by a large margin to the upside, adding 172,000 jobs versus economists' expectations of 125,000. The prior months tally of 114,000 new jobs was revised upwards to 148,000. Additionally, consumer confidence has improved, with the most recent number at 72 from the Conference Board, and ISM has rebounded to 51.7; still modest, but an improvement from the 3 consecutive summer months with a sub-50 reading, which typically signifies contraction. Following a strong 3rd quarter, the excess return of U.S. credit markets versus U.S. Treasuries was 1.30% in October. However, credit softened into the end of the month and is currently moderately underperforming Treasuries as we write this in November. Excess return in credit for the year through the end of October is at 706 basis points, as corporate bond demand has remained strong.

Treasuries have been largely range-bound since yields on the 10-year hit their lows of 1.38% at the end of July. 10 year yields backed up to the mid 1.80's in August and were met with buy. This played out similarly in September(10 year yields peaked at 1.89% for the month) and October, when yields hit their highs of the month at 1.85% only to be met with buying again. After the presidential election turned out a second term by President Obama, Treasuries rallied sharply with the 10-year around 1.63% the day after the election. The rates market has spoken and feel that Bernanke's purchasing ability will be met with little resistance under the current President. The Fed's QE3 was marked by their enormous continuous Agency MBS purchase statement but also discussed the continuation of operation twist, exhibiting downward pressure on the shape of the yield curve. Additionally, there are many difficult macro headwinds and overall growth concerns, most notably the upcoming potential gridlock in Washington, and the fear of falling over the "fiscal cliff". Economists and strategists estimate that should the combination of spending cuts and tax increases go through, it could wind up putting GDP growth into negative territory. The 10-year Treasury finished 2011 at 1.87%, touched 1.38% towards the end of July, and sold off to 1.83% in mid-August. The yield on the Ryan Labs 10-year Treasury Index finished October at 1.69% after closing the 3rd quarter at. The yield on The Ryan Labs 30-year Treasury Index yielded 2.90% at the end of 2011, closed August at 2.58%, and is now at 2.83% to close out the 3rd quarter.

October was marked by strong demand across sectors in the credit markets but spreads paused and widened towards the end of the month, as many sectors of the credit market had hit multi-year tights. Favorable conditions for credit came from a number of factors, including largely healthy corporate balance sheets and the surprise to the upside on the Fed's open-ended MBS buying commitment, even as macro numbers remained mixed. Although forward management guidance has been cautious, and growth of both earnings and top line revenues in the 3rd quarter was weaker compared with a year earlier, companies largely beat their EPS estimates in the third quarter and remain profitable. Within high-grade fixed income, after credit spreads in the Barclays Aggregate Index tightened to 161 bps over Treasuries at the end of the first quarter from 217 bps at the end of 2011, spreads widened back out to 182 to close the second quarter. Spreads tightened more substantially in September to close out the quarter at 144 off of Treasuries. Spreads in the Barclays Credit Index ended the month of October at 137 bps. After ending December 2011 at 337 bps and tightening to 227 bps to close out the first quarter, financials ended the second quarter at 253 bps. Financials continued to tighten to 158 bps off Treasuries in October from 179 bps at the end of September. Industrials closed out October at 126 bps after finishing the 3rd quarter at 143 bps off Treasuries.

Within the securitized sector, ABS and CMBS post-crisis have performed well fundamentally, and have benefitted from the sharp drop in yields in the Agency MBS sector as a comparison. Agency MBS rallied violently off of the QE3 news as the Fed's potential size of future purchases drove valuation level extremely tight. OAS on Agency MBS has backed up about 40 bps from the tights as negative convexity and prepayment concerns have crept into the market at its current valuation levels. Wider trading ABS has been a clear beneficiary of QE3 as a substitute for agency MBS risk. CMBS was up 70 bps versus duration-neutral Treasuries for October and 788 bps for the year. Agency MBS outperformed duration neutral Treasuries by 104 bps for the year. U.S. core fixed income has returned 4.20% YTD after returning 2.33% for 2011.

Yield and Total Returns

Ryan Labs Indexes	YTW	QTD	YTD	12M[1]	Ryan Labs Indexes	YTW	QTD	YTD	12M[1]
RL 2 Year Indexes					RL 10 Year Indexes				
TIPS	-1.37	0.00	1.60	0.87	TIPS	-0.62	1.20	10.02	11.97
Treasury	0.28	-0.06	0.19	0.26	Treasury	1.69	-0.28	4.16	7.56
Agency	0.27	0.02	0.51	0.62	Agency	0.97	-0.14	3.52	4.36
AAA Corporate	0.46	0.15	1.90	1.67	AAA Corporate	2.24	1.18	7.22	7.64
AA Corporate	0.80	0.20	3.24	2.98	AA Corporate	2.61	1.12	9.24	9.06
A Corporate	1.02	0.42	5.85	5.45	A Corporate	2.94	1.36	13.06	13.40
BBB Corporate	1.56	0.62	6.32	6.70	BBB Corporate	3.59	1.46	12.49	12.71
Financials	1.47	0.42	6.98	6.74	Financials	3.52	1.97	17.81	17.47
Industrials	0.70	0.38	3.92	4.16	Industrials	3.16	1.10	10.72	11.29
Utilities	0.97	0.37	3.30	3.53	Utilities	3.02	1.52	10.16	10.72
RL 5 Year Indexes					RL 30 Year Indexes				
TIPS	-1.40	0.17	4.28	4.44	TIPS	0.25	2.66	13.80	16.40
Treasury	0.72	-0.28	1.95	3.20	Treasury	2.85	-0.16	3.84	11.27
Agency	0.88	-0.06	2.63	3.18	Agency	2.87	0.01	8.04	18.72
AAA Corporate	1.27	0.60	5.58	5.33	AAA Corporate	3.55	1.34	13.57	13.85
AA Corporate	1.59	0.59	7.11	6.38	AA Corporate	3.93	2.03	15.52	16.95
A Corporate	1.90	0.83	11.58	11.18	A Corporate	4.06	1.93	17.84	16.77
BBB Corporate	2.47	0.95	10.14	10.47	BBB Corporate	4.64	2.51	18.28	17.83
Financials	2.47	0.84	14.29	13.71	Financials	4.62	2.53	27.22	26.35
Industrials	1.79	0.83	8.25	8.63	Industrials	4.20	2.17	15.53	15.52
Utilities	1.96	1.12	8.22	8.55	Utilities	4.11	1.87	13.62	13.01
Barclays Indexes					Barclays Indexes				
BC Aggregate	1.70	.20	4.20	5.25	BC ABS	0.93	-.01	3.42	3.75
BC CMBS	1.83	.55	8.94	10.74	BC MBS	2.14	-.18	2.64	3.56

The material presented and calculated here is based on information considered reliable. Ryan Labs does not represent that it is accurate or complete.

Ryan Labs TIPS				
	Yield To Worst (%)	MDuration (Years)	Year To Date Returns (%)	Last 12 Month Returns (%)
2 Year TIPS	-1.37	2.69	1.60	0.87
5 Year TIPS	-1.40	5.01	4.28	4.44
10 Year TIPS	-0.62	10.67	10.02	11.97
30 Year TIPS	0.25	22.49	13.80	16.40
RL TIPS Index	-0.84	8.83	7.15	8.10

Market Implied Breakeven Inflation Expectation				
	Yield To Worst (%)		Inflation (%)	
	Nominals [1]	TIPS	BEI [2]	Current [3]
CPI (1 Month Lag)				2.0
2 Year	0.28	-1.37	1.65	
5 Year	0.72	-1.40	2.11	
10 Year	1.69	-0.62	2.30	
30 Year	2.85	0.25	2.60	

1) Nominals represent conventional U.S. Treasury Bonds and Notes.

2) BEI = Breakeven Inflation Rate (Nominal yields minus TIPS yields). Widening BEI indicates that TIPS are outperforming nominal bonds. When realized inflation is greater than implied inflation, TIPS also outperform.

3) Current Inflation = Bureau of Labor Statistics, Year over Year Consumer Price Index (non-seasonally adjusted, all items, 1 month lag)

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