BOND MARKET WATCH

DECEMBER 31, 2012

The year came to a close with a generally positive tone after some stagnation during the middle of December. Fear regarding the "Fiscal Cliff" caused a brief sell-off in equities in the second half of December, only to see a strong rally at the end of the year and into the start of January, as both sides of the aisle came to a solution on tax increases for the wealthy. Although the deal does little to solve budget problems, as tax revenue will still be a far cry from the level needed for a positive operating budget, the near-term resolution led to buying. In the credit markets, any pause in spread tightening that we've seen over the past several months was only marginal and many credits were unchanged despite an interim equity sell-off. For the quarter, wider spread sectors generally outperformed, with credit spreads in BBB 's and financials outpacing other sectors. Credit and securitized investors are still motivated by a search for yield and value, as the Fed continues to lean on both rates and MBS with $40 billion a month of agency MBS buying from the Fed. Additionally, with the marked improvement in bank stocks for the year, financial spreads followed suit and have tightened considerably from the wide levels we saw heading into 2012. For example, 10 year Morgan Stanley credit traded in the 500s (spread) at the end of 2011, and tightened substantially to trade inside of 200 in the beginning of January. Macroeconomic data has improved somewhat, as the November Non-Farms Payroll report surprised to the upside, adding 146,000 jobs versus economists' expectations of 85,000. The December report showed 155,000 jobs added versus an expected 152,000 and the unemployment rate at 7.8%, lower than the 8.5% level from the end of 2011. Consumer confidence has waned a bit with the most recent print of 65.1, down from the 71.5 level we saw at the end of November, but is still well off the lows of 2011 which had a 40.9 reading in October of 2011. ISM continues to show modest expansion, with the December reading of 50.7. Following a strong 3rd quarter, the excess return of U.S. credit markets versus U.S. Treasuries was 0.57% in December and 6.93% for the year.

Treasuries have been largely range-bound for the second half of the year with yields increasing modestly at the end of the month. After 10-year Treasury yields peaked at 2.38% in March, yields on the 10-year hit their lows of the year of 1.38% at the end of July of 2012, then proceeded to back up to the mid 1.80's in August. This played out similarly in September as the 10-year hit 1.89% for the month, before substantial buying. The 4th quarter was similar, when yields hit their interim highs in the middle of October at 1.85% only to be driven back down to 1.58% in mid-November. The Ryan Labs 10-year Treasury Index finished 2012 at 1.75%. The Fed's massive balance sheet has clearly weighed on rates, as multiple forms of quantitative easing, such as the large commitment to Agency MBS purchases along with the continuation of operation twist, has kept pressure on the shape of the yield curve. Many difficult macro headwinds and overall growth concerns - most notably the upcoming potential gridlock in Washington over the debt ceiling, budget issues, and the fear of falling over the "fiscal cliff" - caused Treasuries to remain well-bid for the second half of 2013. GDP improved a bit with the 4th quarter number revised upwards to 2.7% annual growth but concerns for the first half of the year remain in place. The 10-year Treasury finished 2011 at 1.87% and finished the year at 1.75%. The yield on The Ryan Labs 30-year Treasury Index yielded 2.90% at the end of 2011, closed out the 3rd quarter at 2.83% and finished the year at 2.94%.

The 4th quarter saw mostly strong demand across sectors in the credit markets. After companies largely beat their EPS estimates in the third quarter, revenue and the ability to maintain earnings growth are in focus. Earnings are in full-swing as we write this and will shift investors focus briefly from the political headwinds weighing on the macroeconomic environment. 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 2nd quarter. Spreads tightened more substantially in September to close out the 3rd quarter at 144 off of Treasuries. Credit spreads in the Barclays Index ended the year at 133 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 155 bps off Treasuries to end the year from 179 bps at the end of the 3rd quarter. Industrials closed out the year at 133 bps after finishing the 3rd quarter at 143 bps off Treasuries.

Within the securitized sector, ABS and CMBS have performed well fundamentally and have had positive technicals as net supply has been negative. Securitized credit has been one of the largest benefactors of depressed yields in the Agency MBS sector as a comparison. Agency MBS have sold off a bit after a violent rally off of the QE3 news as the Fed's potential size of future purchases drove valuation to extremely tight levels. Wider trading ABS has been a clear beneficiary of QE3 as a substitute for agency MBS risk as well as short duration Treasuries, which offer little carry. CMBS was up 44 bps versus duration-neutral Treasuries for December and 841 bps for the year. Agency MBS outperformed duration neutral Treasuries by 91 bps for the year. U.S. core fixed income has returned 4.21% for 2012 returning 2.33% for 2011.

RYAN LABS
ASSET MANAGEMENT

BOND MARKET WATCH

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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	-1.46	0.35	1.95	1.95	TIPS	-0.56	0.73	9.50	9.50
Treasury	0.25	0.04	0.29	0.29	Treasury	1.75	-0.23	4.20	4.20
Agency	0.05	0.09	0.57	0.57	Agency	0.95	-0.33	3.32	3.32
AAA Corporate	0.44	0.62	2.37	2.37	AAA Corporate	2.22	1.59	7.65	7.65
AA Corporate	0.73	0.59	3.64	3.64	AA Corporate	2.63	2.23	10.43	10.43
A Corporate	1.14	0.96	6.42	6.42	A Corporate	2.87	2.33	14.14	14.14
BBB Corporate	1.58	1.32	7.06	7.06	BBB Corporate	3.60	4.75	16.14	16.14
Financials	1.39	0.99	7.59	7.59	Financials	3.30	3.53	19.61	19.61
Industrials	1.02	0.98	4.54	4.54	Industrials	3.09	2.17	11.89	11.89
Utilities	0.92	1.08	4.03	4.03	Utilities	2.99	2.41	11.13	11.13
RL 5 Year Indexes					**RL 30 Year Indexes**				
TIPS	-1.43	0.39	4.51	4.51	TIPS	0.31	1.63	12.66	12.66
Treasury	0.71	0.00	2.24	2.24	Treasury	2.94	-1.28	2.68	2.68
Agency	0.63	0.01	2.71	2.71	Agency	2.95	-1.83	6.05	6.05
AAA Corporate	1.30	0.93	5.92	5.92	AAA Corporate	3.69	0.73	12.89	12.89
AA Corporate	1.58	1.58	8.17	8.17	AA Corporate	4.02	2.92	16.52	16.52
A Corporate	1.90	1.73	12.58	12.58	A Corporate	4.14	2.72	18.75	18.75
BBB Corporate	2.50	1.97	11.25	11.25	BBB Corporate	4.72	3.63	19.57	19.57
Financials	2.32	2.09	15.72	15.72	Financials	4.59	3.96	29.00	29.00
Industrials	1.89	1.56	9.04	9.04	Industrials	4.29	2.98	16.45	16.45
Utilities	1.95	2.26	9.44	9.44	Utilities	4.21	2.56	14.39	14.39
Barclays Indexes					**Barclays Indexes**				
BC Aggregate	1.74	.21	4.21	4.21	BC ABS	0.91	.22	3.66	3.66
BC CMBS	1.71	1.22	9.66	9.66	BC MBS	2.27	-.22	2.66	2.66

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

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Ryan Labs TIPS				
	Yield To Worst (%)	MDuration (Years)	Year To Date Returns (%)	Last 12 Month Returns (%)
2 Year TIPS	-1.46	2.52	1.95	1.95
5 Year TIPS	-1.43	4.80	4.51	4.51
10 Year TIPS	-0.56	10.45	9.50	9.50
30 Year TIPS	0.31	22.28	12.66	12.66
RL TIPS Index	-0.84	8.57	6.92	6.92

Market Implied Breakeven Inflation Expectation				
	Yield To Worst (%)		Inflation (%)	
	Nominals [1]	TIPS	BEI [2]	Current [3]
CPI (1 Month Lag)				1.8
2 Year	0.25	-1.46	1.71	
5 Year	0.71	-1.43	2.14	
10 Year	1.75	-0.56	2.30	
30 Year	2.94	0.31	2.62	

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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