RYAN LABS
ASSET MANAGEMENT

BOND MARKET WATCH
JULY 31, 2013

After a second quarter that saw one of the worst bond performances in the history of the Barclays Aggregate index, with credit risk softer alongside higher underlying Treasury yields, July has seen more fixed income outflows and bond selling. Equities have also sold off from recent highs but are still up over 14% for the year as we write this, after an extremely strong 1st quarter that saw the S&P500 gain 10.03%. However, stocks have sold off from their highs in mid-July, and reading the Fed tea leaves has been the center of the markets' focus. The Fed's talk of potential tapering in their $85 billion a month in Agency MBS and U.S. Treasury asset purchases has disrupted both the equity and fixed income markets, although certainly bonds have been hit much harder. Stocks corrected about 6% at one point during June, then recovered to the highs of the year with the S&P approaching 1710 in July, and have traded a bit softer since, down about 3.2% since the highs of mid-July . Volatility, underlying Treasury yields and corporate bond yields were all at, or near, multiyear low levels at the end of the first quarter. The VIX made new trailing 12-month lows at 11.41 in mid-March but approached 22 during the later part of June as higher risk credit spreads sold off alongside increased macro concern of the Fed "tapering" their asset purchases. The VIX currently is at 14.83 as we write this. Volatility, as measured by the VIX, has correlated closely with higher beta credit spreads and high yield spreads.

Although Treasuries had remained range-bound for a large portion of 2012, the heavy selling of the 2nd quarter has not improved in July and August. The Ryan Labs 10-year Treasury Index finished July yielding 2.59% and currently stands at 2.90% as we write this, due to a combination of fear regarding the eventual unwinding of the Fed's multiyear QE program and better macroeconomic indicators. This has been a swift decline in the bond market, as the Ryan Labs 10-year Treasury index yield stood at 1.86% at the end of 1Q 2013, and ended 2012 at 1.75%. Throughout most of the second half of 2012, the 10-year remained in a range between the mid 1.5% area and 1.9%, yet we are seeing continued selling in August. On a positive note, the reason for the Fed's tapering discussion was their more positive macroeconomic outlook, and the most recent Non-Farms Payroll report came in at +195K jobs, exceeding expectations of 161K, bringing the unemployment rate down to 7.4%. Additionally, with inflation staying fairly benign and the Core CPI at 1.7%, the real yield on the 10-year is now positive. This is a welcome development and points to more natural long duration buyers at these levels.

Earnings were generally positive in the first quarter with 73% of the S&P500 surprising to the upside, and followed that up with a decent second quarter, with 71% upside surprises. As we highlighted previously, top line revenue growth has been weak, and came in this quarter at 1.37%, with earnings up 3.3%. Financials have again driven earnings strength, with financial sector earnings up 28.7% over the same quarter a year ago. The consumer discretionary sector also had a strong earnings season, Profitability and productivity have generally been stellar throughout this weak macroeconomic recovery, but eventually the market must improve top-line growth as there is only so much margin expansion that can take place in a soft sales environment. Weak GDP growth, tepid CPI numbers, commodity price declines, and growth and leverage concerns out of China still are top of mind, although. We continue to observe periods of spread widening correlated with Treasury yield increases, which is a change of pace from much of the prior couple of years. As government bonds sold-off, corporate bonds and other credit such as high yield, securitized credit, and agency MBS underperformed, leading to poor returns across investment grade fixed income sectors. Within high-grade fixed income, after credit spreads in the Barclays Aggregate Index ended 2011 at 217 bps, and 2012 at 133 bps, spreads widened to 144 bps off Treasuries at the end of June from 130 bps at the end of the first quarter of 2013. Spreads had a sideways month in June, slightly wider to 131 bps. After tightening to 155 bps off Treasuries to end 2012, financials widened to 155 bps at the end of 2Q 2013. Financials finished July tighter at 142 bps off Treasuries, amidst stabilization in credit spreads and relatively strong bank earnings. Industrials closed out 2012 at 133 bps, and ended the 2nd quarter wider at 149 bps from 137 bps at the end of 1Q 2013. Industrial spreads stand at 136 bps off at the end of July.

After a strong start to the year, CMBS underperformed in the recent quarter while ABS outperformed other securitized sectors. Fundamentals in both the consumer ABS and CMBS have largely remained a strength but liquidity and technicals have been weaker recently with heavy issuance in both sectors during the slow summer months, and amidst poor investment grade bond fund flows. In Agency MBS space, the pace of the yield curve steepening has increased the duration of the sector via extension, as refinancing is sharply lower on mortgage rate increases. The average 30-year fixed rate mortgage is currently at 4.59% up sharply from the lows of the year of 3.40%. The agency MBS sector underperformed duration neutral Treasuries for the year by 39 bps through the end of July. The Barclays Aggregate Index has returned -2.31%.

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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	-1.09	0.67	-0.90	-0.36	TIPS	0.52	0.81	-9.31	-8.23
Treasury	0.31	0.14	0.18	0.22	Treasury	2.59	-0.81	-5.51	-6.38
Agency	0.10	0.01	0.07	0.20	Agency	1.51	0.46	-0.68	-0.56
AAA Corporate	0.64	0.27	0.23	1.15	AAA Corporate	3.35	-0.51	-4.44	-4.19
AA Corporate	0.82	0.29	0.51	1.64	AA Corporate	3.53	0.29	-4.51	-3.11
A Corporate	1.31	0.52	0.69	2.72	A Corporate	3.82	0.40	-3.89	-1.25
BBB Corporate	1.93	0.56	1.24	3.84	BBB Corporate	4.57	0.81	-2.93	2.62
Financials	1.58	0.54	0.91	3.22	Financials	4.16	0.93	-2.33	3.07
Industrials	1.26	0.53	0.74	2.38	Industrials	4.03	0.46	-3.66	-1.86
Utilities	1.35	0.44	0.69	2.36	Utilities	3.93	0.76	-2.97	-0.66
RL 5 Year Indexes					**RL 30 Year Indexes**				
TIPS	-0.40	1.05	-3.98	-2.74	TIPS	1.24	-0.76	-17.27	-17.94
Treasury	1.39	0.18	-2.03	-1.97	Treasury	3.65	-2.47	-11.78	-16.49
Agency	1.49	-2.12	-3.32	-3.13	Agency	3.82	0.15	-8.51	-10.36
AAA Corporate	1.98	0.30	-1.58	-0.18	AAA Corporate	4.47	-0.12	-9.01	-11.20
AA Corporate	2.32	0.58	-1.02	0.72	AA Corporate	4.83	0.96	-5.96	-6.45
A Corporate	2.65	0.89	-0.93	2.65	A Corporate	4.91	1.13	-5.40	-4.49
BBB Corporate	3.29	0.91	-0.55	2.90	BBB Corporate	5.58	0.87	-5.90	-2.95
Financials	2.93	1.29	0.04	5.00	Financials	5.28	1.46	-2.41	2.01
Industrials	2.66	0.69	-1.13	1.04	Industrials	5.12	0.83	-6.48	-5.90
Utilities	2.59	0.70	-0.41	3.10	Utilities	4.87	1.24	-4.29	-4.13
Barclays Indexes					**Barclays Indexes**				
BC Aggregate	2.34	0.14	-2.31	-1.90	BC ABS	1.32	-0.18	-1.00	-0.26
BC CMBS	2.25	0.51	-0.80	2.55	BC MBS	3.22	-1.99	-2.13	-2.03

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Ryan Labs TIPS	Yield To Worst (%)	MDuration (Years)	Year To Date Returns (%)	Last 12 Month Returns (%)
2 Year TIPS	**-1.09**	**2.53**	**-0.90**	**-0.36**
5 Year TIPS	**-0.40**	**5.35**	**-3.98**	**-2.74**
10 Year TIPS	**0.52**	**10.36**	**-9.31**	**-8.23**
30 Year TIPS	**1.24**	**21.94**	**-17.27**	**-17.94**
RL TIPS Index	**0.01**	**8.50**	**-7.17**	**-6.35**

Market Implied Breakeven Inflation Expectation	Yield To Worst (%)		Inflation (%)	
	Nominals [1]	TIPS	BEI [2]	Current [3]
CPI (1 Month Lag)				1.8
2 Year	0.31	-1.09	1.41	
5 Year	1.39	-0.40	1.80	
10 Year	2.59	0.52	2.07	
30 Year	3.65	1.24	2.41	

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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