RYAN LABS
ASSET MANAGEMENT

BOND MARKET WATCH
DECEMBER 31, 2013

The year 2013 ended with a boom in risk assets, as stocks rallied, the yield curve continued to steepen, and many segments of the credit markets posted 5 year tights. Financials were the big story of the year as many of the financial credits are marking post-crisis tights with previously higher spread names such as Morgan Stanley and Goldman Sachs tightening throughout the fourth quarter. After several years of intense volatility even in the aftermath of the economic crisis, financials found their footing, overcoming previous concerns such as increased regulation, low ROEs compared to the middle of the last decade, and the Eurozone crisis. Although law suits continued to make headlines, most notably with the large news-making cases of JPMorgan's "London Whale" and mortgage settlements, most market participants have looked at improved macroeconomic numbers, large gains in stocks, and a more stable Eurozone picture as a less risky environment for bank debt. After the fixed income sell-off in the second quarter, and a third quarter marked by a host of macroeconomic, government, and policy uncertainty, the fourth quarter was marked by the Fed's surprise of "no-taper" and stocks ended up the year up 30%. The second quarter was when the bond market experienced the most pain, as the anticipation of the end of the Fed's Quantitative Easing program in September actually wreaked far more havoc then the actual taper. In addition, the prospect of a government shutdown, with the fear of the US Treasury not able to pay its bills due to breaching the debt ceiling caused further turmoil in the T-Bill market. Interestingly, the Fed surprised many strategists, economists, and investors by not tapering their $85 billion in monthly asset purchases in September, with most expecting at least some tapering in Treasury purchases and perhaps a cut back in Agency MBS purchases as well. With a mixed employment picture and mortgage rates substantially higher (The Bankrate.com 30-year fixed rate skyrocketed from the trailing 12 month low of 3.36% in December all the way to 4.67% in early September) the Fed didn't feel comfortable to let their foot off the gas. Equities sold off towards the end of September as the debt ceiling limit loomed and amidst the government shutdown, but rallied into the end of the year. The VIX declined substantially since the government debt ceiling resolution and amidst strong equity market performance The VIX is currently is at 12.86 as we write this. Volatility, as measured by the VIX, has correlated closely with higher beta credit spreads and high yield spreads.

The 10 year US Treasury yield averaged 2.33% in 2013 after averaging 1.78% in 2012. However, after sitting at 1.62% as recently as May, the 10 year finished out the 4th quarter above 3.02%. Most of the Treasury losses were experienced in the second quarter, and 2013 ended as one of the worst years in the history of the investment grade fixed income markets, with the Barclays Aggregate Index posting a negative return (-2.02%) for the first time since 1994. The return on the Ryan Labs 10-year Treasury Index was -7.73% in 2013 and the index finished the year yielding 3.01% after yielding 2.62% to finish out the third quarter. Many of the reasons behind the bond sell-off earlier in the year remain in place, such as the fear regarding the eventual unwinding of the Fed's multiyear QE program and better macroeconomic indicators. However, it should be noted that the real yield on the 10 year has dramatically reversed course and is now closer to long term averages. This is because although a 3% 10 year yield is well-below historical averages; the real yield is almost 2% with inflation remaining remarkably subdued. The December CPI came in at 1.5% while the core PCE Deflator was a meager 1.1% through November.

Fourth quarter earnings are in the midst of being released and the early readings are on the soft side with many of the banks discussing the difficult trading environment. An example is GS earnings, which beat estimates by 22%, but yet earnings are still down 8.4% from the same quarter a year ago. Goldman's ROE was just shy of 12% compared with an average of 16% over the past 10 years. 3Q earnings were generally good with 73% of the S&P500 surprising to the upside but just over 50% are surprising to the upside thus far in the fourth quarter, albeit with less than 100 of the S&P500 reporting so far. Top line revenue growth has still been weak, and came in the third quarter at 1.45%, with earnings up 3.46%. This is a trend to watch as recently reported GDP numbers have been revised upwards. Will that translate to better revenue growth? Within high-grade fixed income, after credit spreads in the Barclays Aggregate Index ended 2011 at 217 bps, and 2012 at 133 bps, spreads tightened to 111 bps to end 2013, from 135 bps at the end of the 3rd quarter. After tightening to 155 bps off Treasuries to end 2012, financials tightened further in 2013, to 109 bps to end the fourth quarter, from 139 bps at the end of 3Q 2013. Industrials closed out 2012 at 133 bps, and continued to tighten to 114 bps to end the year from 142 bps to end the third quarter. The agency MBS sector underperformed duration-neutral Treasuries for much of the 3rd quarter on the fear of the Fed's taper, and the yield curve steepening, but rallied off of the Fed's announcement to delay and finished the year with a 98 bp excess return versus duration neutral Treasuries.

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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	-1.04	-0.06	-1.09	-1.09	TIPS	0.89	-3.18	-12.03	-12.03
Treasury	0.39	0.08	0.32	0.32	Treasury	3.01	-2.45	-7.73	-7.73
Agency	0.18	0.10	0.17	0.17	Agency	1.52	0.31	-0.48	-0.48
AAA Corporate	0.64	0.21	0.67	0.67	AAA Corporate	3.74	-1.14	-5.35	-5.35
AA Corporate	0.93	0.42	1.22	1.22	AA Corporate	3.77	-0.24	-4.78	-4.78
A Corporate	1.25	0.69	1.80	1.80	A Corporate	4.03	0.42	-3.52	-3.52
BBB Corporate	1.88	1.06	2.83	2.83	BBB Corporate	4.81	1.05	-2.08	-2.08
Financials	1.49	0.88	2.41	2.41	Financials	4.32	1.31	-0.85	-0.85
Industrials	1.30	0.65	1.67	1.67	Industrials	4.37	0.42	-3.52	-3.52
Utilities	1.64	0.51	1.32	1.32	Utilities	4.37	-0.12	-3.76	-3.76
RL 5 Year Indexes					RL 30 Year Indexes				
TIPS	-0.12	-1.36	-5.13	-5.13	TIPS	1.56	-5.03	-22.11	-22.11
Treasury	1.74	-0.89	-2.45	-2.45	Treasury	3.94	-3.52	-15.07	-15.07
Agency	0.98	0.30	-0.20	-0.20	Agency	4.18	-1.19	-11.60	-11.60
AAA Corporate	2.18	-0.16	-1.34	-1.34	AAA Corporate	4.70	-0.94	-11.21	-11.21
AA Corporate	2.42	0.79	0.12	0.12	AA Corporate	4.88	1.70	-4.96	-4.96
A Corporate	2.65	1.06	0.76	0.76	A Corporate	5.03	0.62	-5.76	-5.76
BBB Corporate	3.35	1.30	1.19	1.19	BBB Corporate	5.63	1.94	-5.06	-5.06
Financials	2.82	1.41	2.31	2.31	Financials	5.23	2.87	0.38	0.38
Industrials	2.81	0.86	0.05	0.05	Industrials	5.25	0.84	-6.88	-6.88
Utilities	2.79	0.53	0.18	0.18	Utilities	5.06	0.33	-5.81	-5.81
Barclays Indexes					Barclays Indexes				
BC Aggregate	2.48	-0.14	-2.02	-2.02	BC ABS	1.24	0.32	-0.34	-0.34
BC CMBS	2.27	0.53	0.23	0.23	BC MBS	3.28	-0.43	-1.45	-1.45

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	**-1.04**	**2.53**	**-1.09**	**-1.09**
5 Year TIPS	**-0.12**	**5.16**	**-5.13**	**-5.13**
10 Year TIPS	**0.89**	**9.89**	**-12.03**	**-12.03**
30 Year TIPS	**1.56**	**21.43**	**-22.11**	**-22.11**
RL TIPS Index	**0.21**	**7.84**	**-9.16**	**-9.16**

Market Implied Breakeven Inflation Expectation				
	Yield To Worst (%)		Inflation (%)	
	Nominals [1]	TIPS	BEI [2]	Current [3]
CPI (1 Month Lag)				1.2
2 Year	0.39	-1.04	1.44	
5 Year	1.74	-0.12	1.86	
10 Year	3.01	0.89	2.12	
30 Year	3.94	1.56	2.38	

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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