RYAN LABS
ASSET MANAGEMENT

BOND MARKET WATCH
AUGUST 31, 2012

The month of August felt quiet as a run up in asset prices over the previous few months and macroeconomic uncertainty created a feeling of indifference and perhaps complacency in the capital markets. Following a strong July, the excess return of U.S. credit markets versus U.S. Treasuries was 0.40% in August. After another earnings season with more positive surprises than negative, deteriorating macroeconomic numbers have led to a higher percentage investors expecting quantitative easing in the upcoming September meeting. At the end of August, Chairman Ben Bernanke gave a speech at Jackson Hole that largely defended the benefits of past unprecedented easing, saying that "there is substantial evidence that the Federal Reserve's asset purchases have lowered longer-term yields and eased broader financial conditions." Additionally, Mr. Bernanke stated that the benefits of loosening credit markets and the lowest rates in history outweighed the potential costs while "mitigating deflationary risks". Citing the unacceptably high unemployment level, Mr. Bernanke stated that the "stagnation of the labor market in particular is a grave concern not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years." In the context of the speech, investors saw the much-anticipated monthly nonfarm employment report surprise to the downside, with 96k jobs created compared with expectations of 130k. Additionally, the prior months growth of 163k was revised down to 141k. This seemed to be a scenario where "bad is good", with markets continuing to rally on the hope of the Fed coming to the rescue. As we write this, the Fed has just announced that they will buy $40 billion a month of agency MBS, a substantial amount that seems to deliver on expectations.

Outside of the Fed's monetary policy, the European debt crisis and the actions of the ECB have also been in focus. In the recent past few months, Mario Draghi had attempted to generate confidence verbally rather than by way of any real actions, but the recent unlimited ECB bond buying announcement lending to troubled Euro countries has also let the market breathe a sigh of relief. After touching 1.22 the Euro has rallied to 1.28 as we write this. Meanwhile, US Treasuries have sold off despite paltry growth signals. The ISM Manufacturing index dropped below 50 at 49.6 signaling contraction, while regional manufacturing numbers have been poor. Additionally, difficult consumer confidence, and domestic large cap top line revenue growth declining are worrisome. The sell-off in Treasuries seems to be tied to technical range trading, the ECB European bond buying, and yields catching up to the rally in domestic equities and other risk. The Ryan Labs 10-year Treasury Index finished 2011 at 1.87%, and finished the month of July at 1.47%. Although the 10-year yield touched 1.38% towards the end of July, it sold off to 1.83% in mid-August. After trading back to the mid 1.50%'s at the end of August, the 10-year is at 1.76% as we write this. 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 2.92%.

August was a relatively slow month in the credit markets, as equity volatility diminished and macro risk seemed to take on a "Wait-and-see" attitude focusing on both recent ECB actions and potential quantitative easing by the Fed. 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. After closing out July tighter at 162, spreads tightened modestly to 158 bps off Treasuries in August. Financial credits had outperformed earlier in the year but in July Industrial and Utility credit outperformed as demand for high quality credit was strong. After ending December 2011 at 337 bps and tightening to 227 bps to close out the first quarter, financials ended the quarter at 253 bps. After closing out July at 223 bps off Treasuries, Financials continued to tighten to 206 bps off Treasuries in August. Industrials finished August at 155 bps off Treasuries unchanged from the end of July, from and 184bps at the end of 2011.

Within the securitized sector, ABS and CMBS continued to outperform. Agency MBS has also done well on negative net supply, potential QE3 purchases by the Fed, and declining interest rate volatility. ABS subordinate tranches, from subprime auto subs to timeshares, outperformed the Barclays ABS index. CMBS widened in May, as it suffered from macro correlation, but has continued to perform well since. CMBS is up 80 bps versus duration-neutral Treasuries for August and 576 bps for the year. Agency MBS outperformed duration neutral Treasuries by 84 bps for the year. U.S. core fixed income has returned 3.85% YTD after returning 2.33% for 2011.

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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	-1.38	0.84	1.59	1.70	TIPS	-0.44	1.96	7.74	11.67
Treasury	0.22	0.22	0.26	0.26	Treasury	1.56	1.54	5.03	9.28
Agency	0.31	0.13	0.51	0.70	Agency	0.94	1.43	3.48	5.54
AAA Corporate	0.49	0.48	1.54	1.14	AAA Corporate	2.23	1.31	6.70	8.32
AA Corporate	0.83	0.94	2.79	2.79	AA Corporate	2.69	1.75	7.91	9.97
A Corporate	1.28	1.49	4.81	4.57	A Corporate	3.16	2.59	10.64	12.33
BBB Corporate	1.95	1.72	4.99	5.45	BBB Corporate	3.82	2.64	9.84	10.88
Financials	1.82	1.89	5.83	5.77	Financials	3.88	3.44	13.50	13.32
Industrials	0.83	1.10	3.19	3.61	Industrials	3.25	2.01	9.13	11.74
Utilities	1.01	1.16	2.63	3.11	Utilities	3.26	2.03	8.15	10.33
RL 5 Year Indexes					RL 30 Year Indexes				
TIPS	-1.30	1.48	3.60	4.45	TIPS	0.33	3.53	11.37	19.61
Treasury	0.59	0.81	2.27	3.63	Treasury	2.68	2.58	6.91	23.75
Agency	0.52	0.69	2.58	3.15	Agency	2.76	3.64	8.99	16.42
AAA Corporate	1.31	1.44	4.66	4.21	AAA Corporate	3.52	4.41	13.12	24.45
AA Corporate	1.66	1.59	6.10	5.65	AA Corporate	3.99	3.42	13.94	24.08
A Corporate	2.24	2.69	9.12	8.73	A Corporate	4.22	3.54	15.23	21.95
BBB Corporate	2.77	2.22	7.99	8.29	BBB Corporate	4.92	4.08	14.27	20.56
Financials	2.87	3.35	11.25	10.28	Financials	4.97	4.50	22.22	26.75
Industrials	1.96	1.73	6.64	7.55	Industrials	4.34	3.35	12.94	21.87
Utilities	2.19	2.45	6.35	6.69	Utilities	4.19	3.63	11.94	18.95
Barclays Indexes					Barclays Indexes				
BC Aggregate	1.74	1.45	3.85	5.78	BC ABS	0.92	1.06	3.26	3.83
BC CMBS	2.29	2.52	6.98	10.32	BC MBS	2.20	0.93	2.61	3.71

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	-1.38	2.44	1.59	1.70
5 Year TIPS	-1.30	4.91	3.60	4.45
10 Year TIPS	-0.44	10.80	7.74	11.67
30 Year TIPS	0.33	22.57	11.37	19.61
RL TIPS Index	-0.76	8.75	5.70	8.44

Market Implied Breakeven Inflation Expectation				
	Yield To Worst (%)		Inflation (%)	
	Nominals [1]	TIPS	BEI [2]	Current [3]
CPI (1 Month Lag)				1.4
2 Year	0.22	-1.38	1.60	
5 Year	0.59	-1.30	1.89	
10 Year	1.56	-0.44	2.00	
30 Year	2.68	0.33	2.35	

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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