BOND MARKET WATCH
SEPTEMBER 30, 2012

After a quiet August marked by a steady climb in asset prices, activity in September was punctuated by the announcement from the Federal Reserve to add significant additional quantitative easing in the form of agency MBS purchases. Dubbed QE3, the Fed stated that they will buy $40 billion a month of agency MBS until macroeconomic conditions warrant otherwise, surprising many investors who were counting on some future easing, but not anticipating the open-ended nature of the commitment. Additionally, Chairman Bernanke has been commenting much more explicitly on the threat of unemployment, and the trade-offs between risking higher inflation via continued easy monetary policy versus persistently high unemployment. Following a strong July and August, the excess return of U.S. credit markets versus U.S. Treasuries was 1.06% in September to wrap up a very strong quarter across credit. Excess return in credit for the year is at 567 basis points, as yields in many segments of the index have reached historic lows.

Treasuries have remained range-bound over the last couple of months. The sell-off in Treasuries during the first half of September was met with buying on a flight to quality bid, as equities sold-off with some European debt concerns in the headlines. The Eurozone situation is far from solved as there are many steps left to take before we see a productive, well-functioning, growing economy there, and there is significant deleveraging remaining. An example of the recent market moving headlines has centered on potential problems with Spain's execution of receiving ECB bailout money, and general backlash against austerity measures instituted. Additionally, there has been a better bid for Treasuries in the aftermath of the Fed's QE3, perhaps because of many difficult macro headwinds and overall growth concerns, but also moving in line with Agency MBS, a continuation of long-duration Treasury buying from the Fed, and lower overall rate volatility. 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. After trading in the mid 1.50%'s at the end of August, the 10-year backed up to the mid 1.70%'s in September only to be met with buying into the end of the month. The yield on the Ryan Labs 10-year Treasury Index finished at 1.64% to close out the quarter. 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.

September was marked by brisk tightening across sectors in the credit markets, as spreads continued to tighten. Favorable conditions for credit came from a number of factors, most notably the surprise to the upside on the Fed's open-ended MBS buying commitment, even as macro numbers remained mixed. Additionally, earnings estimates have been revised lower and growth of both earnings and top line revenues is weaker compared with a year earlier. As we write this, earnings have been posted from some of the major banks such as JPMorgan, Wells Fargo, and Citigroup. Overall, surprises have largely been to the upside in earnings but these "beats" have been on fairly weak targets. For example, the news out of JPMorgan was mostly positive on the surface with top-line and bottom-line upside surprises and strong mortgage production numbers. However, substantial releases of loan loss reserves as well as decreased estimates were also instrumental. Bank of America beat estimates on earnings yet posted a 28% YoY drop in revenue and a 95% drop in net income mostly related to continuing litigation costs stemming from the Merrill Lynch merger. BofA also had a 48% decrease in provisions for credit losses, a similar story emerging across many of the systemically large banks. 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 modestly to 158 bps off Treasuries in August and tightened more substantially in September to close out the quarter at 144 off of Treasuries. 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 179 bps off Treasuries in September from 206 bps at the end of August. Industrials finished August at 155 bps off Treasuries unchanged from the end of July, and closed out the quarter at 143 bps off Treasuries.

Within the securitized sector, ABS and CMBS have been the recipient of significant inflows, and have benefitted from the sharp drop in yields in the Agency MBS sector as relative value has looked more attractive. Agency MBS rallied violently off of the QE3 news as the Fed's potential size of future purchases outweighed concerns on historically tight valuation levels versus Treasury blends or on an option-adjusted basis. ABS subordinate tranches, from subprime auto subs to more esoteric sectors such timeshares receivables and shipping container backed assets, continued to be extremely well-bid within ABS. After widening in May, CMBS has tightened considerably throughout most of the year and finished out the quarter on a strong note. CMBS is up 129 bps versus duration-neutral Treasuries for September and 713 bps for the year. Agency MBS outperformed duration neutral Treasuries by 115 bps for the year. U.S. core fixed income has returned 3.99% YTD after returning 2.33% for 2011.

RYAN LABS
ASSET MANAGEMENT

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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	-1.50	0.85	1.60	2.28	TIPS	-0.56	2.88	8.71	12.56
Treasury	0.23	0.21	0.25	0.33	Treasury	1.64	0.98	4.45	5.73
Agency	0.25	0.11	0.49	0.69	Agency	0.92	1.60	3.66	5.23
AAA Corporate	0.43	0.67	1.74	1.67	AAA Corporate	2.28	0.62	5.96	5.85
AA Corporate	0.79	1.19	3.04	3.49	AA Corporate	2.66	1.85	8.02	9.06
A Corporate	1.09	2.07	5.41	6.20	A Corporate	3.05	3.43	11.55	13.80
BBB Corporate	1.73	2.38	5.67	6.78	BBB Corporate	3.70	3.62	10.88	12.91
Financials	1.57	2.56	6.53	7.77	Financials	3.65	5.30	15.53	16.99
Industrials	0.70	1.42	3.52	4.28	Industrials	3.21	2.37	9.51	11.21
Utilities	0.97	1.44	2.92	3.68	Utilities	3.17	2.36	8.51	10.12
RL 5 Year Indexes					RL 30 Year Indexes				
TIPS	-1.46	1.98	4.10	5.91	TIPS	0.34	3.06	10.86	16.79
Treasury	0.63	0.78	2.24	3.50	Treasury	2.83	-0.21	4.01	6.10
Agency	0.85	0.80	2.70	3.44	Agency	2.85	2.73	8.03	10.33
AAA Corporate	1.29	1.73	4.95	4.51	AAA Corporate	3.53	3.44	12.07	12.51
AA Corporate	1.59	1.96	6.49	6.48	AA Corporate	4.04	2.76	13.21	16.40
A Corporate	2.01	4.13	10.66	12.03	A Corporate	4.17	3.88	15.61	17.58
BBB Corporate	2.59	3.27	9.10	10.69	BBB Corporate	4.80	5.10	15.38	18.63
Financials	2.59	5.30	13.34	15.08	Financials	4.82	6.09	24.08	28.54
Industrials	1.86	2.41	7.36	8.61	Industrials	4.29	3.47	13.07	15.42
Utilities	2.03	3.10	7.02	7.68	Utilities	4.20	3.25	11.53	12.06
Barclays Indexes					Barclays Indexes				
BC Aggregate	1.61	1.58	3.99	5.16	BC ABS	0.90	1.23	3.43	3.67
BC CMBS	1.97	3.83	8.35	11.71	BC MBS	1.82	1.14	2.83	3.74

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	-1.50	2.36	1.60	2.28
5 Year TIPS	-1.46	4.82	4.10	5.91
10 Year TIPS	-0.56	10.70	8.71	12.56
30 Year TIPS	0.34	22.47	10.86	16.79
RL TIPS Index	-0.87	8.84	6.23	9.08

Market Implied Breakeven Inflation Expectation				
	Yield To Worst (%)		Inflation (%)	
	Nominals [1]	TIPS	BEI [2]	Current [3]
CPI (1 Month Lag)				1.7
2 Year	0.23	-1.50	1.73	
5 Year	0.63	-1.46	2.09	
10 Year	1.64	-0.56	2.20	
30 Year	2.83	0.34	2.49	

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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