Interest Rate Strategy

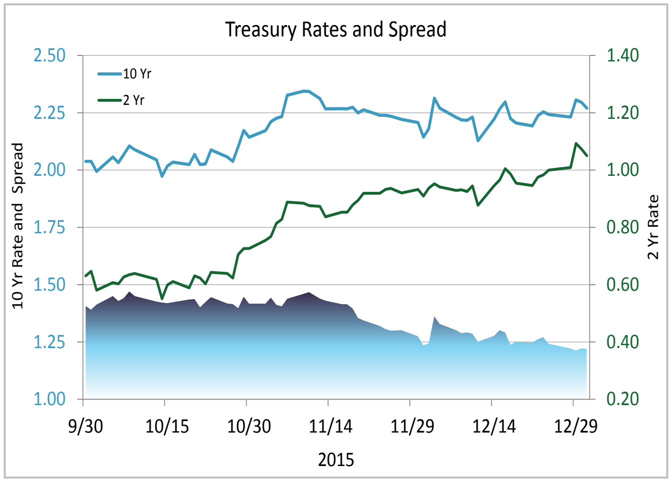
Highlights

- Rates on US Treasury securities shifted higher throughout the final quarter of 2015 as the yield curve flattened in anticipation of the end to the FOMC's zero interest rate policy. Maturities from 6 months to 5 years rose in tandem by 40 bps with longer maturities, 10 years to 30 years, increasing 15-23 bps. The 2 yr bellwether note finished the year at 1.04% while the 10 yr bond closed out the year at 2.27%.

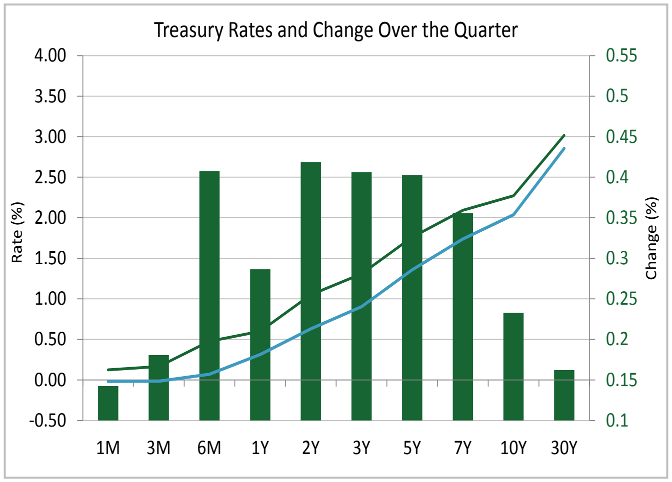
- The rise in shorter maturity rates represented the highest close for the 2 yr note since the first quarter of 2010 and the largest quarterly move since the fourth quarter of 2008. Shorter rates will typically experience sharp increases when markets anticipate less accommodative Fed policy.

Outlook

- Uncertainty around the path of future rate increases will likely continue to be a major factor shaping the level of rates and the slope of the curve. We believe that the market will be unable to handle the rate levels projected by the FOMC and expect a much shallower rate path than their forecast.



Source: Bloomberg



Source: Bloomberg

Mark Kummerer, CFA
Sr. Portfolio Manager

Highlights

- The Barclays Corporate Investment Grade Index generated total and excess returns of -2.31% and 0.45% for the fourth quarter and -0.68% and 1.61% for the year, respectively. The fourth quarter initially rebounded from a dismal third quarter, however, December saw renewed widening of credit spreads. During a period of illiquidity, energy and commodity prices dropped to new multi-year lows.

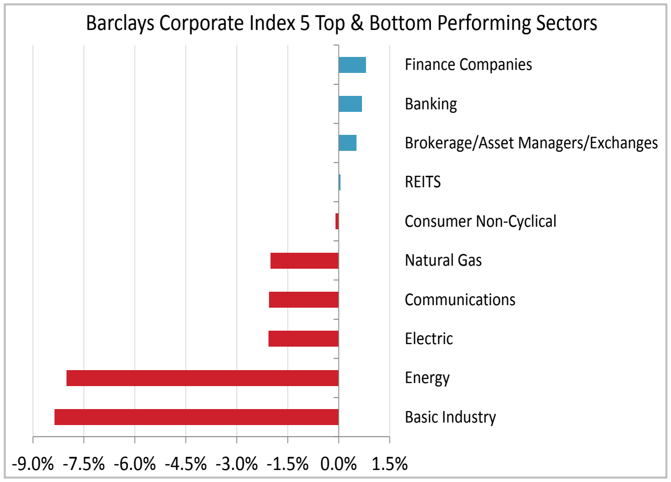
- As expected, energy and commodity related credits were the largest underperformers for the year while banks were perceived as relatively safe havens. During this risk-off market, bonds rated BBB underperformed those rated A, -3.21% versus -0.3% of excess returns, while lower duration generally outperformed on an excess return basis.

- 2015 was a challenging time for credit investors as slower global economic growth, weaker energy and commodity prices, uncertainty around an FOMC rate hike and record new issuances all weighed on performance. Although renewed risk that Greece will exit the Eurozone was the focus at the start of the year, China's slowdown became the primary driver of volatility. Exacerbating the situation was poor liquidity throughout the year and another record year of jumbo mergers and acquisitions which kept event risk elevated.

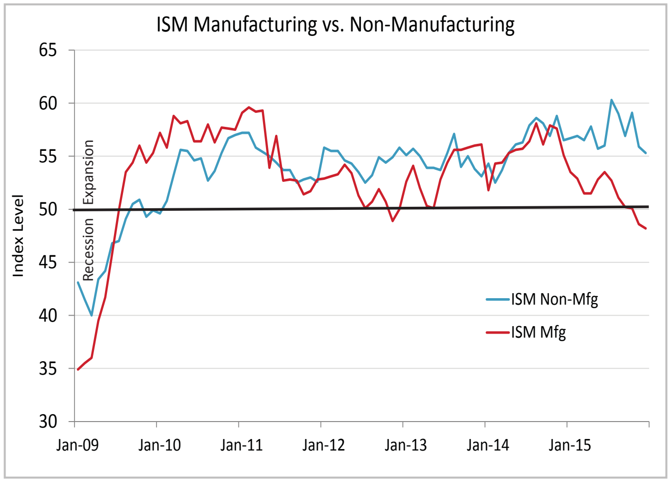
Outlook

- Looking ahead, we see continued challenges in the worst performing sectors. The balance between supply and demand has not been achieved for most of the major commodities, keeping the market bottom elusive. We remain cautious during this period of uncertainty.

- We favor sectors that have shown relative strength. US manufacturers are in a "recession" due to a combination of weak export markets, strong dollar and falling commodity prices. The services sector continues to be expansionary as the domestic economy and the US consumer appear resilient. As a result, we continue to prefer banks, automotive and healthcare sectors in the corporate space.



Source: Barclays



Source: Institute for Supply Management

Dan Kang, CFA
Sr. Research Analyst

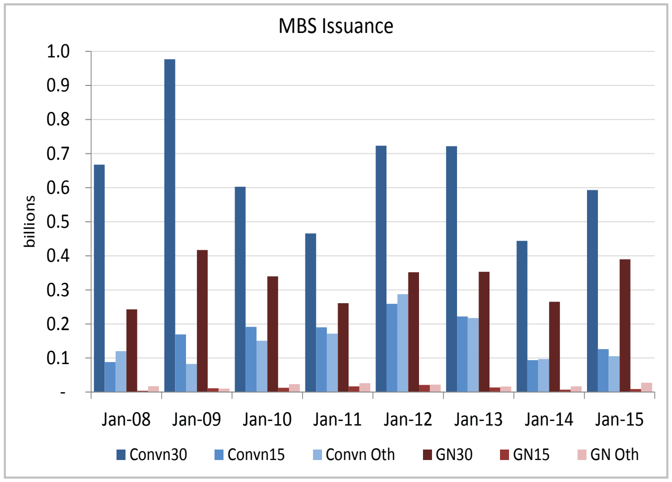
Mortgage-Backed Securities (MBS)

Highlights

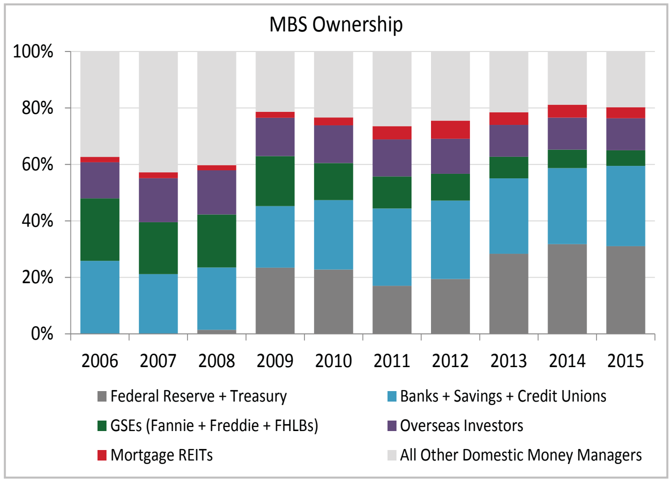
- The Barclays US Agency Mortgage Backed Securities Index posted total and excess returns of -0.10% and 0.61% in the fourth quarter and 1.51% and -0.05% for the year, respectively. Total returns on the 15-year sector lagged the 30-year sector in both periods as the yield curve bear flattened.
- Gross and net issuance of Agency MBS slowed in the fourth quarter due to seasonal factors, totaling $281B and $46B, respectively. For the full year, gross and net issuance totaled $1.2T and $163B, respectively. The 30-year sector represented 79% of total gross issuance (with a rising proportion in Ginnie Mae) and 100% of net issuance, as 15-year issuance was net negative for a second consecutive year at -$7.4B.
- MBS performance was remarkably strong in the fourth quarter despite a number of headwinds including weakening roll markets and the first rate hike by the FOMC in nearly a decade, which brings tapering of Fed reinvestments closer to the forefront. Strong bank demand for MBS continued into the fourth quarter, bringing their total 2015 purchases to $130B. Combined with money manager purchases of $80B during the year, total net issuance was easily absorbed. Relatively range-bound mortgage rates were also a positive, mitigating convexity risks.

Outlook

- Over the near term we expect the Agency MBS sector to post solid performance given carry advantage versus Treasuries, high credit quality and modest supply, particularly relative to expected record investment grade corporate issuance.
- Over the longer term we expect MBS spreads to normalize to more market-driven levels in anticipation of the Fed tapering paydown reinvestments on their $1.75T MBS book, which would add around $300B per year in supply to be absorbed by the private sector. We expect the FOMC to raise the federal funds rate modestly and in an orderly fashion this year, which should mitigate convexity hedging risks; however, a more severe and disorderly rate rise poses meaningful downside risks to the sector.
- We believe the MBS sector still offers an attractive carry advantage relative to Treasuries and believe it is premature to underweight the sector. Instead, we are focused on higher OAS/convexity issues in the specified pools market, as the profile of TBA deliverables continue to weaken. We also like CMOs backed by seasoned premium coupon 20/30yr collateral given prepay burnout and limited extension risk.



Source: Merrill Lynch



Source: Nomura

Perpetua Phillips
Sr. Portfolio Manager

Asset-Backed Securities (ABS)

Highlights

- The Barclays AAA Asset Backed Securities Index generated 4th quarter total and excess returns of -0.61% and -0.11% and 1.18% and 0.36% for the year, respectively. The ABS sector had a few pockets of weakness in 2015 including the impending downgrade of the Federal Family Education Loan Program (FFELP), which is backed by student loans, and specific credit issues surrounding names such as Volkswagen. Total issuance in 2015 came close to $200B and is expected to exceed that in 2016.

- Auto issuance slowed in the fourth quarter as wider spreads forced some issuers to pull their deals. The 2014 and 2015 vintages are experiencing higher losses than 2010 to 2013, though still within normal levels experienced in 2004. Auto sales in 2015 reached 17.4MM units, up 5.4% YOY, and are expected to exceed that in 2016. Despite the continuing high level of the Manheim Index, 125.7 as of December 2015, pressure is starting to emerge as vehicles come off-lease.

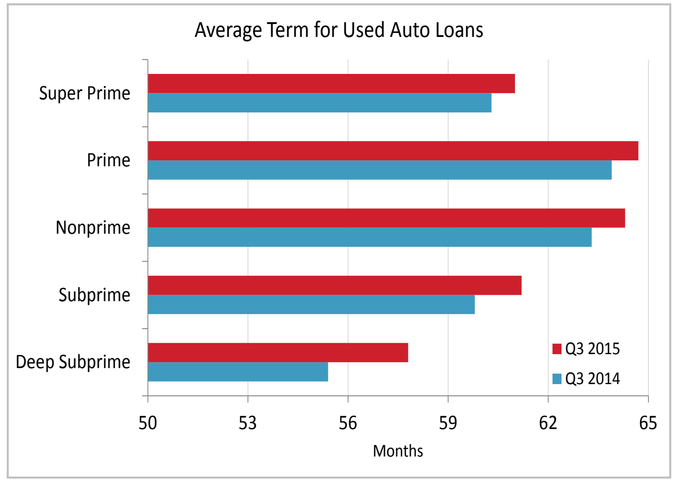
- Credit Card ABS new issuance surprised to the downside in 2015, ending the year at $37B and is expected to shrink in 2016. Citigroup had no new credit card ABS issuance during the year as ABS financing for banks has been less attractive under the new liquidity rules. Underlying consumer lending fundamentals are strong with rising consumer confidence and revolving debt now in excess of $923B. As a result of excellent metrics and well-seasoned receivables on master trust credits, delinquencies are below historic norms at 1.51% as of November 2015.

Outlook

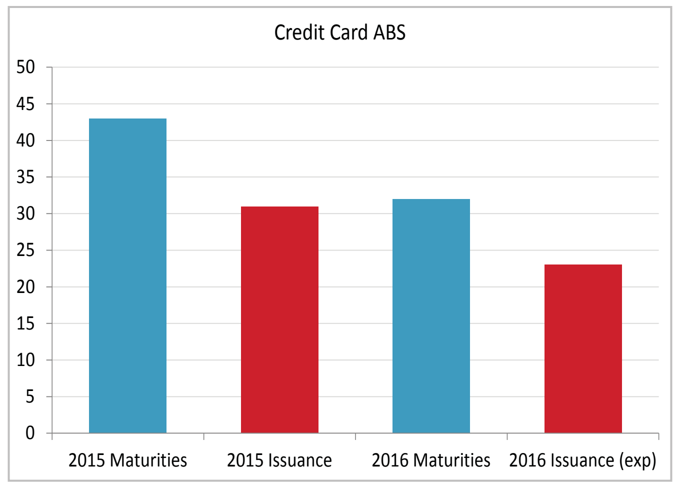
- ABS credit spreads continue to be attractive, specifically in the more liquid auto sub-sectors. We view structures with amortizing cash flows are more favorable, as they will naturally give cash back to investors, even in scenarios where dealer bids are scant. Long bullet bonds are more sensitive to rate moves and liquidity challenges.

- Fundamentals and technicals continue to bode well for the shorter ABS segments. Credit card spreads have benefitted from curtailed supply and historically low losses. Auto ABS has benefitted from liquidity as supply has become half of the total ABS market while losses are normalizing.

- The inverted swap curve has been a result of Treasury selling from foreign central banks and banks readjusting their own balance sheets. With the expectation that these factors may be in place for the near term, credit spreads have widened to maintain absolute yield requirements from investors. As a result, we think current levels in auto sub-sectors and equipment are more attractive than short corporate bonds.



Source: Bank of America



Source: Moody's

Rupa Raman, CFA
Sr. Research Analyst

Commercial Mortgage-Backed Securities (CMBS)

Highlights

- The Barclays AAA Commercial Mortgage Backed Securities Index generated 4th quarter total and excess returns of -1.31% and -0.24% and 1.22% and -0.19% for the year, respectively. CMBS private label issuance, including conduit and single-asset deals, reached 92.1B gross and -18.7B net issuance for all of 2015. Total issuance was 7% higher than 2014.

- Spreads widened in the fourth quarter and ended the year cheap relative to corporate credit. Negative excess returns were concentrated in the 2015 vintage. In December, new issue front-end AAA-rated bonds priced at the widest levels seen in 3 years. Swap spreads continued to ratchet in with negative spreads for maturities longer than 3 years.

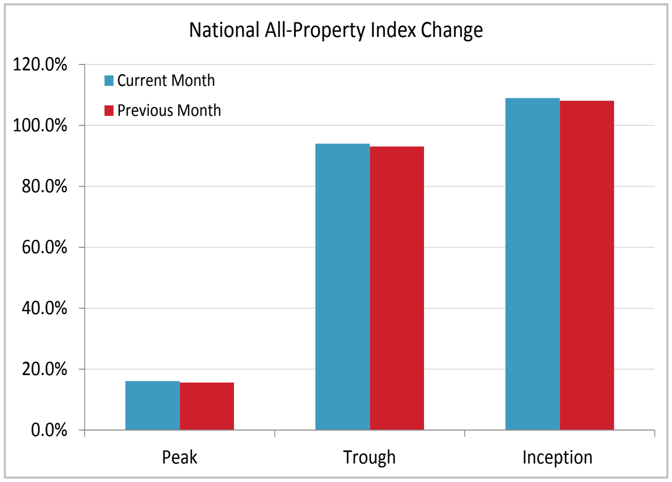
- Nationally, the Moody's/RCA Commercial Property Price Index (CPPI) has recovered 140% of its 2007-2008 peak-to-trough losses. Fundamentals are strong in all sub-sectors reflected by positive net operating income (NOI) growth rates; however, property valuations could be at risk in a higher rate environment unless NOIs sustain a growth rate that offsets increased cap rates.

Outlook

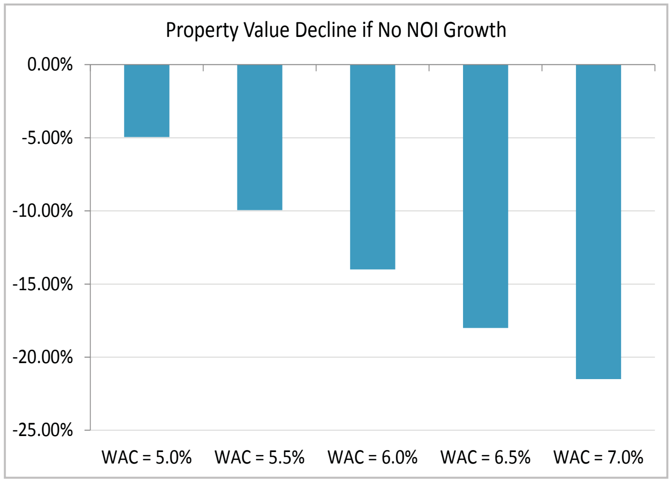
- Retail weakness continues to affect large mall exposures in CMBS deals. Big box retailers, many anchor tenants such as Macy's, Sears, and JC Penney, have struggled to compete with online forums as well as smaller, trendier, activity-based stores. Macy's sales fell 4.7% in November and December compared to a year ago, leading to its recent announcement that it will close between 35 and 40 stores in 2016. Many malls have managed to re-lease space, although some malls, such as the Hudson Valley Mall in New York, have struggled to find replacements and the collateral has been sent to the special servicer. Continued retailer trouble could lead to CMBS note extensions.

- Overall credit metrics are expected to improve as legacy paper continues to pay off and large loans are resolved. The most recent deal with Stuyvesant Town will lower the overall CMBS delinquency rate by about 50 bps, pushing it under 5%. In 2015, both office and retail delinquency rates rose around 10-13 bps while the multi-family and industrial sub-sectors declined. This bifurcation of collateral quality along with underwriting differences has made the most recent 2015 vintages less attractive than the prior years.

- CMBS spreads widened significantly in December and are especially attractive in the short-end where levels are compelling relative to ABS and Corporate bonds. There is more dispersion in the quality of bonds, therefore, new issue deals should not be treated the same. Smaller, less liquid tranches and bonds with a high likelihood of extension should be avoided as rates rise. Liquid on-the-run front-end AAA bonds with a wider spread than ABS are poised to outperform.



Source: Morgan Stanley



Source: Morgan Stanley

Rupa Raman, CFA
Sr. Research Analyst

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The Barclays US Mortgage-Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Barclays AAA ABS Index represents the asset-backed securities within the Barclays US Aggregate Index.

The Barclays AAA CMBS Index represents the commercial mortgage-backed securities within the Barclays US Aggregate Index.

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