

While the 1<sup>st</sup> quarter in the fixed income markets was marked by spread compression and riskier assets outperforming, things reversed in the second quarter. Domestic growth concerns have replaced worries about the European debt crisis as the slack in aggregate demand is slow to abate. Persistent new jobless claims and a stubborn unemployment number at 9.5% has market onlookers worried about the strength of the U.S. consumer. Within high-grade fixed income, credit spreads widened since the tights of late April. Credit spreads in the Barclays Aggregate have widened to 179 bps off Treasuries from tights in April of 127 bps off. However, total return has been supported by the performance of long Treasuries, as the 10 year note marked new lows for the year.

The story of May and June was the flight to quality. The yield on the Ryan Labs 10 year Treasury Index finished the month of May at 3.30% and finished out the month of June at 2.95%. When the 10-year note approached 4% earlier this year, those fearful of inflation refused to extend duration, often citing “historically low interest rates”. But by staying on the short end of the yield curve, the only thing you were certain of is nominal principal protection, as overnight rates hovered near zero. Although short rates essentially cannot go lower, the steepness of the yield curve remains. Flattening occurring in June rewarded investors who extended duration. But with such slack in aggregate demand, there’s no consensus that Treasury yields have bottomed. High unemployment (9.5%), often cited as a lagging indicator, still causes much concern while U.S. GDP growth forecasts were lowered by the Fed. Growing our way out will be difficult with contracting credit and declining prices. Average hourly earnings month-over-month was down -0.1% in June. The PPI and CPI were also down -0.5% and -0.1% respectively in June. The May consumer credit number came in weak, declining -\$9.1 billion with consensus forecasts of -\$2.3 billion. Although inflation pundits point to easy monetary policy, and the flood of money into the system, the deleveraging of the economy from the banking sector all the way through consumer credit makes keeping up with pre-recession spending next to impossible. In other words, although overnight interest rates remain low, getting a loan in the first place is difficult without a pristine credit history.

Within the securitized sector, underwater consumers are delinquent at alarming rates from a combination of the weak recovery and the moral hazard. Foreclosed homeowners are living in their houses for up to 2 years after their payments stopped. For the 20-25% of homeowners that have loan-to-value ratios greater than one, walking away can be their best financial option, depending on the state. Coined “strategic default”, the Government’s pleas to their consciences are a weak incentive for those with their backs against the wall. However, despite the consumer’s difficulties, MBS has performed reasonably well for the month of June. CMBS, one of the strongest performers YTD, continued to produce excess returns in June. Interestingly, commercial real estate, the underlying asset, has not rallied from lows. It appears CMBS spread compression has benefited from the search for yield and reflects a recovering domestic economy.

U.S. core fixed income returned 1.57% in June, in aggregate and was up 5.33% for the year. Equities continued to struggle. Within the investment grade universe, CMBS is up 12.14% YTD while the BC ABS is up 4.82%. MBS has returned 4.59% for the year. As we write the Bond Market Watch, risk assets have posted a rally in the beginning of July but have recently seen some hiccups. All eyes are on earnings, and the early signs are positive but top line revenue growth is a key number to watch. Sustaining profitable growth depends on the consumer, and ultimately top line revenue. Cost cutting and unprecedented output-per-unit of labor cost cannot work in perpetuity.

Yield and Total Returns									
Ryan Labs Indexes	YTW	QTD	YTD	12M <sup>1</sup>	Ryan Labs Indexes	YTW	QTD	YTD	12M <sup>1</sup>
<b>RL 2 Year Indexes</b>					<b>RL 10 Year Indexes</b>				
TIPS	-0.07	0.42	1.70	5.59	TIPS	1.28	6.08	6.35	12.22
Treasury	0.62	1.19	2.04	2.89	Treasury	2.95	8.39	9.87	9.02
FHLMC	1.09	0.28	0.55	2.11	FHLMC	3.18	8.03	8.38	10.13
FNMA	0.73	1.27	2.05	1.77	FNMA	2.76	6.15	7.67	9.41
AAA Corporate	1.27	1.04	2.47	4.64	AAA Corporate	3.67	7.21	9.63	13.73
AA Corporate	1.80	0.88	2.60	6.89	AA Corporate	4.16	5.41	8.50	15.55
A Corporate	2.46	0.87	2.67	8.06	A Corporate	4.70	4.78	7.56	17.67
BBB Corporate	2.71	1.32	3.74	10.28	BBB Corporate	5.20	3.91	7.62	20.75
<b>RL 5 Year Indexes</b>					<b>RL 30 Year Indexes</b>				
TIPS	0.42	2.46	3.73	9.75	TIPS	1.70	8.00	7.71	11.81
Treasury	1.79	4.89	7.00	8.45	Treasury	3.91	15.45	15.68	11.68
FHLMC	2.71	0.69	-3.48	-2.27	FHLMC	4.36	11.25	11.02	11.81
FNMA	2.44	-0.10	0.54	1.55	FNMA	4.38	10.51	10.47	12.02
AAA Corporate	2.42	2.90	5.46	9.47	AAA Corporate	4.68	12.25	14.00	17.95
AA Corporate	2.92	2.91	5.06	11.35	AA Corporate	5.41	7.78	9.83	20.44
A Corporate	3.70	2.60	5.16	13.56	A Corporate	5.63	7.32	9.33	19.98
BBB Corporate	4.16	3.00	6.39	17.25	BBB Corporate	6.15	5.19	7.48	23.08
<b>Barclays Indexes</b>					<b>Barclays Indexes</b>				
BC Aggregate	2.83	3.49	5.33	9.52	BC ABS	2.20	2.54	4.82	12.91
BC CMBS	5.31	2.78	12.14	30.51	BC MBS	3.12	2.93	4.59	7.73

1) Last 12 Months Return

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Ryan Labs TIPS				
	Yield To Worst (%)	MDuration (Years)	Year To Date Returns (%)	Last 12 Month Returns (%)
2 Year TIPS	-0.07	2.27	1.70	5.59
5 Year TIPS	0.42	4.77	3.73	9.75
10 Year TIPS	1.28	10.45	6.35	12.22
30 Year TIPS	1.70	15.03	7.71	11.81
RL TIPS Index	0.83	7.95	4.79	9.82

Market Implied Breakeven Inflation Expectation				
	Yield To Worst (%)		Inflation (%)	
	Nominals <sup>1</sup>	TIPS	BEI <sup>2</sup>	Current <sup>3</sup>
CPI (1 Month Lag)				2.0
2 Year	0.62	-0.07	0.69	
5 Year	1.79	0.42	1.37	
10 Year	2.95	1.28	1.67	
30 Year	3.91	1.70	2.21	

- 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)