

As we start 2012, investors across many sectors have been more than happy to bid farewell to 2011, notwithstanding a "risk-on" 4th quarter. Despite a flat year for the S&P500, correlation across many asset classes - high yield, stocks, investment grade credit - moved sharply higher, making it difficult to own anything with risk that didn't move sharply together one way or the other on any macro or Eurozone news. Fundamentally different equities and credits often moved in lockstep and this was exacerbated by the outsized daily volatility making the year feel anything but flat. Looking forward to 2012, we have not resolved many of the issues that sent equities into a tailspin in the 3<sup>rd</sup> quarter and domestic government bond yields to record lows. Valuation compared to historical ratios certainly was not the main driver as earnings have continued to grow strongly, despite revised estimates downward as we begin 4<sup>th</sup> quarter earnings season. Rather, credit and liquidity fears of a banking collapse triggered by a string of sovereign debt defaults became a more possible, if not probable, scenario on portfolio managers' radar. This leads to an obvious liquidity crunch and the old fixed income adage "sell when you can, not when you have to." That being said, many of the sovereign debt issues were at play for the past couple of years, and were already a problem when domestic equities were rallying sharply and domestic credit spreads were tightening into the first half of 2010. This shows us that timing sovereign debt problems is next to impossible but identifying them isn't. One clear winner for 2011 was the US Treasury market. The yield on the 10-year finished 2011 at 1.87% down slightly from the 3<sup>rd</sup> quarter level of 1.93% and well below levels during the height of the US banking crisis in December 2008. The Ryan Labs 30-year Treasury Index returned 35.32% for 2011, not unlike the 41.85% performance from 2008.

Within high-grade fixed income, credit spreads in the Barclays Aggregate Index were at 128 bps to close out April, widened in November to 225 bps, and only tightened modestly to 217 bps to close out December. Within credit, spreads in financials widened out to 349 bps in November and tightened in December to 337; still well off the 180 bps at the end of April. Both spreads and spread volatility reflect the concern of liquidity in the banking sector as the LIBOR-OIS spread and Euribor-OIS spread remain near their highest levels since the 2008 financial crisis, although Euribor-OIS has shown a slight improvement over the last couple of weeks. In the industrial space, with continued strong trailing earnings and good balance sheet health, spreads tightened to 184 bps after ending the previous quarter at 190 bps off Treasuries. Industrial spreads are still well off levels from the first half of 2011, as they closed out the 2<sup>nd</sup> quarter at 132 bps. Within the securitized sector, spreads in credit sensitive sectors such as ABS and CMBS had a strong December after a difficult 3<sup>rd</sup> quarter for anything with credit risk. CMBS outperformed again, coming off a strong November, while ABS was down 2 bps versus duration-neutral Treasuries. Agency MBS outperformed Treasuries 17 bps for the month, but underperformed by 1.06% compared with duration-neutral Treasuries for the year. U.S. core fixed income returned 1.10% for December and 7.84% for 2011.

Despite having recently been stronger than it was in the 3<sup>rd</sup> quarter, domestic economic data still has many weaknesses compared to typical recoveries. While this is a function of many factors, the deleveraging in the banking sector and at the consumer level seem the most pertinent hindrances to growth. Financials had a terrible 2011 in both the equity and credit markets, and bank performance largely underwhelmed investors as trading revenue was off sharply. Non-financial sector equity performance told a much different tale in 2011, as Financials and Industrial were down 18.41% and 2.92% respectively, and Consumer Staples were up 10.53%. While the last decade of leverage-induced, real-estate led economic performance has been a well-told story, the formula for a strong recovery, and a repaired financial sector, has not played out. In terms of US fundamentals, recently reported jobs data for December was quite strong at a +200k for non-farms payrolls up from +120K the previous month, and a reduction in the unemployment rate to 8.5%. Existing home sales are still a fraction of levels from 2006 and 2007 but are showing some signs of improvement. Consumer confidence has also recovered to 64.5, beating analysts forecast on Bloomberg of 58.9. ISM remains above 50 at 53.5, recovering from its low print for the year in August of 48.4. Investors are now looking towards earnings season to see if large cap US companies can continue to post strong earnings, or if negative European growth, soft US GDP growth, and China's slow-down start to effect revenue growth of US corporations.

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	-0.96	0.68	3.48	3.48	TIPS	0.14	3.54	19.31	19.31
Treasury	0.13	0.08	1.52	1.52	Treasury	1.87	1.23	16.98	16.98
FHLMC	0.89	0.19	0.71	0.71	FHLMC	1.66	1.90	14.09	14.09
FNMA	0.26	0.21	1.36	1.36	FNMA	1.36	1.12	10.07	10.07
AAA Corporate	1.03	-0.07	2.50	2.50	AAA Corporate	2.98	-0.11	13.48	13.48
AA Corporate	1.13	0.44	2.34	2.34	AA Corporate	2.89	0.96	10.29	10.29
A Corporate	2.29	0.74	1.61	1.61	A Corporate	4.46	2.02	9.54	9.54
BBB Corporate	2.95	1.06	3.27	3.27	BBB Corporate	4.18	1.84	10.05	10.05
Financials	3.33	1.16	1.53	1.53	Financials	4.80	1.27	6.54	6.54
Industrials	1.43	0.73	3.10	3.10	Industrials	4.05	1.55	12.12	12.12
Utilities	1.57	0.74	3.27	3.27	Utilities	3.77	1.48	11.96	11.96
<b>RL 5 Year Indexes</b>					<b>RL 30 Year Indexes</b>				
TIPS	-0.83	1.74	9.49	9.49	TIPS	0.74	5.35	28.18	28.18
Treasury	0.84	1.23	9.32	9.32	Treasury	2.89	2.02	35.32	35.32
FHLMC	1.12	0.61	8.08	8.08	FHLMC	3.23	2.20	24.59	24.59
FNMA	1.02	0.82	7.92	7.92	FNMA	3.21	1.89	23.06	23.06
AAA Corporate	1.50	-0.42	6.55	6.55	AAA Corporate	3.57	0.39	25.99	25.99
AA Corporate	2.46	0.00	4.87	4.87	AA Corporate	4.58	2.81	17.76	17.76
A Corporate	3.87	1.25	4.64	4.64	A Corporate	4.78	1.70	15.25	15.25
BBB Corporate	3.54	1.46	6.94	6.94	BBB Corporate	5.50	2.81	15.19	15.19
Financials	4.84	1.53	3.41	3.41	Financials	5.75	3.59	7.89	7.89
Industrials	2.64	1.17	7.74	7.74	Industrials	4.78	2.08	18.87	18.87
Utilities	2.69	0.62	7.93	7.93	Utilities	4.71	0.48	19.94	19.94
<b>Barclays Indexes</b>					<b>Barclays Indexes</b>				
BC Aggregate	2.24	1.12	7.84	7.84	BC ABS	1.56	0.23	5.14	5.14
BC CMBS	3.66	3.11	6.02	6.02	BC MBS	2.73	0.89	6.32	6.32

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Ryan Labs TIPS				
	Yield To Worst (%)	MDuration (Years)	Year To Date Returns (%)	Last 12 Month Returns (%)
2 Year TIPS	-0.96	2.4	3.48	3.48
5 Year TIPS	-0.83	4.81	9.49	9.49
10 Year TIPS	0.14	11.1	19.31	19.31
30 Year TIPS	0.74	21.56	28.18	28.18
RL TIPS Index	-0.28	8.54	13.94	13.94

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)				3.4
2 Year	0.13	-0.96	1.09	
5 Year	0.84	-0.83	1.67	
10 Year	1.87	0.14	1.73	
30 Year	2.89	0.74	2.15	

- 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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