THE MERGANSER FLASH

FIXED INCOME INSIGHTS

AS OF SEPTEMBER 30, 2014

Market Commentary

THE ECONOMY

- Despite headwinds from the Eurozone and China, most economic releases continue to paint a picture of broad base strengthening of the US economy with little inflation pressure. Existing home sales remained in excess of 5 million and continuing jobless claims stayed below 2.5 million in August, while PCE was only 1.5% YoY for the same period.
- Second quarter real GDP growth was revised upward to 4.6% (QoQ), signaling a solid rebound from a weak first quarter and setting the stage for continued momentum for the rest of the year, including GDP growth around 3% for the third quarter.

STRUCTURED MARKETS

- After the sharp widening in May '13 sparked by the initial taper talk, the MBS market out-performed Treasuries by a cumulative total of 154 basis points (bps). The rally, which drove premium prices on higher coupon mortgages even higher, illustrates the lack of net MBS supply. With tighter regulations and origination down, 2014 monthly net issuance is under $20 billion (bn). Also, although the Fed has dramatically wound down outright purchases from $40 bn per month in 2013 to just $5 bn in September (on pace to end in October) the Fed is still reinvesting $30-40 bn per month in cash flows or over half the gross issuance of target coupons.
- Notwithstanding the rally, the market remains cautious and sensitive to changes in the status quo.

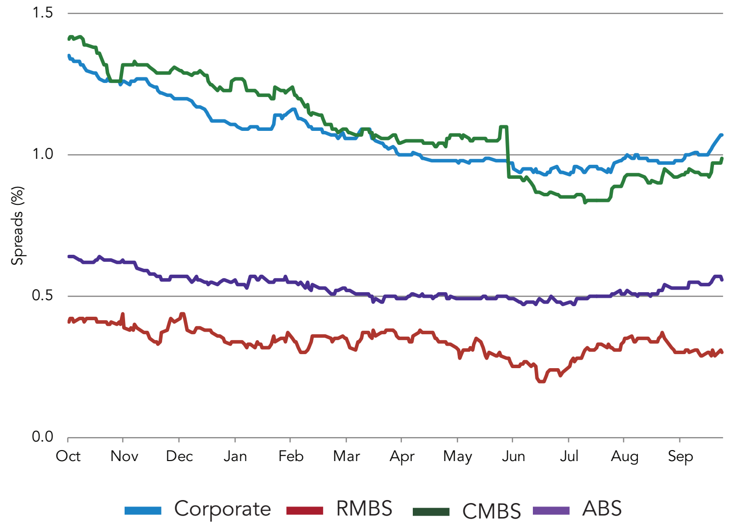
CORPORATE CREDIT MARKET

- Emerging from the summer doldrums, issuers flooded the market with new investment grade debt in September. At approximately $120 bn, September 2014 corporate issuance will likely be in the top five largest months on record. Heavy supply, combined with persistent geopolitical unrest and weaker commodity prices, pushed corporate spreads wider month to date by about 10 bps.
- The Energy sector was among the hardest hit due to a meaningful drop in oil prices (down nearly 9% MoM) and continued shareholder activism. Lower commodity prices also contributed to a sharp move wider among Basic Industries issuers. Despite the softer tone in the market, new supply was eagerly consumed by investors and spreads appear likely to firm as we enter the supply hiatus surrounding the release of third quarter earnings.

GOVERNMENT MARKET

- Treasuries broke trend, selling off in September largely due to the highly anticipated release of the FOMC minutes. The 10-yr and 30-yr peaked at yields of 2.62% and 3.37% respectively before settling in at 2.49% and 3.20%, 15 and 12 bps higher month over month.
- While language regarding the exact timing of the first rate hike was unchanged and still remains data dependent, the Fed did release a document separate from the minutes outlining a plan for policy normalization. Steps towards less accommodative policy include raising the target Fed Funds rate, adjusting interest on excess reserves, using overnight repos and ultimately phasing out reinvestment of mortgage holding proceeds.

SPREADS TO TREASURIES



BARCLAYS BENCHMARK DATA

	Total Return MTD
1-3 Gov/Credit	-0.08%
Int. Gov/Credit	-0.51%
Aggregate	-0.68%
1-3 Yr US Treasury	-0.06%
3-5 Yr US Treasury	-0.37%
5-10 Yr US Treasury	-0.85%
10-20 Yr US Treasury	-1.33%
20+ Yr US Treasury	-1.97%

SECTOR DATA FROM BARCLAYS AGGREGATE

	Total Return MTD	Excess Return* MTD	Current YTM
Corporates	-1.44%	-0.66%	3.11%
Financials	-0.99%	-0.40%	2.80%
Industrials	-1.69%	-0.84%	3.25%
Utilities	-1.45%	-0.39%	3.41%
RMBS	-0.16%	0.38%	2.88%
CMBS	-0.52%	-0.12%	2.37%
ABS	-0.15%	0.01%	1.39%
Agencies	-0.56%	-0.19%	1.75%

*Month-to-date performance of spread bearing bonds versus duration-matched Treasuries