MERGANSER
CAPITAL MANAGEMENT

THE MERGANSER FLASH

FIXED INCOME INSIGHTS

AS OF DECEMBER 31, 2014

Market Commentary

THE ECONOMY

- Economic data, generally strong in December, points to a steadily growing US economy. Third-quarter GDP was revised to 5%, well above consensus expectations of 4.3%. This increase was driven largely by consumer spending (PCE) which was revised to up 3.2% from a previous estimate of 2.2%. Headline CPI slipped to 1.3% year-over-year and oil dipped to a five-year low ($53.27) at the end of December amid fears of continued oversupply. Low oil prices should continue to fuel consumer spending as gasoline prices are expected to remain depressed.
- Greece's failed elections and a delay in the disbursement of the last aid tranche have raised new concerns about their place in the Eurozone.

STRUCTURED MARKETS

- Agency mortgages posted a strong December, finishing 2014 at +40 bps (excess return). Even though QE3 has officially ended, the Fed is expected to continue re-investing principal and interest cash flows through Q4 2015. Consequently the market continues to enjoy strong supply/demand technicals with 2014 net issuance approximately +$80 billion.
- While we remain underweight the agency mortgage sector in general, finding better relative-value opportunities elsewhere, the mortgage positions (reverse mortgages and certain up-in-coupon pools) have handily outperformed the Barclay's Aggregate MBS benchmark, which is dominated by production coupon paper.

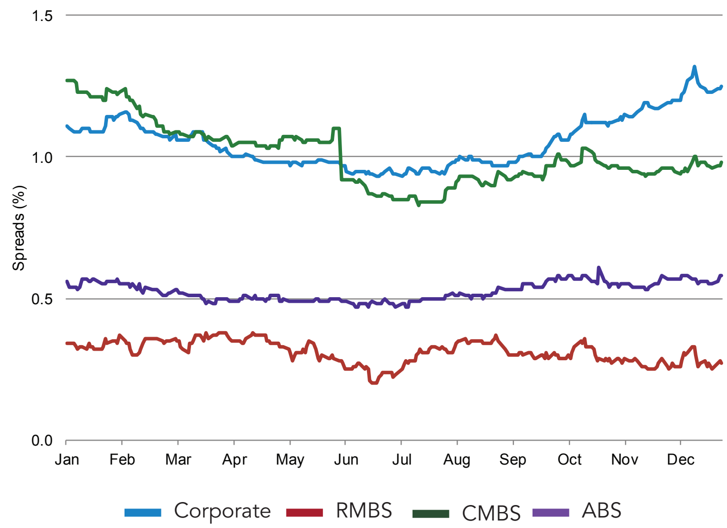
CORPORATE CREDIT MARKET

- Corporate issuance was relatively quiet throughout December, as supply all but ceased leading into the holiday period. Despite typically favorable domestic factors (little supply, equity market rally and positive US GDP news) corporate spreads continued to languish. Concerns abroad (both growth-related and geopolitical) support the recent weakness. Corporate spreads were seven bps wider in December and now more than 30 bps wider from this year's tights. Energy names are the weakest, with average spreads in that sector widening more than 30 bps month-to-date reflecting the persistent drop in oil prices. The corporate market recovered modestly from mid-December wides but trading levels were very light, exacerbating spread volatility.

GOVERNMENT MARKET

- Weakness in oil, strength in stocks and the release of the December FOMC statement drove a flattening of the yield curve in December. The belly of the curve underperformed the most (3s and 5s were up ~22 bps and ~17 bps respectively) while the long bond rallied ~14 bps in yield.
- The release of this month's FOMC policy statement muddied the waters of the future path to rate normalization. It is likely rates will rise at some point in 2015 but timing is still uncertain. The Fed signaled it can be patient in beginning to raise rates, leaving them with significant monetary policy flexibility. Recent low inflation prints do not appear to concern Janet Yellen, who believes the commodity price declines are transitory.

SPREADS TO TREASURIES



BARCLAYS BENCHMARK DATA

	Total Return MTD
1-3 Gov/Credit	-0.26%
Int. Gov/Credit	-0.32%
Aggregate	0.09%
1-3 Yr US Treasury	-0.25%
3-5 Yr US Treasury	-0.47%
5-10 Yr US Treasury	-0.12%
10-20 Yr US Treasury	1.04%
20+ Yr US Treasury	3.20%

SECTOR DATA FROM BARCLAYS AGGREGATE

	Total Return MTD	Excess Return* MTD	Current YTM
Corporates	0.06%	-0.38%	3.12%
Financials	0.02%	-0.12%	2.77%
Industrials	-0.10%	-0.63%	3.28%
Utilities	1.45%	0.44%	3.30%
RMBS	0.15%	0.05%	2.60%
CMBS	-0.15%	0.00%	2.33%
ABS	-0.22%	0.00%	1.47%
Agencies	-0.36%	-0.34%	1.82%

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