Payden&Rygel | Weekly Market Update

May 10, 2013

## MARKET LEVELS

| | Friday* | Last week | Dec. 31, 2012 | One year ago |
|---|---|---|---|---|
| **Dow Jones Industrial Avg** | 15,070 | 14,974 | 13,104 | 12,855 |
| **S&P 500** | 1,626 | 1,614 | 1,426 | 1,358 |
| **NASDAQ** | 3,419 | 3,379 | 3,020 | 2,934 |
| **Russell 2000** | 970 | 954 | 849 | 792 |
| **DJ STOXX Europe 600 (€)** | 305 | 301 | 280 | 251 |
| **Nikkei Index (¥)** | 14,608 | 13,694 | 10,395 | 9,010 |
| **MSCI EM Index** | 406 | 400 | 401 | 366 |
| **Fed Funds Target** | 0%-0.25% | 0%-0.25% | 0%-0.25% | 0%-0.25% |
| **2-Year Treasury Yield** | 0.24% | 0.22% | 0.25% | 0.26% |
| **10-Year Treasury Yield** | 1.89% | 1.74% | 1.76% | 1.87% |
| **U.S. $ / Euro** | 1.30 | 1.31 | 1.32 | 1.29 |
| **U.S. $ / British Pound** | 1.54 | 1.56 | 1.63 | 1.61 |
| **Yen / U.S. $** | 101.76 | 98.99 | 86.75 | 79.93 |
| **Gold ($/oz)** | $1,426.52 | $1,470.75 | $1,675.35 | $1,594.02 |
| **Oil** | $94.64 | $95.61 | $91.82 | $97.08 |

**Levels reported as of 8:00 a.m. Pacific Daylight Time*

## MARKET RETURNS

### Year-to-date (12/31/12-5/10/13)*

| | |
|---|---|
| **Dow Jones Indus Avg.** | 15.00% |
| **S&P 500** | 14.03% |
| **NASDAQ** | 13.23% |
| **Russell 2000** | 14.23% |
| **MSCI World Index** | 11.75% |
| **DJ STOXX Europe 600** | 8.91% |
| **MSCI EM Index** | 1.33% |

### Year-to-date (12/31/12-5/9/13)

| | |
|---|---|
| **90 Day T-Bill** | 0.04% |
| **2-Year Treasury** | 0.17% |
| **10-Year Treasury** | 0.68% |
| **ML High Yield Index** | 5.82% |
| **JPM EMBI Global Diversified** | 1.11% |
| **JPM Global Hedged** | 1.52% |

**Returns reported as of 8:00 a.m. Pacific Daylight Time*

## RECAP OF THE WEEK'S ECONOMIC RELEASES

| Date | Report | Survey | Actual | Prior | Details |
|---|---|---|---|---|---|
| 05/06 | (EC) PMI Composite | 46.6 | 46.9 | 46.5 | Despite a rough stabilization in the overall euro area PMI, only Ireland experienced expansion (reading 52.2) |
| 05/07 | (US) JOLTs Job Openings | 3770 | 3844 | 3925 | See below |
| 05/07 | (US) Consumer Credit | $15.600 B | $7.966B | $18.13 9B | As has been the story, student loan growth continues to drive consumer credit—this month alone, increased student borrowing accounted for 80% of the rise in non-revolving credit |
| 05/09 | (UK) Industrial Production (YoY) | -1.60% | -1.40% | -2.20% | The YoY contraction improved as industrial production picked up 0.7% MoM. Increases in manufacturing production accounted for most of the push, as it rose 1.1% MoM |
| 05/09 | (UK) BOE ANNOUNCE S RATES | 0.50% | 0.50% | 0.50% | The Bank of England held policy unchanged, keeping the bank rate and the size of the asset purchase facility unchanged (still at GBP375) |
| 05/09 | (US) Initial Jobless Claims | 335K | 323K | 324K | See below |
| 05/09 | (JN) Japan Buying Foreign Bonds | -- | ¥309.9B | ¥204.4 B | A long awaited and much anticipated change from Japanese bond investors this week, as they shifted from net sellers to net buyers of foreign bonds |
| 05/10 | (CA) Unemployme nt Rate | 7.20% | 7.20% | 7.20% | While the unemployment rate held steady, the Canadian labor market picked up slightly, adding 12,500 net new jobs during the month of April |

## ECONOMIC OVERVIEW

This week a report on initial claims for unemployment insurance showed the proxy for layoffs fell to 323,000—the lowest reading since November 2007 (a month before the recession officially began). The four-week moving average of initial claims in turn reduced to 337,000. Where many expected a disappointing rise in unemployment claims, this week's report suggests a new recession is not on the horizon. That's the most important implication. However, despite the good news for US labor market, the broad labor market picture suggests that the Fed wants to see more improvement before shifting its policy stance.

Here's why: Even as unemployment insurance claims hit fresh lows, a year ago layoffs were only slightly higher than current levels. The 4-week moving average in early May 2012 was 346k versus 336k as of last week. Further, initial claims (layoffs) represent just one piece of the labor market puzzle. Other data released by the Bureau of Labor Statistics showed a more mixed labor picture. In a healthier labor market, in addition to fewer layoffs we would see more quitting and hiring activity—what labor market economists call "churn." The pace of quitting rises as workers dissatisfied with their job feel confident enough to leave in pursuit of other opportunities. But that has not happened: since one year ago the "quit rate" among workers remains unchanged and the "hire rate" fell. The problem is not that companies are firing workers: it's that, in aggregate, they're also not hiring at as rapid a rate as in previous cycles. Workers cling to current positions—the "churn" is missing.

What does this mean for the Fed? The FOMC examines many indicators when judging the health of the labor market—and the claims data are among these. With the monetary authorities pledging to continue buying bonds until "substantial improvement" occurs in the labor market, our "Fed" jobs data dashboard (see below) shows some progress on the way to the end of QE—with plenty of room for improvement. Over the past year the pace of average monthly payroll growth remains nearly the same. While the unemployment rate fell over the last 12 months, the labor force participation rate tumbled as well. This suggests to us that though the labor market is on the mend, progress remains slow. We worry that workers have become more detached from the labor market due to age, skills, education or duration of employment—not something the FOMC wants to see.

Bottom Line: The good news is that claims do not foretell a pick-up in layoffs. But layoffs remain only part of the labor market puzzle. To date, job growth looks a lot like last year and the subsequent decline in the unemployment rate occurred, at least in part, due to decreased labor force participation. We await signs of a pick-up in hiring. Until then (most likely into 2014) the Fed will continue its QE campaign. Our contention: monetary policy may not be the appropriate spark to reignite labor market churn.

| | May 2012 | May 2013 | Our Comment |
|---|---|---|---|
| **Unemployment Rate** | 8.2% | 7.5% | Better |
| **Monthly Nonfarm Payroll Change (in 1000s)** | 125 | 165 | Slightly better |
| **6 month Avg. Monthly Nonfarm Payroll Change (in 1000s)** | 209 | 208 | Unchanged |
| **Labor Force Participation Rate** | 63.8% | 63.3% | Weaker |
| **Quits Rate** | 1.6% | 1.6% | Unchanged |
| **Hire Rate** | 3.4% | 3.2% | Slightly weaker |

## US MARKETS:

### TREASURIES

- US Treasury yields sold off slightly this week as the market counterbalanced $66 billion of new coupon supply with conflicting economic data reports. The yield curve steepened modestly along the term structure, in typical fashion alongside outperforming equity indices.

- In the weeks ahead, the rates market is likely to focus on the slate of Fed buyback operations (creating a negative Treasury supply period), upcoming inflation data and increased scrutiny of jobless claims as more talk of QE 'tapering' continues to circulate.

### LARGE-CAP EQUITIES

- The stock market rallied for the third consecutive week. Despite a week of light headlines, equities ground to a new record high on improved risk sentiment and the global accommodative policies. The S&P 500 and Dow Jones Industrial Average indices both closed the week up approximately 0.9%, while the NASDAQ Composite jumped 1.3% higher closing the year-to-date underperformance. For the second

straight week, the higher beta small-cap stocks outperformed large-cap stocks. In terms of style, large-cap growth stocks performed in-line with large-cap value stocks. The best performing sectors were industrials and consumer discretionary, while the worst performing sectors were utilities and consumer staples. In fund flow news, Lipper reported that U.S. based equity mutual funds took in $1.8 billion for the week which was the 18th consecutive week of inflows.

## CORPORATE BONDS

- Investment grade primary issuance met expectations this week as more than $25 billion tapped the new issue space. Issuers took advantage of attractive funding levels and continued investor demand with some deals exceeding 10x oversubscription. We are roughly 90% through with earnings so expect issuance to ramp up slightly if market conditions stay accommodative. Notable deals this week included BP Capital ($2.75 billion) and Statoil ($2 billion).

- Investment grade corporate spreads ground tighter during this quiet week as earnings season comes to a close. IG trading volumes were slightly above the YTD average this week, with Tuesday being the most active day of trading in two months. Barclays Credit Index Option-Adjusted Spread (OAS) finished the week at +122, tighter by four. Financials tightened by six (banks -5, insurance -6); industrials tightened by three (basic materials -5, capital goods -1, telecom -5, consumer cyclical -3, consumer non-cyclical -1, energy -2); and utilities tightened by two.

## MORTGAGE-BACKED SECURITIES

- Agency mortgages lagged Treasuries and alternative products as yields jumped sharply at the end of the week. Mortgages had enjoyed solid demand and tame price action until gossip spread that the Federal Reserve has become more concerned about increased risks in the wholesale funding markets. Without major economic data or events to support valuations, spreads on pass-throughs gapped wider by 3-5 basis points versus comparable Treasuries.

- As expected with a bear steepener of the yield curve, lower coupons underperformed higher coupons and 15-year bested 30-year mortgages. Ginnie Mae mortgages, however, outshined conventionals as Japanese bank appetite increased for 'full, faith and credit' products. This week's release of April prepayments was a non-factor as a mixed, slower report was already captured in prices. Prepayment speeds should accelerate over the coming months to account for recent declines in mortgage rates and favorable seasonal and demographic trends.

- According to Freddie Mac, the 30-year fixed rate mortgage edged higher to 3.42% from 3.35%. The Fannie Mae 30-year current coupon versus the 10-year Treasury widened three basis points to 68 basis points.

## ASSET-BACKED SECURITIES

- Demand for auto loan risk returned as CarMax and Santander successfully placed their subordinated classes at levels inside of the initial price talk. The double-A, single-A, and triple-B CarMax classes priced at swaps +55, 95, and 140 respectively. Santander priced similarly rated classes at swaps +75, 125 and 175. Capital One also returned to the market with a 3-yeaer floater pricing at 1-month LIBOR +18 with a nice upsize to $700 million.

- The CLO market remains hot as Columbia, CIFC, Octagon, and others are bringing deals this week.

- The Manheim used car index fell again for the fourth straight month as supply from off-lease vehicles is beginning to pick up. This must be taken in the context of the peak to trough drop of 2.5 million (-36%) vehicles of wholesale supply (rental, off-lease, and repossessed). A weakening used car market should be in play for the next couple of years due to increasing wholesale supply.

### MUNICIPAL BONDS

- The week was marked by much lower primary market volume at around $4.8 billion, which is the second week of declining volume, pointing to a slower issuance season as summer approaches. The low volume, combined with sizeable redemptions in the month of May positioned bonds in the primary and secondary markets to be well received by investors. Muni mutual funds ended an outflow streak by posting modest inflows for the first time in 10 weeks.

- Yields have not reflected this over the week, however. Yields on the MMD AAA GO scale rose by a few basis points throughout the week, taking cues from treasuries mostly. The 2-year yield fell one basis point to 0.28% and the 30-year yield slid two basis points to 2.87%. The 10-year rose six basis points to 1.75% by Thursday. Treasury yields steepened in the belly of the curve as the benchmark 10-year yield jumped five basis points to 1.82%, in response to improving labor market news as the rate of job losses continues to decline.

### HIGH-YIELD BONDS

- The positive tempo of solid earnings and better than expected economic data of the past few weeks continued to drive the high-yield market higher. The Merrill Lynch BB/B high-yield index climbed 0.50% on the week and is now up 5.17% year-to-date. It was the same old song of more buyers than sellers and dealers reluctant to provide much liquidity as their short positions were squeezed further. Add into this mix a $750 million OWIC (offers wanted in competition) list of high-yield bonds which splashed around the street on Tuesday. AMG reported inflows into high-yield bond funds of $789 million for the week. The result was an even greater scarcity of bonds available for purchase. An increase in new issue activity was welcomed by the market, although even the almost doubling of last week's volume did little to sate the thirst for yield.

- Over $11 billion in new issuance from more than twenty different companies came to market this week. The most closely followed deal of the week was a $2.5 billion three-tranche offering from General Motors Finance Corporation. The provider of automobile financing solutions priced $1 billion in three-year new notes to yield 2.75% (+241 basis points), $750 million in five-year notes to yield 3.25% (+250 basis points), and $750 million to yield 4.25% (+247 basis points). The new notes were rated Ba3/BB-, and saw strong interest from both high-yield and high-grade accounts. The deal was multiple-times over-subscribed and allocations were severely cut back. The strongest demand was for the three year note which drove the tranche sizing. The new notes were up two points when freed to trade. The three-year note tightened by 60 basis points, the five-year note moved 38 basis points tighter, and the ten-year note was tighter by 25 basis points.

## INTERNATIONAL MARKETS:

### EASTERN EUROPEAN EQUITIES

- Stocks in Eastern Europe were up 2.14% during the week.

- Turkey's March industrial production (IP) was weak: in unadjusted terms, it expanded just 0.2% y/y. Certainly, the IP series has been very volatile, and the contraction in sequential terms contrasts with a 3.8% cumulative increase in the first two months of the year and thus, in aggregate, still translates into 1% sequential growth in IP in Q1.

- However, the March print still fits into a pattern of a rather modest pickup in economic activity after a disappointing Q4 Gross Domestic Product (GDP) number. Indeed, the PMI has been gradually declining since January (54), including last week's April print (51). Consensus is now for a growth under 4% (i.e., below the government's official target) and moving closer to the IMF recent forecast of only 3.4 % GDP growth for 2013. The weak IP comes on top of last week's better-than-expected April inflation print.

## GLOBAL BONDS AND CURRENCIES

- Major non-US sovereign bond markets came under some pressure in the past week in line with their US counterparts as confidence in the US recovery mounted and global equity markets reached fresh highs. Ten-year Bund and UK Gilt yields rose around 12 basis points as German factory orders and UK manufacturing data exceeded expectations and Euro-zone services sector sentiment improved. Peripheral Euro-zone sovereign bond spreads over Bunds were relatively stable as financial market attention shifted to the US economic outlook and associated currency market developments.

- In currency markets the week's main event was the US dollar's rise against the Japanese yen and the Australian dollar. The yen broke the 100 mark against the US dollar for the first time in four years as US economic data improved and the rhetoric from Japanese officials remained very pro-stimulus. In Australia, the central bank's decision to cut rates a further 25 basis points to 2.75% at the Bank's board meeting in the past week, along with the somewhat dovish tone of the accompanying statement, caught financial markets off-guard. The Bank of Korea, and the central banks of Poland, Denmark and India also cut rates in the past week and the Reserve Bank of New Zealand intervened in currency markets to an effort to improve the competitiveness of its currency. The US dollar was up more modestly against both the Euro and Sterling, as these currencies received some relative support from the week's Euro-zone and UK data and by the Bank of England's decision to keep monetary policy steady at the past week's Monetary Policy Committee meeting.

## EMERGING-MARKET BONDS

- Emerging market dollar-pay debt spreads tightened this week.

- Korea's central bank cut its policy rate 0.25%, to 2.5%, in a move not expected by consensus forecasts. The Korean authorities pointed to weaker than expected economic activity domestically as well as externally in their decision. In Poland, the Monetary Policy Committee chose to cut rates by 25 basis points , to 3%. Central Bank Governor Belka communicated that the cut should not be construed as the beginning of a new easing cycle.

- Malaysia's elections were won by the long-ruling Barisan Nasional (BN) coalition amid opposition allegations of irregular voting. Markets reacted positively to the result, as the BN performed better than expected, indicating policy continuity. The Malaysian central bank kept its policy rate steady at 3%.

- Fitch moved Mexico's credit rating higher to BBB+, from BBB, citing the prospect of improved fiscal performance driven by new structural reforms. Egypt had its credit rating downgraded by S&P for the sixth time, to CCC+ from B-, as a lack of political progress continues to weigh on the economy.

## HIGHLIGHTS OF NEXT WEEK'S ECONOMIC RELEASES

| Date | Report | Consensus | Last |
|---|---|---|---|
| 05/13 | (US) Advance Retail Sales | -0.30% | -0.40% |
| | (US) Retail Sales "Control Group" | 0.30% | -0.20% |
| 05/14 | (EC) Euro-Zone Ind. Prod. wda (YoY) | -2.00% | -3.10% |
| 05/15 | (EC) Euro-Zone GDP s.a. (YoY) | -0.90% | -0.90% |
| | (US) Producer Price Index (YoY) | 0.80% | 1.10% |
| | (US) PPI Ex Food & Energy (YoY) | 1.70% | 1.70% |
| | (JN) GDP Annualized | 2.70% | 0.20% |
| 05/16 | (EC) Euro-Zone CPI (YoY) | 1.20% | 1.20% |
| | (EC) Euro-Zone CPI - Core (YoY) | 1.00% | 1.00% |
| | (US) Consumer Price Index (YoY) | 1.30% | 1.50% |
| | (US) CPI Ex Food & Energy (YoY) | 1.80% | 1.90% |

| | | | |
|---|---|---|---|
| | (US) Housing Starts | 975K | 1036K |
| | (US) Housing Starts MOM% | -5.90% | 7.00% |
| | (US) Building Permits | 941K | 902K |
| | (US) Building Permits MOM% | 3.70% | -3.90% |
| 05/17 | (CA) Consumer Price Index YoY | 0.60% | 1.00% |
| | (CA) Bank Canada CPI Core YoY | 1.20% | 1.40% |
| | (US) Leading Indicators | 0.20% | -0.10% |