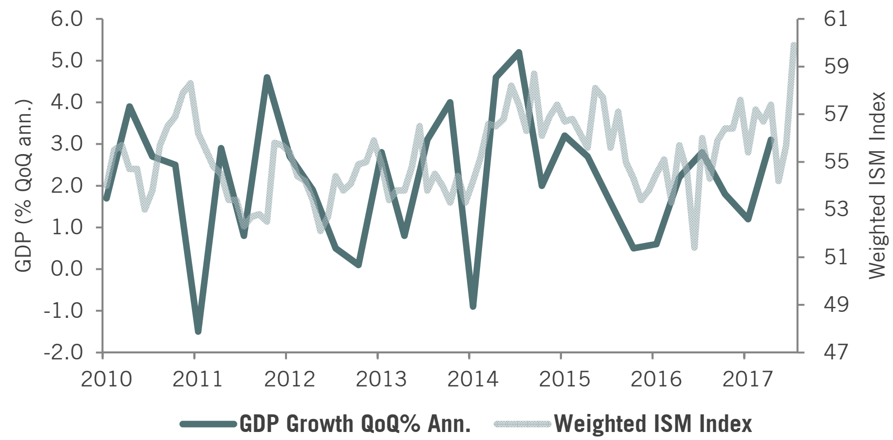
MARKET REVIEW
THIRD QUARTER 2017

GROWTH REBOUNDS IN Q2, SURVEY DATA SUGGESTS SOLID Q3

- U.S. GDP growth advanced by +3.1% in 2Q17 as consumer spending rebounded following weakness in the first quarter. Business investment and net exports also boosted growth in the quarter.
- The Institute for Supply Management's (ISM) surveys of activity in the manufacturing and non-manufacturing (services) sectors both advanced to multi-year highs in September, suggesting that growth momentum carried well into the third quarter.

GDP Growth vs. Weighted ISM Indices

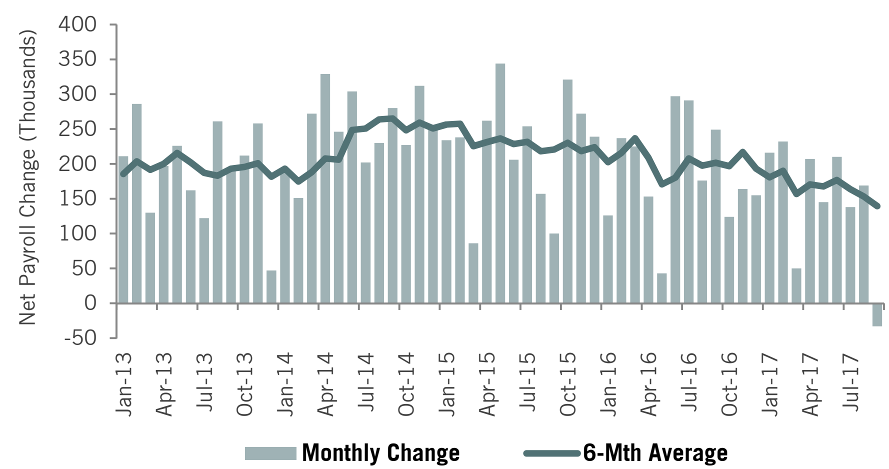


Source: Bloomberg, U.S. Bureau of Economic Analysis, The Institute for Supply Management

LABOR MARKET STAYS SOLID, BUT HURRICANES TAKE A TOLL

- Labor market gains slowed somewhat in the third quarter. Employers added an average of only 91,000 jobs per month over Q3, although September's jobs number (-33k) was an outlier versus July and August's two-month average gain of +153k.
- September's jobs number was likely significantly depressed by the impact of Hurricanes Harvey and Irma, which temporarily displaced thousands of workers.
- The unemployment rate fell to 4.2% in September. The broader "U-6" measure of underemployment, which includes discouraged workers and those who are working part-time but want a full-time job, declined to 8.3% in September.
- The Atlanta Fed's Wage Growth Tracker showed workers' wages rose at a 3.4% annualized pace over the three months ended in August.

Change in Non-Farm Payrolls



Source: Bloomberg, U.S. Bureau of Labor Statistics, Bloomberg

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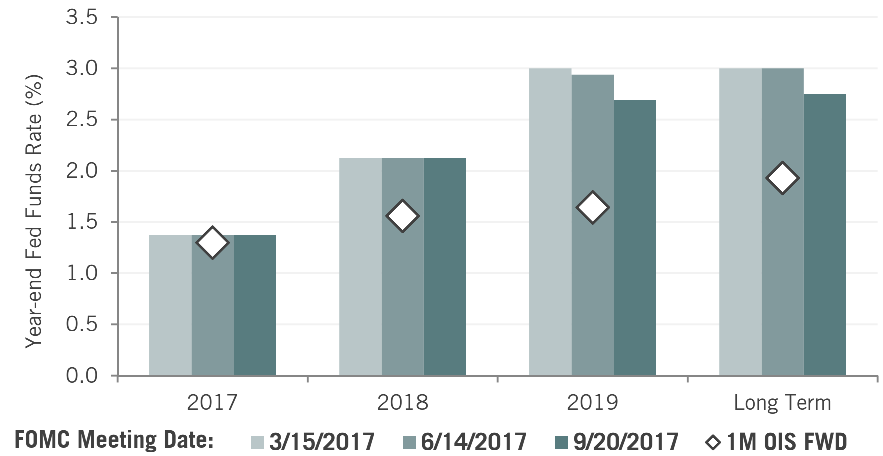
FED HOLDS RATES STEADY BUT SENDS HAWKISH SIGNALS

- The Federal Reserve (Fed) left its policy rate range unchanged at 1.00% to 1.25% at both of its policy-setting meetings during the third quarter. However, Fed officials struck a more hawkish tone than the market expected regarding the need for additional hikes over the near-term.
- In a major policy address during the quarter[1], Fed Chair Yellen carefully – but ardently – outlined the case for continued gradual normalization of the policy rate, despite the recent decline in core inflation, which the Fed still views as likely to be temporary.
- The Fed's September dot plot of policy rate projections showed Federal Open Market Committee (FOMC) participants saw one more hike in 2017, followed by three hikes in 2018. The market-implied odds of a December hike have risen to around 80% from as low as 25% in early-September.

FOMC Fed Funds Forecast vs. Market-Implied Fwd Rates

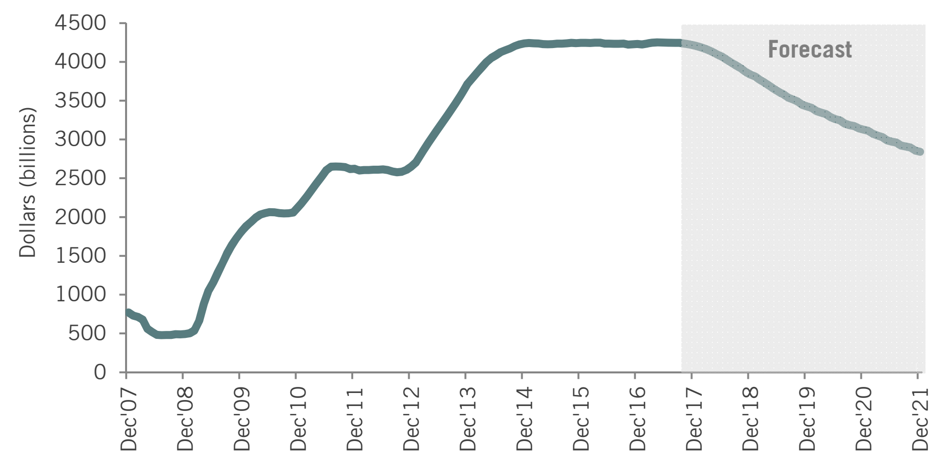


Data as of 9/30/17. Source: Bloomberg, Federal Reserve

FED SETS BALANCE SHEET RUNOFF PLAN IN MOTION, MARKET MOSTLY YAWNS

- In a well telegraphed move, the Fed officially announced at its September FOMC meeting that it will commence its balance sheet normalization plan in October.
- The plan will ultimately shrink the Fed's asset portfolio by $50 billion per month via maturities and principal paydowns, reducing the Fed's balance sheet by approximately $1.4 trillion by the end of 2021.
- The market's reaction to the official announcement has been muted. That said, as the market begins to actually experience the impact of the balance sheet unwind (larger Treasury auctions, more MBS new issue supply), the market's mood may change.

Federal Reserve Balance Sheet



Source: Federal Reserve, Capital Economics

[1] *"Inflation, Uncertainty and Monetary Policy"*, 9/26/17, NABE 59th Annual Meeting Cleveland, OH.

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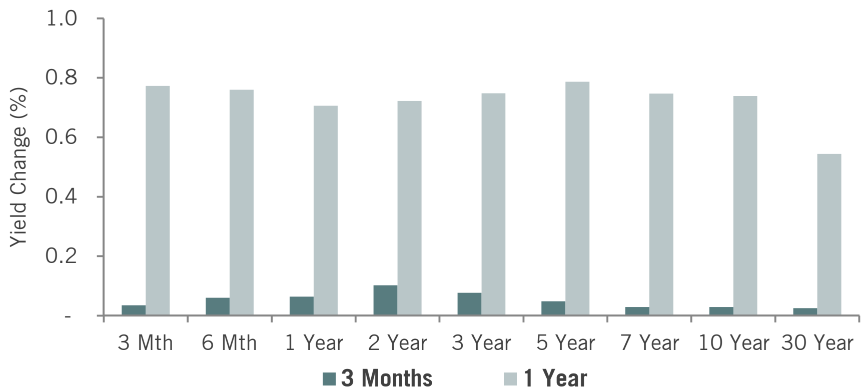
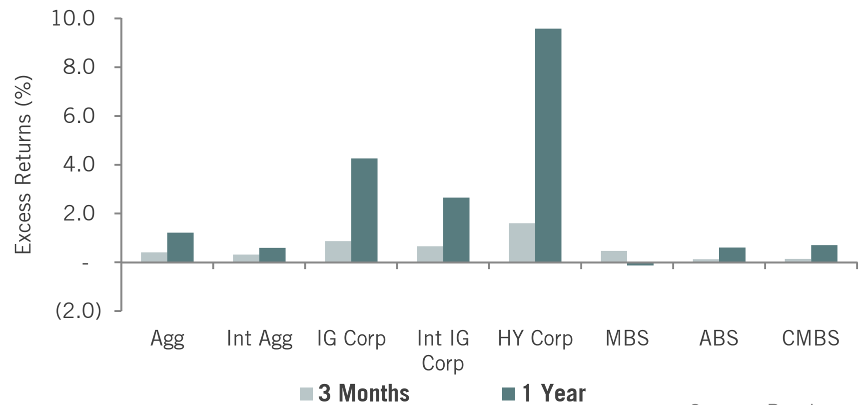
INTEREST RATES LITTLE CHANGED DURING QUARTER, RALLY IN SPREAD SECTORS CONTINUED

U.S. Treasury Yield Curve Rate Changes



Source: Bloomberg

Barclays U.S. Excess Returns vs. Treasuries



Source: Barclays

- The Fed left its policy rate unchanged during the third quarter, at a range of 1.00% to 1.25%, and instead chose to focus on telegraphing the start of its balance sheet runoff plan, which will begin in October.
- The yield curve was little changed during the quarter, as a further decline in core inflation measures was offset by broader activity and survey-based data which showed the economy gained steam over the quarter.
- The two-year Treasury note yield rose 11 bps over the quarter, finishing at 1.49%, while the 30-year T-Bond yield rose just 2 bps, closing the quarter at 2.86%.
- Volatility remained near multi-year lows during the quarter as stocks continued climbing to new records and Fed Chair Yellen's consistent and deliberate policy communications appear to have lulled bond market investors almost to sleep.

- Investment grade corporate bonds posted another strong quarter of excess returns versus U.S. Treasuries (+87 bps). Lower quality (BBB, HY) outperformed higher quality (AA, A), while longer maturities outperformed shorter maturities. Finance and utility names outperformed industrials during the quarter.
- Agency MBS posted strong excess returns during the quarter (+47 bps) as the sector tightened in sympathy with other spread sectors. Interest rate volatility has remained benign, and the Fed's ultra-gradual plan for reducing its balance sheet has given market participants better visibility in terms of additional MBS supply in the near-term.
- ABS posted muted excess returns for the quarter (+14 bps) as front-end swap spreads rose modestly after declining sharply last quarter. As a high quality alternative to corporates, CMBS benefitted from the rally in credit spreads during the quarter. CMBS performance (+34 bps excess returns vs. U.S. Treasuries) was tempered by new issue supply as well as concerns over the potential for property losses from Hurricanes Harvey and Irma.

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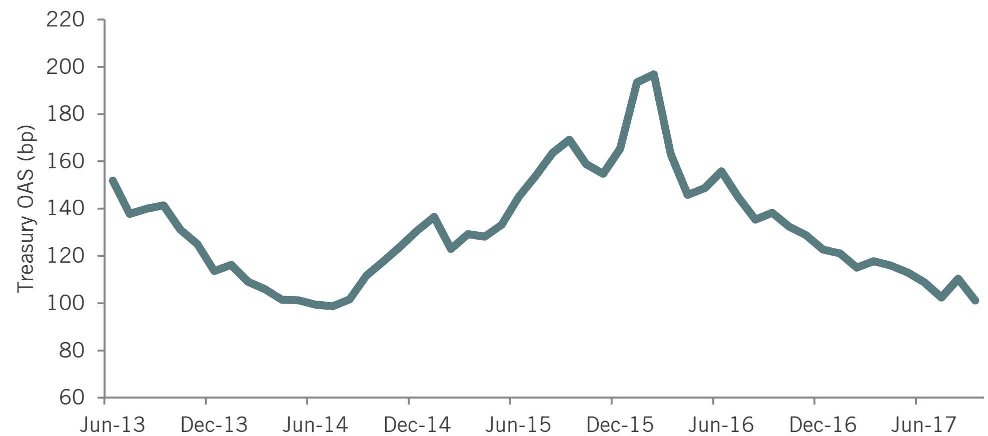
CREDIT SPREADS EXTEND RALLY, NEAR POST-CRISIS TIGHTS

- The Bloomberg Barclays U.S. Corporate Investment Grade index returned +1.34% over Q3, outperforming similar duration U.S. Treasuries by +87 bps. Over the last 12 months, the corporate index returned +2.21%, outperforming U.S. Treasuries by over 425 bps.
- During the third quarter, energy and metals/mining names rallied on a rebound in crude oil above $50 and supportive metals pricing. Utilities, REITs and subordinated banking also outperformed. Meanwhile, the consumer products, supermarkets, cable/media and capital goods sectors lagged the broader market.
- The option-adjusted spread (OAS) of the Corporate index finished the quarter at +101 bps to Treasuries, just 2bps above the post-crisis low set in July 2014 (+99 bps). Still, the index's OAS remains nearly 25bps from the all-time tight level of +77bps (Feb 2005).

U.S. IG Corporate Index Spread to Treasuries

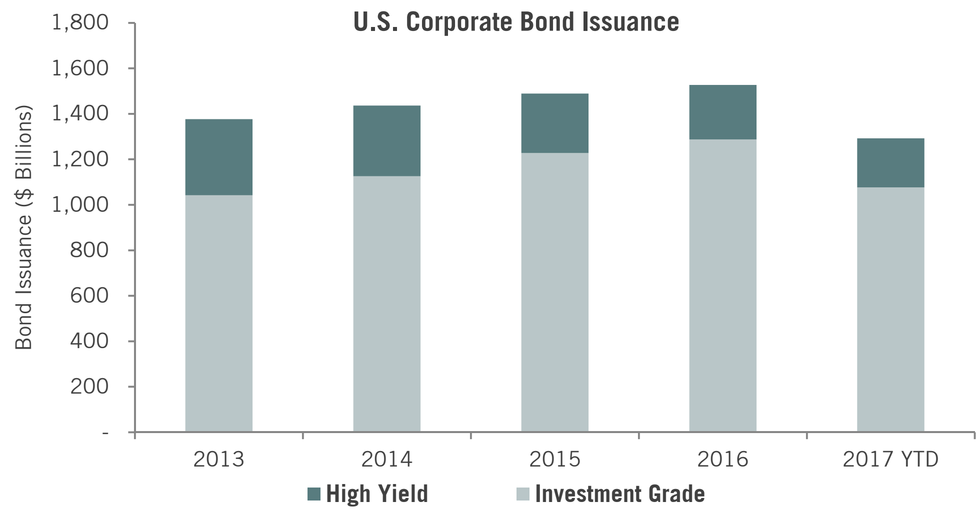


Source: Barclays

CORPORATE ISSUANCE IN 3Q17 CLOSELY MATCHES LAST YEAR'S PACE – SLOWDOWN COMING?

- Investment grade new issuance totaled $353 billion in the third quarter according to SIFMA data, largely in-line with the same quarter a year ago. Year-to-date issuance ($1,077 billion) also remains in-line with the last year.
- High yield new issuance was $63 billion in Q3 versus $68 billion for the same period last year. Overall, however, HY issuance remains up over 13% on a year-to-date basis.
- Based on the forward supply calendar and anecdotal information from Wall Street syndicate desks, new issue supply may be on the lighter end for Q4. Meanwhile, investor demand for corporate debt remains very strong.

U.S. Corporate Bond Issuance



Source: SIFMA

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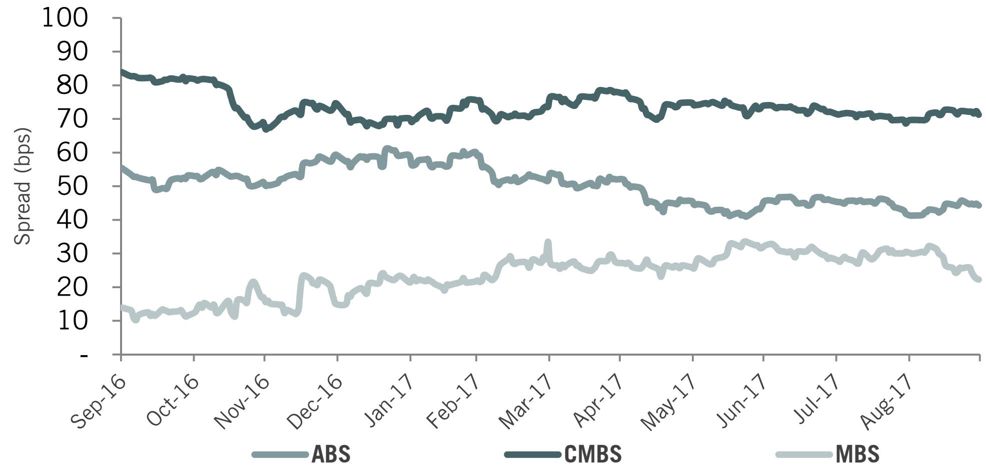
MBS SPREADS BENEFIT FROM BROADER RALLY IN SPREAD SECTORS, STEADY AND METHODICAL FED

- Agency MBS posted positive excess returns (+47 bps) during the quarter, bringing year-to-date excess returns to +27 bps. The sector benefitted from a broad-based rally in credit-sensitive spread sectors and continued low interest rate volatility.
- The Fed formally announced a plan for reducing the size of its balance sheet at its September Federal Open Market Committee (FOMC) meeting. The plan involves a controlled tapering of reinvestments that will start in October. Initially, the Fed will reduce MBS reinvestment by $4 billion per month, gradually building to $20 billion per month over the next four quarters. This effectively increases the amount of Agency MBS that private investors will have to absorb going forward.
- Home prices continued to post steady gains. The S&P CoreLogic Case-Shiller 20-City Home Price Index rose 5.81% for the 12 months ended in July.

SECURITIZED CREDIT ISSUANCE REMAINS ROBUST

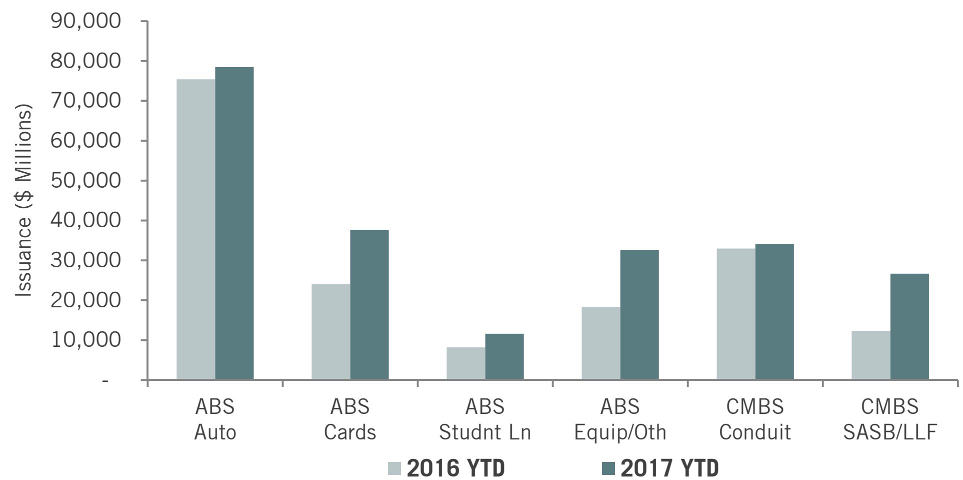
- ABS new issue supply is 27% higher year-to-date versus the same time period last year. Credit cards, student loans and other ABS (primarily equipment) supply has been significantly higher versus last year. From a credit perspective, the auto ABS sector continues to garner attention as delinquencies and defaults have moved higher.
- With approximately $61 billion of new supply year-to-date, CMBS new issue volume is 34% higher than during the first three quarters of 2016. Notably, the lion's share of this increase has been in the Single Asset/Single Borrower (SASB) space.

Securitized Spreads vs. Treasuries



Source: Barclays

ABS/CMBS Issuance YTD 2017 vs. Year Ago



Source: Citi Research, Bloomberg, SIFMA

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