AAM 2012 Sector Review and 2013 Outlook *January 25, 2013*

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MACRO-ECONOMIC REVIEW AND OUTLOOK

Entering 2012, our macro-economic outlook could have best been described as cautious. Although the U.S. economy was coming off a strong fourth quarter in 2011, we felt that the risks to the 2012 growth outlook were skewed to the downside. Chief among the risks were contagion stemming from problems in Europe and a potential disorderly default by Greece. Additionally, we saw growing unrest in the Middle East and the potential for a fiscal policy drag here in the U.S. Our cautious tone proved to be correct as real GDP grew by an average of 1.6% during the first half of the year versus a beginning of year consensus forecast of 2.0%.

By the middle of the year, the problems in Europe were front and center and concerns about the looming fiscal cliff in the U.S. began to make their way into economic forecasts. Given the uncertainty in Europe, slowing growth abroad, and the looming fiscal cliff, we continued to feel the risks were skewed to the downside. In late July, the European Central Bank committed to "do whatever it takes" to preserve the Euro and, in September, the Federal Reserve announced a third round of quantitative easing (QE3). The market reacted positively to the reduction of tail risk. Although the economy surprised on the upside in the third quarter, fourth quarter GDP growth is projected to have been negatively impacted by uncertainty surrounding fiscal policy.

As we start 2013, the macro-economic outlook is very similar to the start of 2012 – below-trend growth in the first half with a more optimistic second half. We believe the risks to the economy have become more balanced. On the positive side, an accelerating housing recovery and continued accommodative monetary policy both in the U.S. and abroad should provide a boost to economic growth. Headwinds include tighter fiscal policy and a continued recession in Europe that could escalate the Eurozone crisis. Real GDP growth during the first half of 2013 is expected to average 1.7% and then improve to 2.5% in the second half.

Inflation was relatively benign in 2012 and we expect the same for 2013. With low inflation expectations, the Federal Reserve in 2013 will likely keep monetary policy very accommodative. That means a Fed Funds rate near zero and continued purchases of Treasuries and MBS. With Fed policy seemingly on hold, short-term Treasury rates should remain anchored throughout the year. Although longer-term rates increased following the year-end fiscal cliff deal, we believe tougher negotiations regarding spending cuts and the debt ceiling in the months ahead will most likely drive rates modestly lower. However, we are projecting that longer term rates will end the year modestly higher than where they started. This forecast is predicated on two key assumptions: Congress' ability to reach a compromise, and economic growth above 2% for the second half of the year.

SECTOR OUTLOOK SUMMARY

As we think about fixed-income performance for 2013, we believe a strong focus on individual credit selection and remaining nimble to take advantage of market opportunities as they arise will be keys to a successful year. In the corporate sector, we will look for credits that offer more yield and better opportunity for spread tightening. Corporate fundamentals remain strong and technicals should be favorable. Having said that, we believe the risk of negative credit events will be higher in 2013 and we will avoid those sectors and credits that could be pressured to enhance stockholder value at the expense of bondholders.

When considering Structured Products (MBS & CMBS), we are cognizant of the Fed's program of purchasing Agency-Backed MBS and how the market will adjust once it perceives that the program is coming to an end. We believe that the non-agency MBS sector offers more compelling relative value opportunities given our outlook for a continued housing recovery in 2013. Within the commercial space, both the fundamentals and technicals are positive and should be supportive of CMBS valuations. However, we are cautious of loosening underwriting standards and need to be vigilant when considering individual CMBS transactions.

For our taxable crossover accounts, tax-exempt municipals will continue to be an asset class that we will utilize when yields are attractive relative to taxable alternatives. Underlying credit fundamentals for municipals have improved, and we expect this to continue. With new supply expected to be marginally higher in 2013 versus 2012 and strong demand from mutual funds, technicals should be supportive of municipal performance in 2013. A primary risk to the sector is tax reform and a possible capping of tax-exempt interest. Although we believe this risk to be low, it continues to hang over the market.

For those accounts willing to take on more risk, convertible securities, high yield bonds, and bank loans offer attractive risk/reward characteristics. Given the low overall level of fixed income yields and convertible bond exposure to the equity markets, the long-term performance expectations of convertibles are compelling. In addition, the lower interest rate sensitivity of convertibles provides a good hedge against the prospect of rising rates. In the high yield bond/loan sector, yield spreads remain compelling given our outlook for a benign credit environment over the next few years. We favor the bank loan segment given more favorable pricing, seniority, and the floating rate structure.

STRUCTURED PRODUCTS

Structured products performed relatively well in 2012, however, there was quite a bit of disparity in performance within the asset class. Commercial mortgage backed securities (CMBS) was the top performing sector of the Barclays Aggregate Index with a total rate of return of 9.66% and excess returns over Treasuries of 841 basis points. Mortgage pass-through securities (MBS), on the other hand, were the poorest performing spread sector besting only Treasuries, generating excess returns of 91bp and a total rate of return of just 2.59%. Looking forward to 2013, we see MBS presenting an unfavorable risk/reward opportunity due to stretched valuations as a result of the Fed's recently announced QE3 purchasing program and see better opportunities in CMBS, although we're anticipating more modest returns following last year's stellar performance.

MBS did outperform Treasuries in 2012 particularly in lower coupon 3% and 3 ½% securities that benefited from sizeable purchases under the Fed's existing QE2 program. Steadily increasing prepayment rates caused by 30-year, fixed mortgage rates dropping to 3.75% and the governments streamlining the HARP refinancing program rules and regulations, however, offset many of the gains from the FED buying program. Higher coupon securities such as 5% and 5 ½% pass-throughs were particularly hard hit.

As we look to 2013, we anticipate that Fed buying will continue to support lofty valuations in the pass-through market. While there have been public comments from members of the Fed indicating that there is a possibility that the QE3 program could be discontinued prior to the end of 2013, we believe that to be an unlikely event. If the Fed does continue to purchase nearly $500 billion in mortgage securities as planned, valuations should remain at their current, elevated levels. The real risk is how and when market prices adjust to the inevitable conclusion of the purchase program. Once the market perceives that the end of QE3 is at hand and that the Fed might become a net seller of securities, MBS valuations could fall precipitously. With the MBS index yielding 2.27% as we begin the new year, MBS could underperform Treasuries by 100 basis points over the course of 2013 if spreads were to return to pre-QE3 levels.

Better opportunities within the mortgage market lay in the non-agency market. While enjoying steep price appreciation over the course of 2012, we believe that further gains are in store for 2013. With limited supply and more investment dollars being dedicated to the acquisition of non-investment grade securities, the technical back drop is very supportive of pricing. From a fundamental perspective, various housing price measures reflect a steadily improving housing market with prices rising anywhere from +4.3% to +7.2% nationally in 2012. With further appreciation expected in 2013, the market appears to be on solid footing. Our expectation is that prime, non-agency securities can be purchased with NAIC 2 ratings and yields in the low to mid 4% range. While a far cry from the NAIC 1 rating and 6% yields of mid 2012, we nevertheless feel that these valuations remain attractive.

The exceptional performance of CMBS was generated by the significant drop in yield spreads as steadily improving real estate fundamentals enticed investors to invest more aggressively over the course of 2012. Declining delinquencies and improving property cash flows when combined with low interest rates generated strong gains in property pricing as reflected by the 37% appreciation of major market properties and by the 21% appreciation of non-major market properties from the 2010 lows. With new conduit issuance aggregating a mere $45 billion, market demand drove pricing spreads lower. Last cash flow senior securities, from new conduit transactions compressed from 130 basis points to 75 basis points while legacy senior bonds from the 2006 and 2007 vintage tightened 110 basis points on average. Mezzanine bonds performed even better as AM and AJ bonds realized an average reduction in yield spread of 250 and 400 basis points respectively.

New construction of commercial property has collapsed since the beginning of the recession. With no new supply, landlords are better positioned to lease vacant space and increase lease rates. As the economy begins to recover, even small job gains can have a dramatic impact on real estate demand, helping drive further increases in occupancy and lease rates, propelling property valuations higher. With a growing base of investor capital pursuing a broader range of opportunities in the commercial property markets, overall valuations appear to be very well supported and should continue to climb in 2013.

From a security perspective, conduit pool delinquencies have been declining and are forecast to drop below 9.0% this year. When combined with loss severities hovering around 45% on liquidated properties, loss estimates are being revised lower, encouraging risk taking. This growing risk appetite along with the improvement in underlying property fundamentals should continue to support valuation across the credit spectrum during 2013.

Despite this very positive fundamental and technical backdrop, some caution is warranted. As we noted back in 2011, current conduit underwriting discipline is well below our standards and continues to weaken. Conduit issuance still suffers from limited pool diversification and in many cases we're seeing some marginal properties being recycled from 2006 and 2007 vintage transactions into new conduit origination. Most importantly many of the very positive fundamentals noted earlier are very supportive of large, centrally located properties being financed by the large bank and insurance underwriters. These properties are usually retained on the underwriter's balance sheets, leaving the conduit market to compete over less desirable properties in tertiary locations. While we believe that CMBS will generally do well in 2013, discretion needs to be exercised when choosing among the various conduit offerings. The increasing level of competition among lenders is creating an environment of looser underwriting standards that could bode ill for the credit performance of some securitizations in the future.

MUNICIPALS

Technical imbalances were the major theme driving tax-exempt relative performance for the first three quarters of 2012. New issuance supply increased considerably by 44% versus the prior year, with refinancing/refunding supply being the major component. Overall, refinancing-related supply made up approximately 62% of total issuance. Even with the heavier supply cycle, demand has been relatively strong all year. The only exception was in the second quarter, which saw issuance spike up dramatically to $114 billion. That was an increase of 44% over first quarter issuance and a 65% increase versus second quarter 2011 issuance. Consequently, 10-year municipal tax-adjusted spreads to Treasuries during June spiked to a 6-month high of 118 bps. However, supply over the next three months contracted by 26% and the drop in issuance, combined with the year's heaviest reinvestment flows of coupons/calls/maturities, led to 10-year spreads tightening by 22 bps.

The municipal sector exhibited a considerable amount of volatility during the final quarter of 2012, with most of the volatility being attributed to news events out of Washington DC. The presidential election results, which ushered in the prospects for higher marginal tax rates, were a huge boost to municipal performance in November. From November 6, 2012 through November 29, 2012, 10-year municipal yields collapsed by 25 basis points (bps) and tax-adjusted yield spreads to Treasuries tightened by 31 bps. With the highest marginal tax rate expected to return to Clinton-era levels of 39.6% from 35%, the municipal market quickly priced in the increased value of the tax-exemption. At this point, 10-year tax-adjusted yield spreads were at their tightest of the year at 51 bps.

However, from the end of November to December 20, 2012, 10-year yields spiked 35 bps and spreads widened by 34 bps. A large proportion of the selloff was attributed to concerns over tax-reform and the increasing probability that the municipal tax-exemption could be compromised as part of the proposal to cap deductions and exclusions at the 28% marginal tax rate. As the new-year approached and it became clear that the "fiscal cliff" agreement would not include the 28% cap, municipals outperformed taxables as 10-year Treasury yields increased by 14 bps from December 31, 2012 to January 3, 2013, while municipal yields were higher by only 6 bps.

As of this writing, 10-year tax-adjusted municipal spreads stand at 72 bps, which remains substantially wider than the 51 bps spread that existed at the end of November. However, a tax-reform concern continue to be an issue hanging over the market, and has led to a more muted conviction around current spread levels. Investors remain nervous that there is some probability that additional revenue-raising measures as a part of tax reform could come out of the sequestration (the mandatory, across-the-board spending cuts) and debt ceiling discussions coming within the next two months. This legislative risk has led to a very quiet tone during the first week of January, and the typical performance boost from the "January effect" on low primary issuance and heavy reinvestment flows of coupons/calls/maturities has been slow to develop.

As for the near term outlook for the sector, positive technicals should provide solid relative performance. Supply/demand imbalances are generally constructive during the first two months of the year and there should be a general bias toward tighter spreads going forward for the next seven to eight weeks. However, legislative risk surrounding the tax-exemption status of municipals remains a concern that won't be abated until a deal is reached on both the sequester cuts and the debt ceiling. Although the probability is low that Republicans will agree to additional revenue-raising measures beyond what was accepted in the fiscal cliff agreement, investors are likely to remain cautious. Consequently, demand flows into the market should lead to strong relative performance, but the buying conviction for municipals will remain less than optimal until we reach a final resolution to the legislative issues.

The longer-term outlook for the market for 2013 is generally favorable. Underlying credit fundamentals for the sector have been and should continue to gradually improve. Although there remain credit concerns and heightened default concerns on some local issuers, especially in California, defaults overall have continued to exhibit a declining trend. Payment defaults in 2012 declined 31% to $903 million from $2.2 billion in 2011.

A major reason for the improvement in the credit profile for the sector is the steady growth in revenues. State and local government revenues have seen positive growth over the last ten quarters. As the economy continues to see growth in employment, states should continue to see steady growth in income tax revenues. Additionally, property taxes have seemed to be on an improving trend over the last two quarters. Most of the improvement can be ascribed to higher assessment rates, and with property taxes being the primary source of funding for general operations of local issuers, this improvement should continue to lessen some of the credit concerns surrounding local credits.

Tightening of credit spreads has been reflective of the improvement in underlying credit fundamentals for the sector. Spreads on 5-year A- and BBB-rated paper have tightened by 45 and 66 bps, respectively, during 2012 and spreads are now back to levels that existed just prior to the 2008 financial crisis. As the municipal market continues to exhibit a generally improving credit profile and fully regains its notoriety as a semi-safe sector, these spread levels should continue to see a tightening bias during the course of 2013.

Technicals should also be supportive for solid municipal performance in 2013. One measure of the demand trends in the municipal market is to examine mutual fund flows. In 2011, tax-exempt funds saw net outflows of $17.9 billion, primarily as a result of heightened credit concerns surrounding predictions of a massive wave of defaults to hit local issuers. As these risks have subsided, and as the prospects for higher marginal tax rates became evident late in the year, 2012 saw a massive turnaround in flows. Municipal mutual funds experienced net inflows of $49.48 billion during 2012, according to Lipper data and, at one point, saw a streak of positive inflows in 65 of the prior 67 weeks as of December 14, 2012. However, in the last two weeks of the year, legislative risks tied to the 28% cap on deductions and exclusions resulted in outflows of $2.7 billion, before moderating in the new year. The risks related to tax-reform and the possible resurrection of the 28% cap discussion may linger over the market and suppress flows until final details have been agreed upon to resolving the debt ceiling and avoiding the sequestration cuts. Outside of these legislative risks, demand should continue to remain solid during 2013.

Supply during 2013 is not expected to put pressure on relative valuations. Consensus estimates for new issuance is $400 billion in 2013, which would be an increase of only 7.2% over 2012's levels and would be just north of the 10-year average of $385.8 billion. Additionally, with interest rates remaining near all-time lows, refinancings/refundings are expected to remain a major component of new supply. In 2012, total refinancings accounted for a total of 62% of issuance. As long as rates remain near historic lows, we believe that issuers will continue to target borrowing costs as a source for potential budget savings as part of their overall austerity focus.

The focus on spending restraint should also translate to a continued below-trend in new money issuance for infrastructure spending. The average issuance in this category over the last 2 years has been $148 billion, which is 40% below the average of $248 billion from 2003 through 2010. With local issuers cutting education-related employment by approximately 54,000 during 2012 and with the trend in new money issuance in 2012 down 6% to $143 billion from $153 billion in 2011, it does not appear that there will be a turnaround in project-related financing in 2013. Consequently, refinancing supply should continue to drive the new issuance cycle. Additionally, any substantial move higher in rates could drastically reduce refinancing opportunities. Actual total issuance under this scenario could come in well below consensus estimates, which would be very constructive for municipal relative valuations for 2013.

CORPORATE CREDIT

2013 Outlook – Security Selection Expected to Drive Results

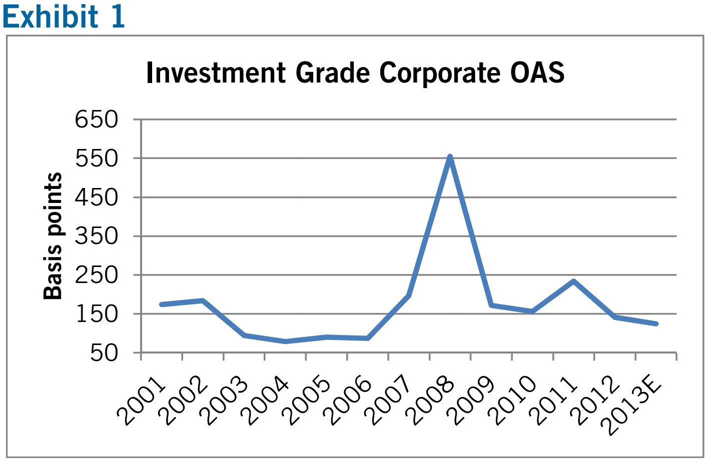
Overview

With excess returns of 7.34% relative to Treasuries, the Investment Grade Corporate market recorded its second best year of performance. The monetary support from central banks coupled with supportive commentary from the European Central Bank (ECB) lessened the tail risk that had existed at the beginning of the year. This fostered a risk taking environment that even the "fiscal cliff" did not derail. Outperformance came largely from the Finance sector (12.5% excess return) followed by BBB rated Industrials (7.0%). Unlike the typical rally, the long end of the Corporate market did not outperform, as credit curves steepened.

We are maintaining our positive view of the market, expecting the rally to continue albeit at a decelerated pace. Our base case is for the market to tighten 16 basis points (bps) from year-end 2012 to 125 bps, a level last seen in mid-2007 (Exhibit 1). Versus 2007, the U.S. economy is slightly larger and company fundamentals are better, as firms have more financial flexibility (higher free cash flow margins and cash balances). The systemic risk premium has lessened after mid-2012 due to central bank support unlike in 2007 when systemic risk was increasing. Market technicals are expected to support spreads in 2012 as the supply of spread product remains lower vs. 2007 due to lower dealer inventories, QE3 (Fed buying mortgages), and negative net new issuance in the majority of spread sectors (highlighted in Exhibit 6 later in this report).

The default rate is expected to remain very low due to the refinancing that has taken place, the accessibility of capital, and the small amount of CCC rated credits today. Recovery rates are high in a low default rate environment; hence, the default risk/loss premium assigned to investment grade credit will continue to be minuscule in 2013. Downside risks to our forecast include heightened volatility from the European debt crisis, prolonged sequestration/debt ceiling negotiations, weaker than expected economic growth in China, the U.S. or Germany, as well as more aggressive use of leverage by corporations. Upside risks to the forecast include stronger economic growth and/or market technicals. We expect an average level of spread volatility (20 bps) in 2013, a range that includes a minimum OAS of 105 bps and a maximum of 155 bps.

Exhibit 1

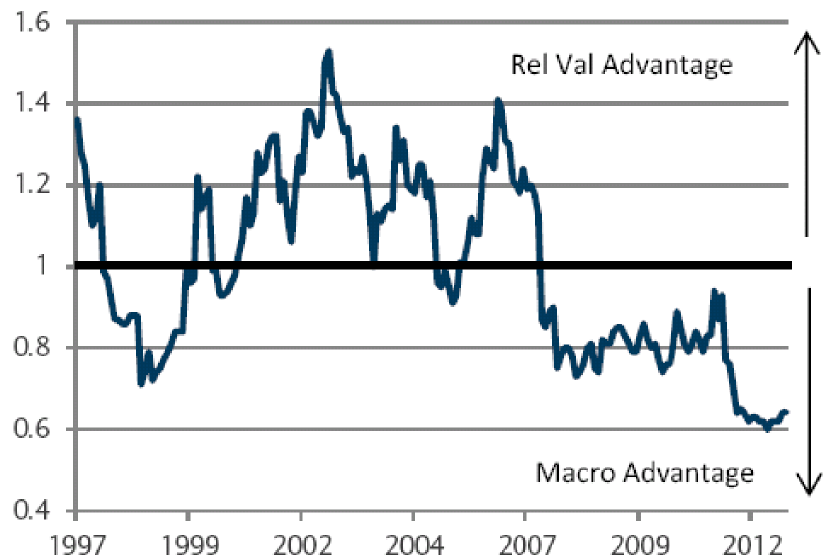


Source: Barclays, AAM

To outperform in 2013, investors will generally need to own more BBB rated credits and correctly position along the curve (intermediates vs. long). We expect Financials to outperform Industrials, driven more by the BBB compression than by compression with Industrials. Banks represent some uncertainty in the Financials sector as the Fed and the FDIC make a concrete proposal on the implementation of an Orderly Liquidation Regime. This proposal could result in heightened regulatory/write-down risk, increased supply and/or further rating downgrades.

In non-Financials, we believe the trend of levering the balance sheet to increase shareholder return will continue, and security selection will be a greater contribution to returns in 2013. This is highlighted in the sector discussions later in this report. As Exhibit 2 shows, the correct macroeconomic call has driven performance since 2006 as opposed to security selection. The extraordinary central bank support around the world should lessen the macro economic volatility, decreasing the correlations among credits. In this market, nimble firms, from a trading perspective, have the ability to outperform as they are able to efficiently execute the ideas that are generated.

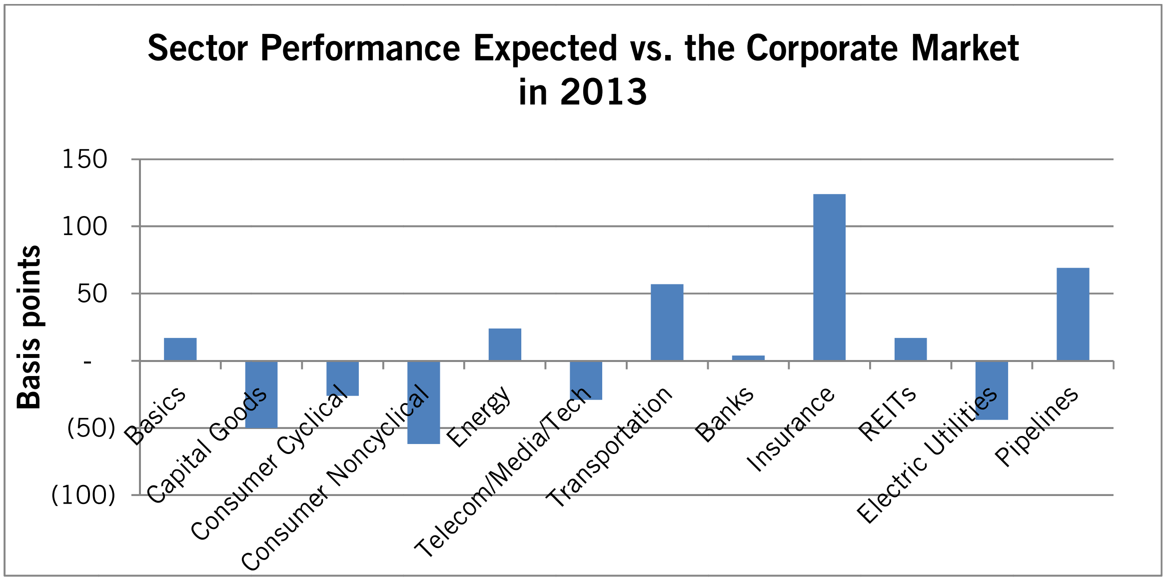
Exhibit 2: Macro Strategies Have Been More Important Than Relative Value Strategies Lately



Note: Values greater than one are periods with relatively higher single-name potential; values less than one are periods with relatively higher macro potential.
Source: Barclays Research

Our sector picks are similar to 2012, choosing those that offer more yield and tightening opportunity without the heightened event risk (e.g., Insurance, Energy, Metals/Mining, Pipelines) (Exhibit 3).

Exhibit 3



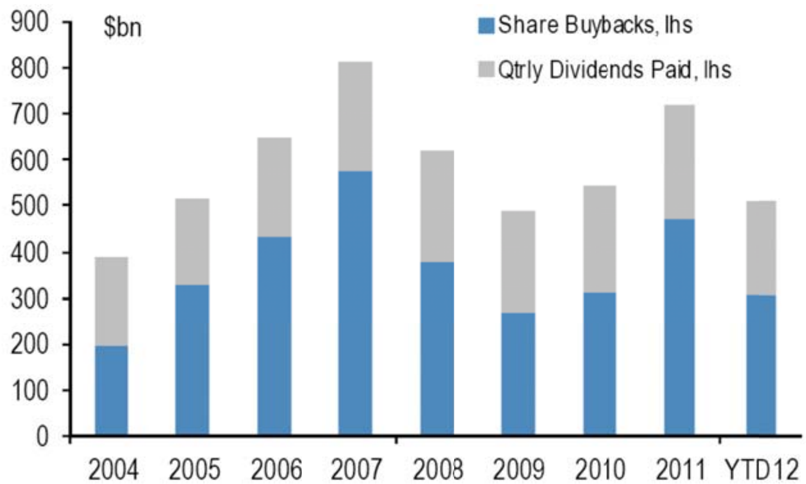
Source: AAM's expectation for excess returns in 2013 for the Barclays sectors vs. the Barclays Corporate Market (excess return for sector minus excess return for corporate market)

Credit Fundamentals Expected to Remain Healthy in 2013

Credit fundamentals for non-Financials remain solid albeit weaker than their peak in 2010. EBITDA margins compressed in 2012 for the Metals & Mining, Pharmaceutical, and Oil & Gas sectors and increased for Transportation. Leverage increased modestly overall, as Metals & Mining and Pharmaceuticals levered up more than other sectors. Only the Defense and Chemical sectors reported lower debt leverage in 2012 vs. 2011. Five sectors spent less on capital expenditures vs. revenues in 2012 while two (Consumer Products, Oil & Gas) spent more, which is reasonable given the high level of economic and fiscal uncertainty and lower economic growth and commodity prices. On average, share repurchases were down from 2011 and flat vs. 2010 when more companies were issuing shares. Cash levels remained high and relatively unchanged in 2012 vs. 2011.

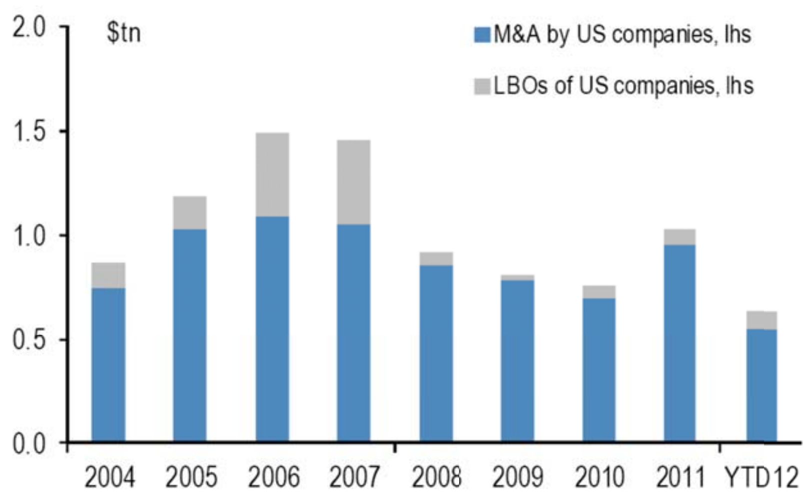
In summary, companies are using their higher level of revenues and debt to build cash and fund operations, and to a lesser extent, on mergers and acquisitions and shareholder payments (Exhibit 4 and 5). We expect this activity to increase in 2013 (Dell being the most recent example), but not affect the performance of the market overall. Highly leveraged deals are difficult to justify as most buyers are forecasting modest economic growth, valuations are higher, and synergies will be more challenging due to the cost cuts that have taken place since the recession.

Exhibit 4: Share Buybacks and Quarterly Dividends are Down in 2012 from 2011



Source: Dealogic, JP Morgan

Exhibit 5: Mergers and Acquisitions Activity Has Also Decreased in 2012 YTD



Source: JP Morgan

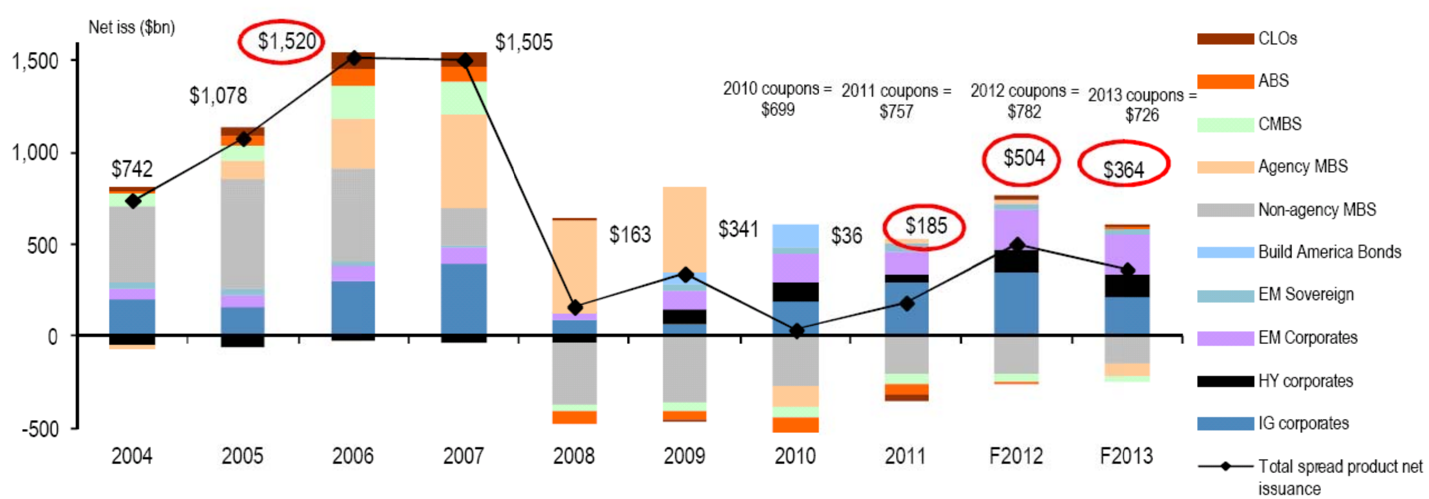
Our sector commentary that follows highlights sectors we believe are most vulnerable. Generally, we believe creditors are not being compensated to own high quality Industrials, as the break-even spreads (spread widening required to offset the coupon return for a 1-year holding period) are very low and event risk is highest in these sectors (e.g., Consumer Products, Defense). We expect ratings migration to continue from the A to the BBB category. The low cost of debt (especially for investment-grade issuers), the tax advantages of issuing debt, and the pressure to return money to shareholders suggest that other considerations can outweigh the benefit of having an 'A' category rating.

Secondary Market Liquidity Continues to Worsen and Supply of Spread Product Expected to Decrease (Once Again) in 2013

Last year set records in terms of investment grade corporate issuance. Corporate bond supply increased 24% to $869 billion. Issuers took advantage of a historically low interest rate environment and termed out their debt profiles. However, the real story was demand: Issuers were more than happy to feed the beast, as investors aggressively sought paper throughout the year. This was particularly evident in the fourth quarter of 2012, as supply was undoubtedly pulled forward from 2013. Consider that as of the end of the third quarter of 2012, total 2012 supply was estimated to finish at $750 billion. We believe the need to issue will be less in 2013; however, it will not decrease dramatically. Rates remain low; companies are increasing leverage, and mergers and acquisitions looks to increase.

Importantly, demand from traditional investors, such as insurance companies, pensions, and mutual funds, should continue. This group alone holds approximately 60% of the corporate bond universe. The post crisis period has seen a shift toward fixed income and away from riskier assets. As a result, corporate bonds have become the spread product of choice, particularly with the lack of available product in other spread sectors such as agency debt and mortgages. Net issuance across all spread products in 2013 is expected to total $365 billion. Non-agency MBS, Agency MBS, and CMBS are all expected to be net negative (Exhibit 6).

Exhibit 6: Net Issuance Across Spread Products to Remain Low Compared to Demand and to Coupons Received Even Before Fed Purchases



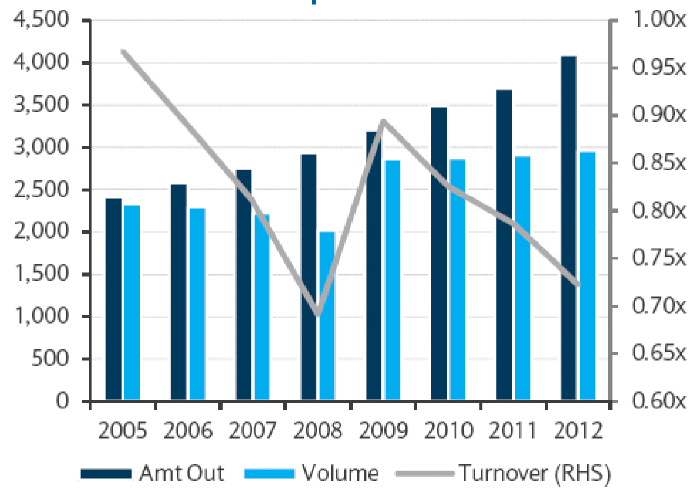
Source: JP Morgan. Note: ABS includes Card, Auto, Student Loan and MH ABS

This data does not include Fed purchases in mortgages, which currently run at about $40 billion per month. That leaves investment grade corporates where net issuance for 2013 is expected to be $310 billion. This number is not negative, but, certainly not heavy considering total coupons received from spread products in 2013 is expected to total $725 billion. For 2013, we expect gross investment grade corporate bond issuance to decrease approximately 13% to $750 billion. Within that total, we expect Financials to increase 4% to $250 billion and Non-Financials to decrease 19% to $500 billion. Within Financials, we expect Banks to increase 12% to $190 billion, driven mostly by Yankee Bank issuance which should increase 21% to $115 billion. U.S. Bank issuance was down 12% in

2012 and should remain subdued in 2013, closing the year unchanged at $75 billion. Within Non-Financials, we expect Industrials to decrease 16% to $450 billion. However, we do see Telecoms increasing 30% to $36 billion. Lastly, we expect Utilities to increase 17% to $68 billion, driven mostly by issuance from the Pipeline companies while Electrics should be largely unchanged.

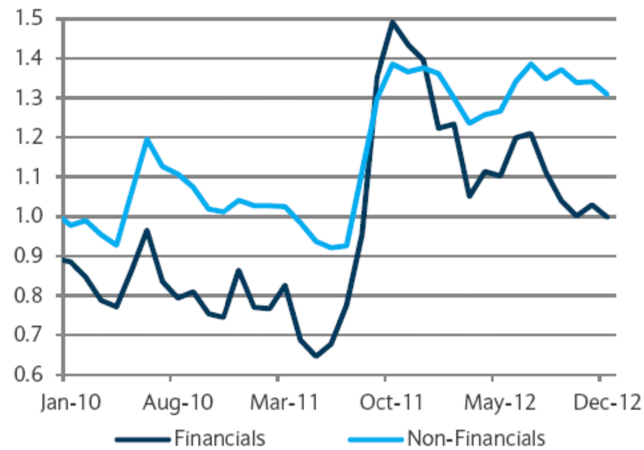
Fortunately, new issuance has been robust since the secondary market has not grown, as dealers continue to hold much smaller inventories due to regulatory and structural changes post financial crisis. Based on trading turnover (down 7% in 2012), liquidity has deteriorated further in 2012 (Exhibit 7). Barclays reports that trading volumes were up 2% vs. 2011, but that was due to the robust new issuance[1]. Transaction costs have risen for both Financials and Industrials (Exhibit 8) since early 2011 despite the fact that spreads have tightened, which has historically resulted in lower transaction costs. This has resulted in investors taking increased exposure to more liquid parts of the market, namely Financials and large issuers. We believe this trend is likely to continue, although the liquidity premium should compress.

Exhibit 7: Turnover for Investment Grade Corporates Has Continued to Decline ($bn)



Source: MarketAxxess, Barclays Research

Exhibit 8: Transaction Costs Have Risen for Both Financials and Industrials (Measured by LCS, %)



Source: Barclays Research - LCS (Liquidity Cost Score) measures the cost of immediately executing a round-trip transaction for a standard institutional trade, by multiplying a bond's duration by the bid-ask spread.

[1] Jeffrey Meli and Bradly Rogoff, "U.S. Credit Alpha – An Extended Festive Season," Barclays Credit Strategy, (1/4/13)

Regarding maturities, we are recommending exposure to the intermediate part of the corporate spread curves to start in 2013. This positioning offers the best expected return based on income and roll-down in most sectors. We expect that corporate curves will remain near their current steep levels in 2013. The front end outperformed sharply in 2012, as the corporate curves steepened. This was partly driven by increasing supply in intermediates and longer-dated maturities. Also, Financials, which have a shorter average duration than the overall market, significantly outperformed last year, helping the front end. Therefore, we believe the 3 to 5 year portion of the curve is less attractive in 2013 and prefer the 8 to 10 year area. We are also less sanguine on the long end due to potential volatility in interest rates to start the year and look to invest selectively in this area, taking advantage of specific credit situations.

SECTOR OUTLOOKS

INDUSTRIALS

We expect Industrials to underperform Financials once again in 2013, but by a smaller margin. Our expectation is for outperformance in Basics, Communications, Energy, and Transportation, with underperformance coming from the more defensive and event risk prone sectors, Capital Goods and Consumer Cyclical and Noncyclical, and Technology. The following highlights AAM's analysts' views regarding one or two sub-sectors for each broad category.

Basic Industries

Metals and Mining (Attractive)

We believe this sector is "attractive" given relatively wide spreads and our expectation of stable fundamental performance versus 2012. We don't expect much improvement in global GDP growth in 2013, with growth estimates moving to 2.42% from 2.22% in 2012. More importantly, China is expected to grow over 8% in 2013 up from 7.7% in 2012. China, given its huge infrastructure build, represents about 40% of global metals demand. In general, we expect metals prices to remain volatile but expect them to be pretty similar to 2012. Given the weak environment in 2012 for the sector, we saw most large metals/mining companies lower their capital spending by an average of almost 10%. We would expect continued caution from management teams until it is clear we are in a better growth environment. Coming off of a weak 2012, we forecast revenue growth to be up mid-single digits in 2013. We will continue to focus our attention on the more diversified global players in the sector and will stay away from single commodity focused credits especially those which carry an unfavorable supply/demand profile (aluminum/steel).

The OAS of the sector is 183 bps or 137% of the broader Industrial index. Approximately half of the OAS tightening in 2012 was due to ArcelorMittal falling out of the Barclays Index in late 2012 because of ratings downgrades to high yield. The spread of this sector should compress throughout the year given the expectation of stabilizing global demand and increasing comfort with more cyclical asset plays.

Capital Goods

Aerospace/Defense (Unattractive)

Our recommendation for this sector is "unattractive" based on fundamental concerns and relatively tight spreads when compared to a larger universe of Industrial credits. The one bright spot in this sector is the commercial aerospace business, which continues to benefit from strong demand due to reasonable global GDP growth and strong aircraft replacement rates given low interest rates and high oil prices. Having said that, this sector is dominated by defense companies and our recommendation for the sector is based primarily on our outlook for defense. Apart from Boeing, we expect revenues and EBITDA to be down in 2013. The U.S. defense industry has entered into an extended period of lower defense spending. We continue to expect volatility around sequestration since the Budget Control Act has been pushed back to March 1, 2013. As currently written, the Act could result in additional defense budget cuts of more than $50 billion a year for 10 years which would be around a 10% decrease to the total U.S. defense budget. In general, management teams have not incorporated the impact of sequestration in their strategic planning for 2013. In addition, we expect margins to narrow as the overall budget shrinks and competition increases among the major defense contractors. The sector's liquidity and balance sheet positions remain strong. Going forward, we expect the industry to favor shareholders with more aggressive share repurchase plans and larger dividends. In addition, we expect the challenging growth prospects will lead to significant consolidation. That said, the downside is limited, as we do not believe the large defense contractors would do anything to jeopardize their investment grade ratings.

The OAS of the sector is 119 bps, which is 90% of the broader Industrial index. This low spread limits performance upside, especially for a sector we think is out of favor from both a fundamental and secular perspective. Our recommendation could change to a more positive tone based on budget discussions over the next couple of months.

Consumer Discretionary

Retail (Unattractive)

We have set an "unattractive" recommendation for the retail sector. Our recommendation is based on relatively tight spreads and key fundamental concerns. The main risk for the sector centers on consumer spending. The typical consumer will see more of his/her paycheck going to taxes while typical household expenditures such as healthcare and gasoline remain expensive. We would expect this to be a drag on spending for at least the first half of the year. Currently, the consensus is that the second half of the year will be better than the first. The retail sector may be set up for a disappointing year if the recovery does not materialize. This has been, and will continue to be, a bifurcated sector. On the one side, the highly rated discounters benefit from the value shopper and some niche players benefit from such secular positives as the strength of the high income shopper (Nordstrom) or the growing use of prescription medicine (CVS). On the other side, the big box middle market retailers continue to struggle with a plan to differentiate themselves and some specialty retailers suffer from new retail challenges such as online shopping (Best Buy). On top of that, we saw more examples of conservative management teams adding significant leverage to their balance sheets (Lowe's, Walgreens).

Unfortunately, most of the retailers we like from a fundamental perspective (Wal-Mart, Home Depot, Target) trade at the tight end of the retail spectrum and account for more than half of the Retail industry in the Barclays Corporate Index. We expect that the remaining credits on the other end will continue to struggle or will try to appease shareholders with debt financed acquisitions or aggressive share repurchase programs. At an OAS of 110 for the retail sector, we don't believe there is a good opportunity to perform versus the broader Corporate market.

Consumer Nondiscretionary

Environmental (Attractive)
We view this sector as "attractive" given solid fundamental prospects and spreads which are wide relative to the broader market of Industrial credits. The defensive nature of this sector, given the essential nature of its service, should resonate well in the uncertain economic environment in the U.S. We expect revenue growth to be close to GDP growth with free cash flow improving given lower planned capital spending this year. Even in the face of lower volumes, we expect the industry to remain disciplined with pricing and will continue to benefit from Consumer Price Index (CPI) linked contract price increases. We do not expect much growth from volumes, although we recognize potential upside from improvement in housing and oilfield waste opportunities. Credit measures should stay relatively flat going into 2013 with free cash flow used for tuck-in acquisitions and share buybacks.

The OAS of the sector is 149 bps, which is 112% of the Industrial index. Modest spread tightening from this quiet sector along with carry should help this sector outperform the market.

Energy

Independents and Integrateds (Attractive and Unattractive respectively)
We have a neutral fundamental view of the Independent and Integrated sector. The upstream (independents and integrated, collectively) generates revenue by producing oil and natural gas and selling it at the market price. Given our expectation for strong oil prices, flat natural gas prices and stabilized natural gas liquid prices, top line should be similar in 2013 to what has been realized in 2012. However, we expect capital expenditures to be spent more judiciously in 2013 (particularly in North America). This should allow marginally more free cash flow in the upcoming year.

We expect Independents to generate excess returns greater than Industrials due to the larger composition of triple-B rated issuers, such as Anadarko, Southwest Energy and Noble Energy. Each of these issuers could compress by 20 bps in 2013 in a benign macro environment. Conversely, we expect Integrateds to underperform Industrials in 2013 due to limited spread compression opportunities of credits such as Shell, Chevron, Total and Eni.

Oil Service & Contract Drillers (Attractive)
We have a neutral fundamental view of the Oil Service sector. Future revenue and cash flow from the Oil Service sector is dependent on the capital spending of the Independents and Integrateds (collectively, the upstream). Most experts believe that in 2013, the capital spending of the upstream should increase slightly. We believe that the North American market will be in better shape than in 2012 simply because we don't forecast the natural gas drilling market to decline or the pressure pumping market to collapse in 2013 like it did in 2012. High utilization rates of offshore drill ships should continue in 2013, which will allow the contract drillers to have good years.

We expect the Oil Service sector to provide the best returns of the four energy subsectors, largely due to Weatherford and Transocean. These two issuers make up more than 6% of the Energy sector, have substantial room to tighten following positive developments in the past month.

Telecom/Media/Technology

Cable/Satellite (Fair)

2012 was fairly benign for the cable and satellite operators. Increased programming costs weighed on EBITDA margins, causing the declining trend since late 2009 to continue. The cable operators did a better job of preserving subscribers this year, losing less than they did in years prior. We attribute this to an improving housing sector and the improvement in technology, mainly the increased flexibility offered to consumers via video-on-demand (22% of time spent on video viewing in 2012) and viewing with portable devices (11%). In 2013, we believe cable operators will continue to invest in portability/mobility, including Wi-Fi hot spots, as well as their networks (capex expected to be unchanged versus 2012). We expect event risk for bondholders to be higher in 2013. In addition to the telecom providers, video providers face increased competition from new technologies and entrants offering faster broadband speeds (gigabyte). However, the more significant issue in the near-to-intermediate term is the inability to control programming costs, especially sports. Content providers continue to win these battles and earn more power, as the cable/satellite operators need broader rights to display their programming (using portable devices) and can not afford to lose content to emerging providers like Netflix or Amazon. Accordingly, we expect margins to continue to compress and leverage to creep higher. The event risk resides mainly with DirecTV, which we expect will bid for GVT (Brazilian telecommunications company), pressuring spreads. Taking this into account, we expect the sector to perform slightly better than the market unlike other BBB sectors that should outperform handily. Specific to the cable sector, a Court decision is expected by year-end on the appeal of the FCC's Open Internet Order. If the Court rules against the FCC, and the FCC decides to impose Title II regulation on broadband (an unlikely outcome), opening their networks to competitors at a minimum, we would expect equity prices to react sharply negative and spreads to widen.

Telecommunications (Unattractive)

As opposed to the broader market that witnessed declining mergers and acquisitions, the North American telecommunications sector was active in 2012. Notably, T-Mobile announced a merger with MetroPCS, followed shortly by Softbank's $20 billion investment in Sprint. These deals strengthen the market positions of the #3 and #4 operators in the market, as opposed to removing one of them under the prior AT&T/T-Mobile deal.

We believe Softbank's CEO, Masayoshi Son, sees a similar opportunity with Sprint that he did with Vodafone Japan. Sprint is working to improve its network, upgrading to LTE and decommissioning the Nextel network in addition to acquiring spectrum. This is a time intensive process, but we believe it is achievable and Sprint should reap the benefits starting in 2014. Until then, we expect Softbank's influence will begin to materialize in Sprint's marketing. Sprint's actions should disrupt the industry, moving prices down and increasing marketing related costs. We expect the industry to prepare for this in 2013, and are seeing signs of that with AT&T temporarily suspending its 1.5x leverage target to advance its capital spending to expand its wireless 4G LTE and U-verse platform coverage while maintaining its aggressive share repurchase program.

We believe AT&T and Verizon will be pressured to maintain their lead and appease equity investors, neither of which is good for bondholders in the near term. While this does not mean a rating downgrade, given the liquidity of these issuers, increased debt issuance is likely to result in spread widening especially with AT&T funding its new capital expenditure plan. Over the intermediate term, we believe Sprint has the potential for disrupting the industry and moving Verizon and AT&T into the BBB rating category. That is not our base case at this point, but the likelihood has increased.

Despite the potential for outperformance in the near term from the lower rated telecommunications companies, either European or rural local exchange carriers in the U.S., we do not expect to invest in these credits in 2013. We expect nonexistent European economic growth in 2013. . This will keep pressure on companies' financial metrics, and thus, ratings. Telecom operators in Europe are behind the U.S. from a capital investment standpoint, are more indebted, and many have structural rigidities that make it difficult to cut costs as revenues fall due to increased competition, consumer friendly regulatory changes, and the weak economies. Many have diversified away from their stagnant home markets into Eastern Europe and Latin America, but these areas are facing their own challenges, either economically or competitively. We need to see fundamental improvement in these credits, which means real deleveraging, stable-to-improving economies, and a measured network investment plan.

Transportation

Rails (Attractive)

We view the Rail sector as "attractive" based on solid fundamentals and relatively wide spreads relative to the broader industrial index. We use the monthly rail carloading information to get a better understanding of the drivers and health of the economy given the demand derived characteristics of the diverse industries the rails serve. Rail carloadings for 2012 were flat to 2011. Areas of strength were seen in petroleum products, motor vehicles, and housing related segments including building products and lumber. Grain and coal were down substantially for the year, reflecting low natural gas prices and a disappointing crop yield. If you take these segments out of the equation, carloads would have been up by almost 5% for the year. We believe this is a better reflection of the strength of the economy because grain and coal have less to do with demand and more to do with extraneous factors such as natural gas prices and weather patterns.

We continue to view the Rail industry as favorable from a fundamental point of view. Shipping by rail is the most cost effective way to move goods across the country. Improvement in service and growth in infrastructure should allow the industry to continue to be somewhat flexible with pricing. Volumes for the industry should move with GDP growth in the U.S. We believe that the western rails (BNSF & UNP) should do better than the eastern rails (CSX, NSC) given their exposure to the highly successful Bakken oil field versus the lagging coal industry in the east. Credit metrics are strong, and we have seen a positive move in credit ratings for the sector to high-triple-B, low-single-A. Free cash flow will continue to be limited based on the high capital spending needs of the sector.

The OAS of the sector is 132 bps, which is on top of the OAS for Industrials. Strong secular characteristics and solid fundamentals should result in modest spread tightening in 2013, which should outpace the broader Barclays Index.

Electric Utilities (Unattractive)

We have a neutral fundamental view of the electric utility sector. We expect revenue and cash flow to be stable in the upcoming year based on higher demand, weaker electricity prices and slightly weaker margins. Recall that utility revenue is dependent on demand for electricity and electricity prices. We expect demand to be slightly higher based on modest domestic GDP growth and flat weather related demand. We expect electricity prices to be flat based on stable prices for both natural gas and Powder River Basin coal, the raw materials used to generate electricity.

We have a negative relative value opinion of the Electric Utility sector given the very tight levels that it trades with limited spread compression opportunities. The large allocation of single-A rated, sub-100 bps OAS electric utility bonds in the index, make adding duration the one avenue to get returns near Industrials.

Pipelines (Attractive)

We believe the fundamentals for the pipeline segment are positive. Volumes of oil, refined products, natural gas and natural gas shipments are largely determined by domestic GDP. We think volume growth should increase slightly based on modest domestic GDP expectations. Notably, volumes of natural gas liquids should probably increase faster than GDP growth given the heightened demand from the chemical sector. We believe another positive fundamental is the expanding number of resource basins, which will lead to greater size and cash flow generating capability. This will lead to greater size and cash flow generating capability of the master limited partnerships (MLPs) involved in the build out.

We have an attractive relative value opinion of the Pipeline sector. The OAS of 171 bps combined with modest spread contraction of more than 10 bps should allow the sector to outperform Industrials. The one caveat is that we expect a significant amount of issuance in 2013, as companies fund the expansion of Canadian exports and crude oil pipelines from the Bakken and Eagle Ford.

FINANCE

Banks (Fair)

Summary Outlook

We continue to see relative value in the US Bank sector versus Industrials. Despite the rally of the past year, we believe there is modest opportunity for the Bank sector to tighten towards Industrials in 2013. However, banks are unlikely to experience the outsized excess returns of 2012. This view is supported by continued bank balance sheet strength, but only modest economic growth and persistent low rates. However, the one note of caution we raise is that pending regulatory developments associated with the Dodd-Frank Act (much delayed, but still coming) have the potential to materially alter the market's perception of risk premiums and supply technicals.

Fundamentals

The fundamental backdrop in the Bank sector is modestly supportive heading into 2013. Balance sheet fundamentals are very strong, with capital and liquidity both at all-time highs. Despite the resumption of dividends by most banks, the combination of the new Dodd-Frank/Basel III capital rules, as well as the recurring Comprehensive Capital Analysis and Review (CCAR, aka the Fed's annual stress test), meaningfully constrain the banks' ability to re-lever or engage in excessive return of capital to shareholders. In that respect, the Bank sector stands in contrast to the rest of the corporate sector which engaged in modest re-levering during the second half of 2012, as they rushed to raise cash and pay special dividends to shareholders in advance of the fiscal cliff.

In contrast to sector balance sheets, operating fundamentals remain subpar due to persistent low rates and weak loan growth, both of which are symptomatic of weak economic growth. While banks enjoyed moderate commercial and industrial loan growth in the first half of 2012, commercial borrowers held back towards year end given the uncertainty associated with the fiscal cliff. At the same time, run-off of non-core legacy loan books (out-of-footprint home equity, commercial real estate, etc.) put downward pressure on consolidated loan books. As well, net interest margins have shrunk as loan books have re-priced and the benefit from expensive wholesale funding roll-off has largely been realized.

On the non-interest income side of the business, the strength in mortgage banking looks like it has another couple of quarters to run. The strong refinancing environment has partially offset the impact of regulatory developments of the past two years that reduced other fee income (Durbin Amendment/Reg E). The just announced Qualifying Mortgage (QM) standards by the Consumer Financial Protection Board, and the recently announced Global Foreclosure settlement should also ease the flow of mortgage credit into the greater economy.

Capital markets revenues have been uneven, and largely driven by volatility. However, the ultimate impact of Dodd-Frank (Volcker Rule and derivatives clearing requirements) and Basel III (risk weighting for capital market business activities) is not yet clear, and could result in reduced business activity and potentially the exit of certain businesses.

With regard to regulatory developments and rules arising from Dodd-Frank, the fee income impact has not been as bad as expected to date. However, we note that of the 398 rules that Dodd-Frank mandated the Federal Reserve to create and implement, only 133 have been implemented (more than two years after Dodd-Frank became law) and 132 rules have not even been proposed. Rules which have yet to be implemented include the Volcker Rule (still being defined), mortgage risk retention and collateral requirements for central clearing of derivatives. All of the previous should generally be beneficial for bank credit investors though. The one possible exception is the implementation of Resolution Authority and Orderly Liquidation, which will be discussed separately below.

Europe

We maintain heightened caution towards the European Bank sector. The actions of the European Central Bank (ECB) in the latter half of 2012, most notably the Open Market Transactions (OMT – potentially unlimited sovereign buying), succeeded in stemming the immediate financial market stress and fears of an uncontrolled sovereign default. However, the European economies remain stagnant, unemployment, already high, continues to rise, and the continent is likely to experience recession in the first half of 2013. The European Union (EU) is only half heartedly moving towards the structural reforms (market liberalization) and fiscal integration needed to drive economic growth. Paradoxically, the stabilizing actions of the ECB may have removed some of the sense of immediate crisis, the urgency of which had previously pushed the EU members to address the underlying issues afflicting the European economy. Regardless, without renewed economic growth, the EU (and especially the peripheral members such as Spain, Italy and Greece) will be unable to undertake the fiscal consolidation that would end the crisis and allow for survival of the common currency and further harmonization of economies and financial markets.

We acknowledge the strong performance of the European Bank sector in the wake of the actions of the ECB. However, absent a resumption of economic growth, political risks to the EU will only grow, and we have seen emerging politics at the country level spark volatility in financial markets on multiple occasions over the past three years. The most obvious flashpoints during the first quarter of 2013 are the Italian general election and the German general election. The quarterly review of Greek progress by the Troika (ECB/EU/IMF) has also been the source of market volatility in the past.

Orderly Liquidation Authority

We view the potential emergence of an Orderly Liquidation Authority (OLA) regime in the United States as the key downside risk to our baseline forecast of modest excess returns in the US bank sector in 2013.

OLA refers to the Dodd-Frank Act's provision for the resolution of systemically important financial institutions ("too big to fail") that have reached the point of non-viability (failure) in a manner that does not endanger the US economy, while at the same time, refraining from providing taxpayer funded bail-outs such as those conferred upon AIG, Citigroup and Bank of America. Although such an approach was legislated by Dodd-Frank, the practicality of implementing such a form of receivership continues to be uncertain. This is because systemically important institutions are by their nature highly complex, and not easily taken into receivership or run-off absent financial support from a lender of last resort (typically the taxpayer via government intervention).

Over the course of 2012, the FDIC began to float the concept of single entry receivership in order to implement a workable OLA regime in the US. The concept envisions regulators taking a distressed financial institution into receivership at the holding company level, while allowing operating subsidiaries to continue normal operations. The holding company would serve as a "source of strength" for its subsidiaries with the holding company capital structure being written down in order to recapitalize troubled subsidiaries. As envisioned, the receivership would occur outside of bankruptcy (with an explicit stay on creditors). Following the restructuring and stabilization of a failing institution, equity holders would be largely wiped out, and holding company creditors (bondholders) would be haircut, with the balance of their holdings either converted into equity or paid out on a pro-rata basis following sale of the now stabilized institution. More recently, in December 2012, Fed Governor Daniel Tarullo floated the idea requiring large financial services firms to maintain a minimum amount of long-term debt in addition to equity capital at the holding company level. Such a requirement explicitly envisions a minimum layer of "capital" at the holding company that could be written down to ensure orderly liquidation/rehabilitation of a failing financial institution.

We believe that the Fed and the FDIC (who are jointly charged with implementing an OLA regime) will make a concrete proposal regarding the same during 2013. While the concept of OLA has been public since 2010, the lack of details from the regulators on the scope, scale and framework have prevented investors from properly analyzing the impact of OLA on bank bond investments. However, we perceive three principal risks:

a) If regulators explicitly transform holding company debt from a funding instrument to capital instrument that is eligible to written down through the OLA process (outside of bankruptcy and without creditor rights), the market may assign an explicit risk premium for such a probability which would be reflected in wider spreads.

b) If regulators mandate a minimum amount of holding company debt, the issuance required to achieve such a level of debt would reverse the positive technical of reducing wholesale funding requirements and a shrinking amount bank bonds outstanding.

c) The rating agencies have stated that imposition of a credible OLA regime would likely cause a reconsideration of the implicit support of the US government and regulators for the systemically important financial institutions (on the assumption that such support would no longer be forthcoming once OLA became effective). Were the agencies to do this, it is likely that they would engage in another round of downgrades of the largest financial institutions which currently benefit from several notches of rating uplift.

Although the market is broadly aware of the likelihood of an OLA proposal being made public later this year, we are uncertain how it will react to a firm proposal (either through a white paper or a Notice of Proposed Rulemaking). The prospect of heightened regulatory/write-down risk, increased supply and further ratings downgrades would likely be negative for bank bond spreads, although a lot depends upon details which have yet to be made public. And it is likely that some of these risks are already reflected in current trading levels, or would be absorbed without excessive volatility. However, we will carefully follow the regulators' progress on OLA over the course of the year. While the potential risks associated with OLA do not justify changing our current investment stance on the sector, we acknowledge the performance risks associated with the same, we will carefully follow developments over the course of the year.

Insurance (Attractive)

Insurance companies' sound fundamentals should counteract expected sluggish economic performance in 2013. U.S. insurers' strong balance sheets, a stable business climate, and improved enterprise risk management will enable them to maintain stable credit trends. In this environment, we prefer lower rated (and higher yielding) but high performing companies, expecting the sector to outperform the broader market. The earnings of life insurance companies continue to be helped by top-line resiliency and hurt by yield-related margin pressures. The property & casualty insurers should benefit from continuation of modest rate increases while persistent low interest rates weaken investment returns. Health insurers will continue to successfully manage changes brought about by the Patient Protection and Affordable Care Act's (PPACA) eight year implementation, but credit quality could be challenged by acquisition activities and the increasingly blurred roles between payers, providers and hospital systems.

Real Estate Investment Trusts (REITs) (Fair)

We view REITs as fairly valued at current levels and the sector continues to offer better spread than Industrials despite the rally over the last quarter of 2012. REIT fundamentals remain strong, with low levels of leverage, high liquidity and only modest development risk. Occupancy and NOI (net operating income) have generally exceeded previous cycle highs, but REITs still benefit from a competitive advantage in capital and funding versus private real estate operators. In this environment, we continue to favor pure play performers (dedicated to a single subsector) and best-in-class performers for the most part. We expect continued opportunistic property acquisitions by our preferred credits in the REIT space over the course of 2013, but very modest levels of development outside of the multifamily sector. However, as capitalization rates have compressed, we remain vigilant for signs of more aggressive operating or financial maneuvers by REIT management teams. Subsectors we favor include multi-family, central-business-district office and regional malls. In contrast, we have avoided industrial REITs, which we view as having business risk profiles closer to below-investment-grade, and healthcare REITs, which are undergoing aggressive consolidation with an unproven business model and market size.

CONVERTIBLE SECURITIES

The key drivers of convertible securities' valuation had a strong 2012, contributing to solid performance for investors in the asset class. Equity markets rallied with the S&P 500 Index returning 16.0% for the year, credit spreads tightened leaving US Corporate bond investors with a 9.8% total return, and the investor's search for yield ensured that, in general, the market remained well-bid. Slightly offsetting this strength was a decline in market volatility due to benign domestic economic conditions and much improved sentiment out of Europe during the latter half of the year. As measured by the BofA Merrill Lynch Investment Grade Convertible Index – Ex Mandatories (VOA1), the convertible market returned 11.3% during 2012. Not surprisingly, below investment grade convertibles as measured by BofA Merrill Lynch's VOA2 index were exceptionally strong, posting a 16.7% total return for the year.

Convertible bond market issuance was lower than 2011 with $21 billion of deal flow in 2012. With straight debt capital markets offering low cost financing to high grade borrowers, much of the convertible new issuance was from sub-investment grade or non-rated issuers. The market maintained a disciplined approach to pricing new deals, a positive characteristic in our view. As we look forward into 2013 and 2014, redemptions/maturities will further reduce the size of the investment grade convertible bond market. The potential for rising rates may help mitigate the expected redemptions/maturities as issuers move away from straight debt issuance and into convertibles.

At present, we view convertibles as fairly valued with long-term performance expectations that are compelling. Within the convertible market, we believe that portfolios containing select exposure to sub-investment grade issues ('BB' and below) offer better risk/reward prospects than investment grade only portfolios. Should equity markets in 2013 post a repeat performance of 2012, we anticipate that the convertible bond market will participate in a significant portion of any upside move. Nevertheless, should equity markets move to the downside, the convertible market would also provide protection. The market exhibits low interest rate sensitivity and, as such, we would view the impact of rising rates to be limited with the underlying cause of higher rates likely a bigger driver of convertible performance.

HIGH YIELD AND BANK LOANS

U.S. and European high yield bonds and bank loans continued to "chug along" positively in the second half of December 2012–albeit on very little volume—as investors took a breather, satisfied by a year of strong, double-digit high yield returns. As a result, high yield largely sidestepped the drama and late month volatility experienced by world equity markets as investors nervously watched U.S. lawmakers careen toward the impending “fiscal cliff.” Combined loan and bond new issue activity ended the year at a record $668 billion, dwarfing the previous 2007 combined record of $536 billion, but, like the market, went quiet in the closing days of the month. All considered, 2012 is likely to be remembered as offering investors in higher-yield credit “the best of all possible worlds.” Borrowers and lenders alike found exactly what they were looking for without the market losing credit discipline. Corporations were able to successfully refinance debt at attractive yields, while investors benefited from both yield and capital appreciation. Money lent through the bond markets went overwhelmingly to lender-friendly refinancing as dividend deals and LBO activity continued to be restrained. Supported by strong balance sheets and disciplined corporate management, U.S. high yield defaults remained historically low around 1%.

2012 was a strong year for corporate credit. Looking ahead to 2013, fundamentals in the market appear as solidly attractive as at any point last year. Less than $60 billion in U.S. high yield bonds and bank loans combined comes due in 2013. As a result high yield spreads—designed to compensate investors for increased default risk—remain appealing even if the overall yield environment remains low. While we do not expect capital appreciations to lead the high yield markets in 2013, we believe that investors should continue to find the asset class’s balance of risk and reward particularly compelling.

We would not rule out a short-lived market re-pricing in response to headline news outside of the high yield markets. Both U.S. and European countries have postponed serious questions of dealing with government debt into 2013; however, we would anticipate such corrections to be shallow and short-lived buying opportunities.

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