NORTHVIEW ASSET MANAGEMENT

Third Quarter 2012 Market Review

ECONOMIC OVERVIEW

As in previous quarters, policymakers, both here and abroad, continue to drive the market. Here in the U.S., the FED committed to purchasing Agency mortgage-backed securities to the tune of $40 billion per month. This, coupled with other FED programs, brings the monthly total to $85 billion. Even though these purchases are small compared to the overall Agency sector, their impact on mortgage spreads, lowering interest rates and accelerating prepayments is significant. The intent is to twofold, lower mortgage rates for homebuyers and increase investor interest in other sectors of the market.

The debate over the fiscal cliff continues. Of the $600+ billion in play, most economists feel less than half of this amount will result in fiscal contraction. The latest economic report from PIMCO says it best:

“While there are clear differences in views between the two parties, there is actually more agreement than disagreement between Republicans and Democrats on the fiscal cliff issues. For instance, both parties generally agree that the Bush tax cuts should be extended for those who earn less than $250,000. The biggest area of disagreement is for those earning more than $250,000. The Democrats are determined not to extend them, although there is some indication they may compromise on dividend and capital gains taxes. We think a compromise is likely before the end of the year.”

In other economic news, we saw modest improvement in housing over the quarter. This should continue with the FED determined to keep interest rates low. And, coupled with housing related sectors, will have a positive impact on the economy. However, the impact is not enough to achieve real GDP growth and lower unemployment. Weighing on the U.S. recovery is also the crisis in the Middle East, a slowdown in China’s growth and political and economic deterioration in Europe.

MARKET

U.S. Corporates

Investment Grade corporate bonds had a great run over the past few quarters as evident by the decline in yield and spread relative to treasuries. Inflows into the corporate bond market have been historic as investors seek yield relative to the low rates available in other asset classes and, in turn, capture some positive real rates of return versus inflation. While corporate bonds can underperform the market once investors start to shy away from risk, that hasn’t been the case this year. One reason is the continued improvement in corporate credit profiles and the record levels of cash on their balance sheets. Another positive for the sector has been the low absolute level of Treasury rates the last few years. The historically low rates have contributed to companies being able to refund debt at a much lower level of interest than they had in the past. Many companies have issued new debt at the lowest levels in their corporate history. So far, 2012 continues to be the year of the corporate bond as companies have taken advantage of near record-low borrowing costs and subsequently corporate bond issuance in the U.S. now stands over $1.18 trillion, marking a new all-time record and passing the $1.03 trillion corporations borrowed back in 2009. To put this historical market in context, the average A-rated and BBB-rated corporate bonds have spreads of 112bp and 190bp respectively, down significantly from the 212bp and 276bp corporates bonds were trading at the beginning of the year. In September, we saw spreads on these two rating categories decline to 126bp (-14bp) for the A-rated bonds and 207bp (-26bp) for BBB-rated credits, after only slight spread movement for the month of August. Financial spreads continue to narrow at a rapid pace, having now fallen to an average of 161bp, the lowest level since May 2011, after being as high as 366bp over treasuries at this time in late 2011.

We believe that credit spreads will continue to narrow as we get past the uncertainty in Europe and the upcoming elections are behind us, and then investors will begin to focus once again on the strong fundamentals of the U.S. corporate sector.

Mortgages

With QE3 and other FED programs in full swing, mortgage spreads continue to tighten offering great mortgage rates for homebuyers and little opportunity for investors. With the FED expected to continue its policy through 2015, we expect mortgage spreads to remain tight.

Treasuries

We saw some volatility in this sector during the quarter ending with short maturities higher in price (lower in yield) and long maturities lower in price (higher in yield) pushing the curve steeper.

Treasury	6/30	9/30
2 year	0.29%	0.23%
5 year	0.66%	0.61%
10 year	1.59%	1.64%
30 year	2.69%	2.84%

OUTLOOK

Domestically, with the FED's dual mandate of price stability and full employment, we expect rates to remain generally low no matter what the presidential outcome. The fiscal cliff (more appropriately a fiscal slope) will not cause a major contraction in GDP because of compromises by our political parties.

Internationally, any negative geopolitical event such as disruptions in the Middle East that raise oil prices or a sharp slowdown in China would be a hit to consumer confidence and slow our growth.

As a result, our investing remains cautious. We continue to look for low leveraged corporates that can best handle potential shocks in the market and mortgage products when they present reasonable risk reward characteristics.