First Principles Quarterly

Summer 2013

FPCM is a fixed income investment manager with over $8bn in assets under management.

We provide customized investment portfolios for our institutional clients, which include endowments and foundations, commercial banks, insurance companies and corporations.

To our private clients - which include single- and multi-family offices, trusts, family-owned businesses and high net worth individuals and their advisors - we offer various investment management and wealth maximization strategies.

Contact:
140 Broadway, 21st Floor
New York, NY 10005
Tel: 212-380-2280
Fax: 212-380-2290
www.fpcmllc.com

First Principles Capital Management, LLC ("FPCM")

FPCM is a privately held investment management firm with expertise across the global fixed income securities and derivatives markets. Founded in 2003, FPCM is a Registered Investment Advisor.

In this Issue

2 **CIO Perspective**

5 **Rates, Inflation, Mortgages and Municipals**

7 **Corporate Credit**

9 **Emerging Markets Debt**

11 **Asset Backed Securities**

CIO Perspective

Doug Dachille
CEO & CIO
ddachille@fpcmllc.com
212-380-2281

"It gets late early out there"

Yogi Berra

In my CIO letter from first quarter of last year, I described the emergence of a troubling motivation for fixed income investing among a growing subset of investors. With the expected rate of inflation exceeding the after-tax risk-adjusted yield-to-maturity in many fixed income sectors, it is only natural that few investors would find fixed income an attractive hold-to-maturity "marriage" candidate. Instead, for a growing subset of investors, fixed income is viewed as a "fun date" with capital appreciation being the sole attraction. This thinking is reinforced by all the fun dates over the prior two years as a result of a steady decline in bond yields driven by Federal Reserve purchase activity and follow on purchases from investors seeking more fun dates.

The big challenge facing these investors is determining the optimal time to break off the relationship. Break off too soon and you sacrifice enjoyment of more fun dates. Wait too long and your fun date can quickly turn into a fatal attraction. Few investors ever get the timing just right; with most erring on the side of continuing the relationship far too long.

Ending a prolonged dating relationship with a financial asset entails an important complexity not often encountered in terminating a romantic one – the need to find a replacement for your date. To break off a relationship with a financial asset, another investor must enter the relationship. However, trying to find a new investor when dating no longer seems fun can be a very expensive proposition. With market movements capable of wiping away years of income earnings on bonds within the course of minutes, investors can become quite noncommittal.

Unfortunately, for fixed income investors assuming there was no end in sight to Federal Reserve purchase activity and many more fun dates remained, it got late early out there in June. Last year, I concluded an end to Quantitative Easing would not result in a quiet exit, given the primary motivation for investing in fixed income. Instead, the slightest hint that policy accommodation was nearing its end would result in a chaotic evacuation.

Moreover, the price action in June was not in response to an announcement that the Federal Reserve was definitively ceasing QE activities or, even worse, initiating a sale of its security holdings. Instead, June's market reaction was in response to the announcement of a much more muted change in monetary policy – the potential for a near-term reduction in ongoing purchases. If the potential for a second order change in the QE purchase activities of the Federal Reserve resulted in the market movements experienced in June, what will the market impact be of an announced first order change in monetary policy?

The Human Element and Monetary Policy

Over the course of the prior two months, we estimate the market value of the Federal Reserve's security holdings declined by approximately $150 billion. To put this in perspective, I recall my first uncomfortable

trading loss as a young inexperienced trader in the late '80s – a loss of about $100,000. With more trading experience, I gradually became desensitized to losses of this magnitude, but regardless of my experience level, each time I encountered a trading loss of a magnitude I never faced before, it was unnerving.

Consider this normal human element in the context of decisions made by the members of the FOMC. Few, if any of these members, have any prior trading experience to aide with the desensitization process. Moreover, there is no one in the world with experience managing an investment portfolio of a size or risk comparable to that of the Federal Reserve's account. Therefore, it is unlikely that the FOMC members are completely desensitized to losses of such incredible magnitude. What influence, if any, did the most recent losses have on the June policy statement and what influence will hundreds of billions of dollars of potential losses down the road have on future monetary policy?

If FOMC members were questioned about the impact of large declines in portfolio value on policy decisions, the most likely response would be that portfolio holdings are not part of a trade and the change in portfolio value does not influence decisions. While this may be true for FOMC members, could the same be said for members of Congress? Rarely does a trader's telephone ring requesting an explanation of profitable transactions. However, the instant large losses mount, the whole world starts to converge on the trading desk demanding explanations.

If hundreds of billions of dollars of losses occurred in the Federal Reserve's portfolio, is it difficult to imagine Congress demanding an explanation from the Chairman of the Federal Reserve? Based upon prior testimony by the current Federal Reserve Chairman, the tact likely to be taken is to recount the positive profits that the portfolio has generated in the past and to explain that by holding the securities in the portfolio to maturity, the current mark-to-market losses will never be realized. Throughout my career managing traders, handfuls have attempted to use these arguments, with each resulting in immediate termination. I am not certain the Federal Reserve Chairman will fare any better using a similar tact. Therefore, it is likely portfolio losses will have at least a subliminal influence on future FOMC policy decisions.

Monetary Policy and Market Volatility

Paradoxically, the combination of large scale asset purchases by the Federal Reserve, along with attempts to improve policy transparency, will likely exacerbate market volatility. Policy transparency should not be confused with policy stability and certainty. The Federal Reserve has conditioned future policy actions upon the evolution of future economic data and provided some guidance on metrics that will trigger changes.

As the U.S. economy transitions into the later stages of recovery, economic data is liable to become more volatile and conflicting. The conditional nature of policy will heighten the perceived importance of each economic release and its market moving potential. With future monetary policy as uncertain as the volatile economic data it is predicated upon, the one certainty investors can be assured is heightened market volatility.

The volatility experienced in the market for Treasury Inflation-Protected Securities (TIPS) over the second quarter provides empirical support for the statement above. From the end of March to mid-June, real yields on TIPS with a maturity of two years increased by 135 bps. The last time a two-year Treasury experienced a comparable yield increase was in early 1994 as Chairman Greenspan embarked upon an aggressive

< Back to Page 1

policy tightening campaign. Yet, this recent market move was not related to any definitive policy tightening. But instead, was driven by participant fears that policy stimulus would be modestly reduced sooner than expected.

With the stated policy of the Federal Reserve to maintain short-term interest rates at zero for an extended period of time, nominal Treasury yields are essentially anchored and offer no insight into market expectations. However, real yields on short-term TIPS are free to move as a result of changes to near term inflation expectations. Almost the entire increase in real yields for short-term TIPS was a direct result of a significant decline in inflation expectations as market participants became concerned that the Federal Reserve would withdraw ongoing stimulus through asset purchases prematurely. Movements in the real yields of short-term TIPS will be driven by market expectations of the timing of policy withdrawal. If the expected withdrawal is perceived to be premature, short-term inflation expectations will decline with real yields rising. If the expected withdrawal is perceived to be too late, inflation expectations will rise with real yields declining. During the last week of June, as market participants began to reassess the likelihood of imminent policy withdrawal, inflation expectations rose and short-term real yields declined 50 bps, ending a quarter of unprecedented volatility for a short-term Treasury instrument.

Longer maturity TIPS experienced comparable volatility over the quarter, with the real yield on 30-year TIPS increasing by over 100 bps by mid-June. The reason for the rise in real yields for longer maturity TIPS had less to do with changes in long-run inflation expectations, and more to do with the manifestation of pricing by market participants based upon long-term economic fundamentals, rather than prices clouded by Federal Reserve central planning. For a brief period of time in June, market participants glimpsed market pricing more closely aligned to economic fundamentals and more commensurate with risk.

Opportunities in Tax-Exempt Bonds

Volatility was not contained to markets dominated by Federal Reserve purchase activity, i.e., Treasuries and Agency mortgage-backed securities. While yields increased significantly for these asset classes, after adjusting for the costs of embedded options, prepayment risks, taxes, and inflation expectations, the case for purchase is still not compelling for taxable investors. However, the case for tax-exempt bonds is very different.

In the last week of June, yields on long-term tax exempt bonds increased in excess of 100 bps, with tax-exempt yields for some of the most liquid and the highest credit quality issuers exceeding 4.5%. Mutual fund redemptions and exchange-traded fund redemptions triggered by retail share sales have resulted in a significant supply of tax-exempt bonds. Instead of focusing on the fundamental economic value of a tax-exempt bond – after-tax risk-adjusted yield in excess of expected inflation - mutual funds and ETFs focus investor attention on the daily price oscillations of the bonds. The substantial price declines experienced in June motivated widespread selling.

With the highest marginal Federal tax rate now at 43.4% (including the Medicare surtax) a 4.5% tax-exempt yield translates into a pre-tax equivalent yield of 7.95%. When considering long-term inflation expectations are currently priced at 2.5%, long-term tax-exempt bonds are certainly now worthy of marriage consideration!

< Back to Page 1

Rates, Inflation, Mortgages and Municipals

David Ho
MD, Asset Management
dho@fpcmllc.com
212-380-2292

Quick Read

- **Rates sell-off significantly affected all fixed income markets**
- **Inflation expectations came down during the quarter**
- **Yields for municipals are now attractive outright and relatively**

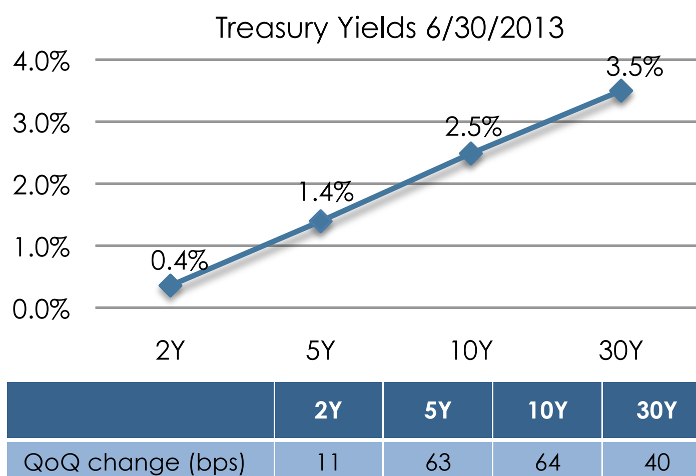
Liquid Rates

In 2Q2013, the liquid rates market sold off significantly on asset purchase tapering talk from the Federal Reserve. U.S. Treasuries widened 44 bps, LIBOR swap rates increased by 46 bps, and TIPS sold off 107 bps!

The sell-off was led by real yields, as seen by the abysmal performance of the TIPS market. Inflation expectations came down drastically over the quarter. For example, 10-year break-even inflation (the difference between 10-year nominal Treasury yields and 10-year TIPS yields) decreased to 203 bps at the end of June from 252 bps end of March.

In past rate sell-offs, break-even inflation typically increased as a result of heightened future inflation expectations which would elicit tightening action from the Fed. However, the market seemed to think higher interest rates would stymie nascent growth, boost the dollar, and crush commodity prices. These effects would exert downward pressure on inflation. We think the current disinflation fear is overdone. The most likely scenario is the economy will absorb higher rates and break-even inflation will widen out again.

Current expectations for the Fed include the start of tapering in September 2013 and completion of the asset purchase program by mid-2014. Fixed income investors have to ask themselves: with the largest buyer out of the picture within a year, where will yields be? We think yields will have to be attractive enough for long-term investors to step in the Fed's shoes. In the next year, if the economy experiences modest growth and if inflation is contained, a 3.25% nominal 10-year yield and 1.25% 10-year real yield might be able to attract long-term investors to replace the Fed.



	2Y	5Y	10Y	30Y
QoQ change (bps)	11	63	64	40

Mortgage-backed Securities

The MBS market sold off significantly and under-performed Treasuries and LIBOR swaps. For the quarter, the FNMA 30-year fixed-rate current-coupon mortgage rate increased by 70 bps.

While the Fed stressed that it would sell Treasuries before MBS, high premium dollar prices in almost the entire mortgage universe had investors on edge. At the first hint of higher rates, the mortgage extension buzzer sounded and a rush for the exits ensued.

Mortgage spread widening caused tremendous stress on MBS REITs, which own leveraged MBS positions with various degrees of interest rate hedges, but no hedges against mortgage spread widening. A downward spiral in the book value of these REITs increased leverage ratios. Consequently, REITs had to sell MBS holdings to bring the leverage ratios down and further exacerbated the MBS market. Unless mortgage REITs raise equity, future dividends may take a big hit. 2nd quarter earnings reports may cause further investor panic.

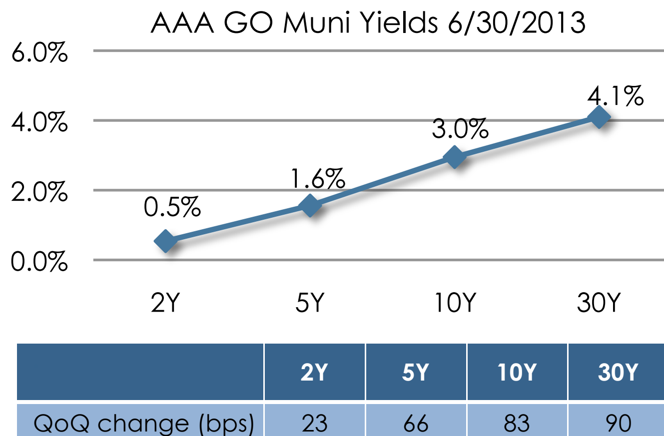
Liquidity in the MBS market is now poor.

While option-adjusted spreads (OAS) on most coupons appear currently attractive, they can only be taken advantage of by the few leveraged accounts that can hedge the delta and vega risks of MBS and have a long investment horizon. We do not recommend a net long mortgage basis, yet. We would particularly stay away from the most negatively convex portion of the coupon stack, i.e., 4.0% and 4.5% coupons.

Municipal Bonds

Municipal bonds sold off and significantly underperformed Treasuries and LIBOR swaps. For the quarter, Bloomberg AAA G.O. yields increased by 66 bps.

During the low interest rate environment of the last several years, retail investors had rushed into municipal bond mutual funds and ETFs due to their relatively attractive yields versus other fixed income assets - especially on a tax-adjusted basis. With increased fear about higher interest rates, retail investors quickly pulled money out. The forced selling by these funds placed tremendous downward pressure on municipals. Larger than normal inventory (in preparation for large calls/maturities in July and August) exacerbated the sell-off. During the three business day stretch from June 20th to 25th, the MMD scale rose by 60 bps, more than 3x the 10-year Treasury sell-off during that time.



	2Y	5Y	10Y	30Y
QoQ change (bps)	23	66	83	90

During the peak of the panic, some newly-issued municipals were trading north of 100 bps wider than issued. Some of the first bonds that came out of municipal funds were the most saleable: well-known, high credit quality names. Longer maturities were chosen to reduce duration exposures.

We find yields for munis highly attractive, on an outright basis and even more on a relative basis to other fixed income assets. Yields, especially on the long end, have reached levels close to where they were before the financial crisis. Yes, there could be more volatility if large fund redemptions continue, but investors are now getting yields that make sense long term.

< Back to Page 1

Corporate Credit

Mark G. Alexandridis
MD, Asset Management
malexandridis@fpcmllc.com
212-380-2293

Quick Read

- **Sell-off in the credit markets was particularly disorderly**
- **Volatility of the asset class likely to persist for the foreseeable future**
- **Opportunistic and/or dedicated investors can earn excess return**

The end of the innocence

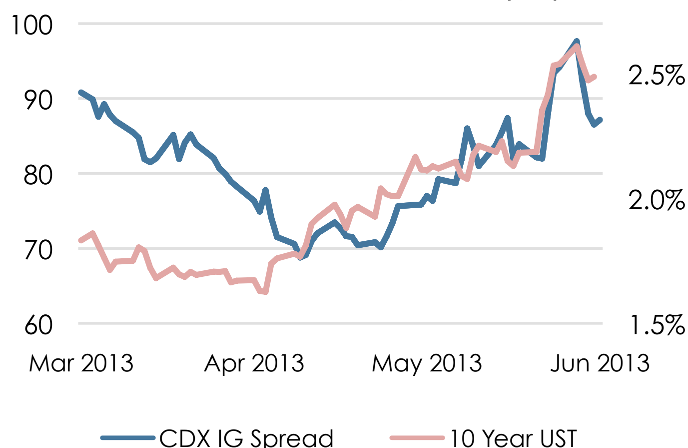
Unleveraged credit investors have been well rewarded post crisis. Improving corporate fundamentals supported lower spreads, and the Federal Reserve monetary programs suppressed underlying long-term rates. Episodic shocks (European sovereign debt crisis, domestic fiscal and debt ceiling emergencies) to the market were mitigated by lower Treasury yields as a consequence of the flight-to-quality.

The ability to select attractive credits was diminished by indiscriminate demand predominantly from: (1) traditional investors increasing their allocations to fixed income and (2) investors seeking equity-like returns with a fraction of the volatility and income. This narrative remained in place through April 2013.

That was then, this is now

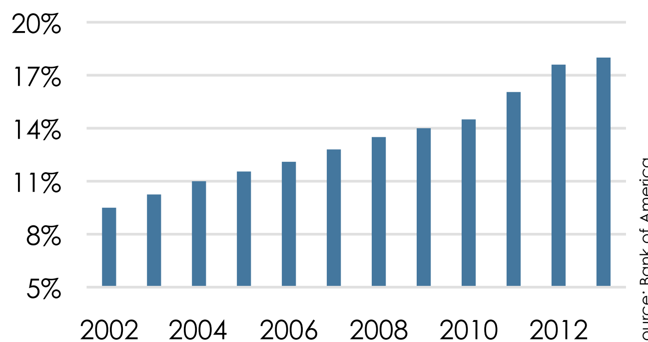
The stability of underlying Treasury rates and their

Figure 1. 10 Year Treasury Yield (rhs) and CDX IG Spread (lhs)



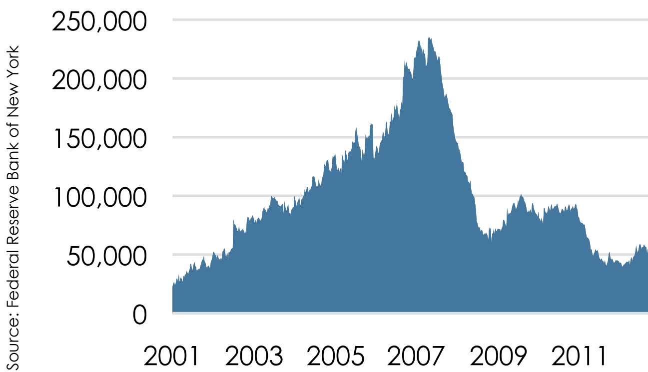
diversifying capacity during chaotic periods for risk markets came to an abrupt and largely unanticipated end in May as the Federal Reserve Chairman hinted that the latest QE program could be curtailed if the pace of the recovery so warranted. This resulted in a violent sell-off in Treasuries and most other asset classes. The experience in the credit markets (both investment grade and high yield bonds) was particularly disorderly as a consequence of the tsunami of credit ETFs (Figure 2) redemptions and the reduced capacity/appetite of the broker/dealers to place bonds on their balance sheets (Figure 3).

Figure 2. Corporate Bonds Held by Mutual Funds, ETFs, and CEFs



The toxic combination of a rising proportion of credit that is held with non-traditional investors and limited liquidity from the street is wont to increase the volatility of the asset class for the foreseeable future. Moreover, the liquidity premium between benchmark bonds and off-the-run bonds will continue to widen as ETFs and mutual funds buy/sell the most liquid issues first to accommodate large inflows/outflows. Fortunately, demand from pension and insurance funds materialized at higher yields/spreads experienced in mid-June.

Figure 3. Primary Dealer Corporate Positions > 1 yr [$mm]



Making lemonade

In an environment where the bias is toward higher rates, can opportunistic and/or dedicated investors earn excess return in the credit markets? The prevailing wisdom is that as rates lurch higher, credit spreads will follow. This behavior was evident during the Treasury sell-off in May and June.

Committed credit investors will be rewarded – in the absence of another surge in Treasury rates – by overweighting the following bonds/sectors: (1) off-the-run financials, (2) short-dated Ba/B high yield, (3) high-coupon yield-to-call/make-whole, and (4) BBB/BBB- Industrial credits.

Off-the-run Financials. The quality and quantity of capital at financial institutions is arguably better than it has been in decades. Additional regulatory proposals (e.g., strict leverage ratios) will continue to pressure these institutions to, at worst, transparently demonstrate that their risks are manageable and, at best, conform to tighter regulatory provisions. Current spreads (Barclays Capital Financial Institutions Index OAS is at 158 bps) and the marked improvement in the capital structure of the industry offer unsecured investors attractive risk-adjusted returns.

Short-dated High Yield. The fundamentals, the absolute level of yields (5.45% Barclays Ba/B 1-5 Year Index), and the fact that short rates are anchored for, at least, the next two years strongly support an allocation to this sector.

High-coupon Yield-to-call/Make-whole Bonds. The recent spike in Treasury rates has heightened the urgency for issuers to extend their debt profile at attractive yields. The probability of exercising premium calls and even make-whole calls at spreads well below where the underlying issuers trade has increased dramatically. With Yield-to-Call typically well above 2% for one to two year calls, these securities provide sufficient carry to offset the small probability of the call not being exercised. Some representative credits are: Petrohawk Energy (BHP), Wynn Resorts, Plains Exploration and Production, and HCA.

BBB/BBB- Industrial Credits. Given the expectations of continued recovery and higher growth in the US, solid corporate fundamentals, greater demand from pension and insurance funds at higher yield, and lower overall corporate issuance in the second half of 2013, it is probable that corporate spreads continue to tighten. With BBB Industrial spreads at 180 bps and a nearly 80 bps differential between A and BBB Industrials, there is ample room for spread compression at these levels.

< Back to Page 1

Emerging Markets Debt

Prasad Kadiyala
MD, Asset Management
pkadiyala@fpcmllc.com
212-380-2297

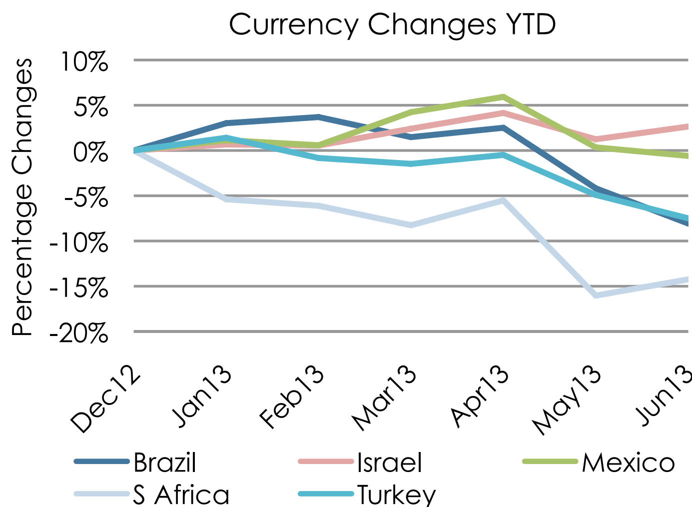
Quick Read

- **Emerging Markets were negatively affected by the movement in U.S. rates**
- **Local currency movements exacerbated the sell-off**
- **Real rates in many of these EM countries continue to be relatively high**

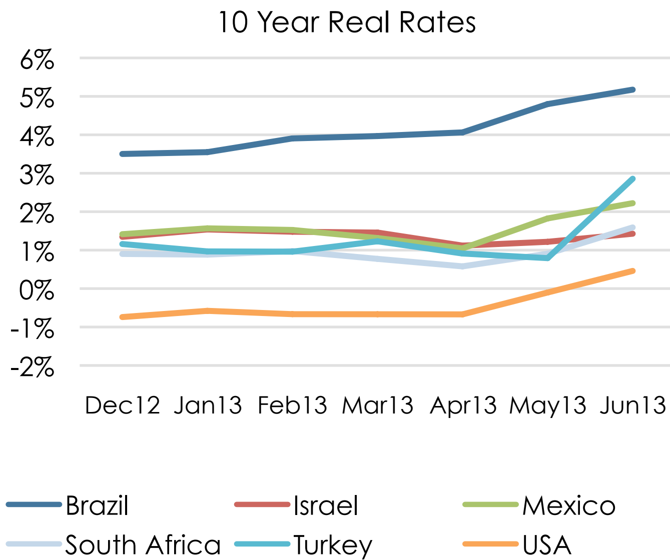
Quarter-end arrived in the midst of a tumultuous correction of the prevailing low interest rate regime in the U.S. The accompanying sell-off in the Emerging Markets (EM) was more severe. The JP Morgan EMBI Index (U.S. dollar- denominated EM bonds) lost 6.06% for the quarter while the GBI-EM Index (local currency bonds) moved -7.03%.

Market technicals and shifts in sentiment - as opposed to changes in economic fundamentals - triggered this sharp upward move in rates. JP Morgan and Bank of America research showed outflow of EM bond funds for June was around 4.6% of outstanding investments (approximately $12 billion). Larger outflows were observed from more liquid categories: EM sovereigns compared to EM corporates and EM hard currency funds compared to EM local issues. Institutional investors are now playing a more prominent role, likely motivated by low long-end rates in the U.S. and expectations of continued near zero short-end rates for an extended period. As a result, a segment of EM funds may exhibit higher correlation to long-end U.S. rates.

Interestingly, the observed rate moves are not predicated upon the traditional motivations for rate changes: an overheating economy or a flight-to-quality. Over the last year, while the U.S. has shown consistent signs of stabilizing and settling to a steady GDP growth rate of around 2%, many previously fast growing BRIC economies are exhibiting Developed Markets (DM) growth rates. This slowdown has aided the sharp drop in commodity prices over the past year, thereby, moderating inflation globally and lowering future expectations for inflation. Consequently, in the U.S. and elsewhere, inflation-linked securities have underperformed their nominal counterparts.



An outcome of increased U.S. rates is a sharp appreciation of the U.S. Dollar. The South African Rand is down 15% for the year; both the Turkish Lira and the Brazilian Real are down nearly 8% for the year. The severe and abrupt currency depreciation is likely to pass through to higher inflation over the next six to nine months. This phenomenon should be pronounced in South Africa and Turkey, two countries with significant imports. Rising realized inflation will flow through to inflation-linked securities thus making an investment in these securities more appealing relative to their nominal counterparts.



Overall, current sentiment and market developments continue to pose serious challenges to allocating assets to EM fixed income. The building expectations of a continuing retrenchment of U.S. interest rates is likely to keep pressure on local currencies and interest rates, at least in the short term. However, relative to DM, the fundamentals of EM countries continue to be more attractive, with better debt profiles and stronger growth prospects.

The real rates in many of these countries continue to be relatively high. In countries such as Brazil, an investor in inflation-linked securities would achieve a real rate above 5% and realize inflation above 6% for a total carry of over 10%. This should be an attractive entry point for a patient investor with a long term vision. These markets also tend to rebound the fastest when the investment environment normalizes.

< Back to Page 1

Asset Backed Securities

Richard Dolan
CFO
rdolan@fpcmllc.com
212-380-2283

Becky Li
VP, Asset Management
bli@fpcmllc.com
212-380-2296

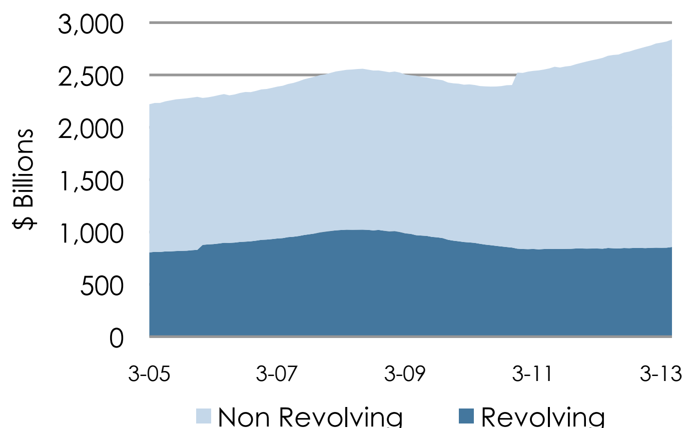
Quick Read

- **Credit expansion continues while credit performance stays stable**
- **Consumers have shifted away from higher-cost credit card debt**
- **Some lenders, such as in the sub-prime auto sector, have relaxed standards**

Continuing the trend seen in the past three years, consumer credit outstanding has reached yet another record high level. Since hitting a multi-year low of $2,389 billion in July 2010, U.S. outstanding consumer credit balances reached $2,839 billion in May 2013, according to the Federal Reserve. That represents a 19% consumer credit expansion over this period.

The majority of consumer credit expansion is in the non-revolving category (light blue in Chart 1), including auto loans/leases and student loans. Growth in auto loans has been driven by very strong auto sales in the past few years, from a seasonally adjusted annual rate (SAAR) low of 9 million in February 2009 to a multi-year high of 15.89 million in June 2013. Non-revolving credit outstanding was $1,983 billion, accounting for 70% of total consumer credit outstanding. On the other hand, revolving credit (in dark blue), which is primarily credit cards, was $857 billion - well below the peak level of $1 trillion reached in July 2008.

Consumers have shifted away from higher-cost credit card debt to lower-cost - as well as fixed rate (offering inflation protection) - auto loans and student loans. Consequently, the household debt



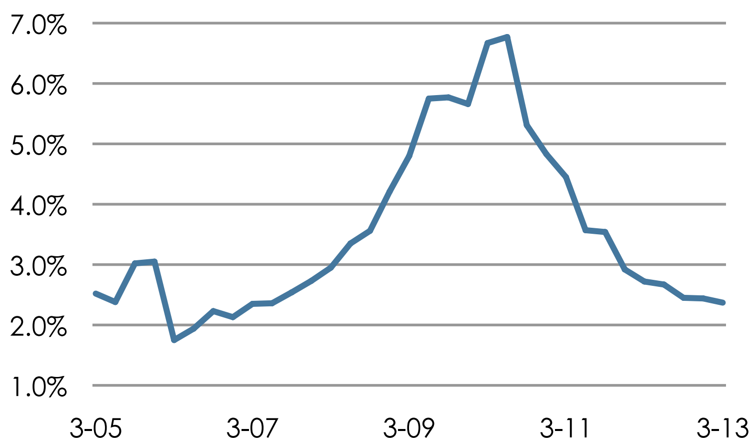
service ratio has fallen from a high of 14.05% in 3Q 2007 to a low of 10.49% in 1Q 2013, according to the Federal Reserve.

In line with strong auto sales and loans, auto ABS new issuance totaled $49 billion in the first six months of 2013, accounting for 53% of the $92 billion ABS issuance year to date. Student loan ABS accounted for 16% of total ABS new issue, credit card 15%, equipment 6%, and others 10%.

As interest rates rose across the board since May, the Barclays US Aggregate ABS index yield jumped to 1.28% on June 30, 2013, up from a year-to-date low of 0.87% on May 1, 2013.

While consumer credit has been expanding, overall consumer credit performance in the U.S. has continued to improve over the past three years. Performance in terms of charge-offs and delinquency has now almost recovered to levels prior to the onset of the credit crisis in 2007. We can see this clearly in Chart 2 based on Federal Reserve data on consumer loan charge-off rates at all U.S. banks.

The charge-off rate on all consumer loans was 2.37% in the first quarter of 2013, down from a peak of 6.77% in the second quarter of 2010. However, our expectation is for this data to slowly change direction over the next few quarters and trend upward. As employment improves, banks have relaxed their lending standards to accommodate the marginal borrowers with a lower credit profile.



Some lenders/originators, especially those in the subprime auto segment, have relaxed their lending standards since 2012. We've seen a slight pick-up in loan-to-value ratio, delinquency, and loss rates in the auto subprime sector. However, overall consumer credit performance still remains relatively strong, and much stronger than during the 2008 stress period.

Data sources: Bloomberg, unless otherwise stated

< Back to Page 1