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Bond Market Weekly

Week of December 22, 2008 | Municipal and Corporate Review

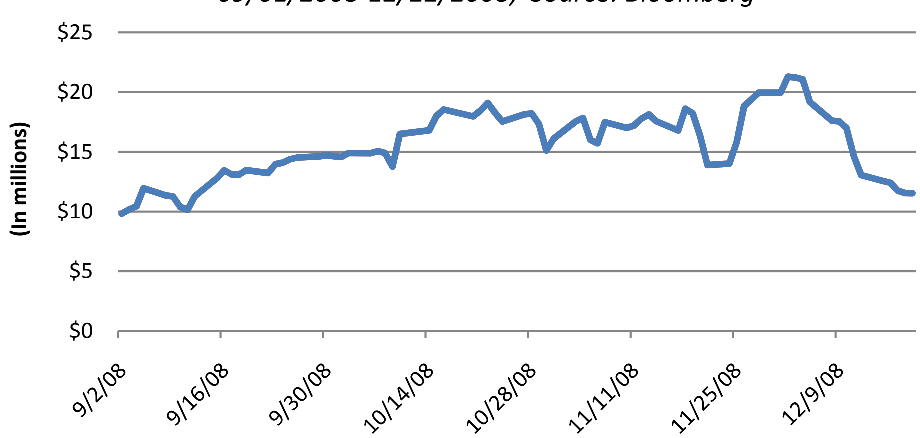
Market Overview

- The FOMC turbocharged a bond market rally last week with an unconventional post-meeting statement and a surprise move to a zero interest rate policy (Fed funds target 0-0.25%). An explicit statement indicating that the Fed was considering purchases of longer maturity Treasuries launched the long end of the curve higher in price and left the benchmark 10-year 44 bps lower in yield at 2.13% for the week. These support signals flattened the yield curve to +138 (43 bps lower) from 2- to 10-years, and +181 (47 bps) from 2- to 30-years.
- The Fed's action benefited nearly all fixed income markets. Even TIPS performed well despite fears of an eventual inflationary consequence to the Fed's policy. Breakeven inflation did experience a small uptick to -0.16% over the current 5-year horizon but the 5-year forward horizon moved 19 bps lower to just 0.58%. All in all, no signs of inflation fears in the bond market yet.
- Economic data released last week was much of a side show to the Fed; however, the data did confirm dire weakness in the economy and a quickly diminishing inflation picture. November CPI fell the greatest on record at -1.7% and brought the year-over-year change all the way down to 1.1% from 3.7% in October. Core inflation in November was unchanged from October and moved back to more comfortable levels at 2%. The holiday week ahead contains mostly second tier data and is likely to be listless with traders distracted. Traders are looking to an active January which is expected to mark the beginning of Fed's purchase of mortgages along with agencies as quantitative easing heats up.

Tax Exempt Markets

Bond Buyer US 30-Day Visible Supply

09/01/2008-12/22/2008; Source: Bloomberg



- Municipal bonds experienced a strong rally last week with 10-year bond yields falling 23 bps to 4.05% due to lack of new issuance, the belief that a January rally will occur, and the steep yield curve giving value to the roll trade.
- While this rally may continue through year-end on light volume, the typical January effect rally may not occur due to the persistent liquidity problems and investor concern in the municipal markets.
- The weakness in the municipal market has greatly reduced the number of new deals this year with expected new issue volume to be approximately 9% less than last year, according to Merrill Lynch. Most

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of these postponed deals must get sold at some point which could potentially put pressure on the market going well into 2009.

- Standard & Poor's downgraded 11 major financial institutions last week, which included many of the remaining national municipal dealers. This could continue to pressure the market as capital allocated to municipal trading continues to diminish and the commitment to the municipal market may wane as seen earlier this year when UBS decided to exit the municipal underwriting market.
- California seems closer to passing a new budget to deal with the looming deficit at the state level. Lawmakers found a way to circumvent legislative rules (which stipulate a 2/3 majority when passing new taxes or tax increases) by labeling existing taxes as fees and surcharges. Governor Schwarzenegger said he will veto the budget; however, it seems that all parties involved have at least come closer to an agreement.
- Most of our activity last week was focused on the sell side meeting client requests for cash before year-end. With the growing illiquidity in the market, and the Street closed at year-end, please be aware that liquidity will become more constrained. If possible, delaying cash requests until after the holidays would be most advantageous from a pricing stand point.

Taxable Markets

- With the exception of the MBS market, taxable bonds had a strong showing last week. Relative spreads in the corporate bond market improved as the Lehman U.S. Corporate Investment Grade Index option-adjusted spread (OAS) ended at +582 OAS, a 28 bps improvement from the prior week. Within the Index, Industrials tightened the most with a 34 bps improvement to +518 OAS. It seems the conviction demonstrated by the Fed last week has given confidence to investors in the corporate market.
- New issuance in the corporate market remained robust as issuer names like Walt Disney Co. and Proctor & Gamble Co. were well received. Disney issued $1 billion of a 5-year note to yield 4.72% (+338 bps to Treasuries) and P&G issued $2 billion of a 5-year note at a spread of +310 bps to Treasuries. FDIC-backed debt issuance accounted for about 72% of total issuance for the week.
- MBS spreads initially posted gains after the FOMC announcement but sold off over the course of the week as the reality of potentially lower mortgage rates set in, reflecting supply pressures and extension risk as premium coupons will likely be paid down and replaced with longer-duration 30-year 4% and 5% coupons. The Lehman U.S. MBS Index widened 6 bps to +150 OAS.
- Agencies continued their strong performance throughout the week. The Lehman US Aggregate Agencies Index rallied 20 bps to +102 OAS on the wording from the FOMC stating "it stands ready to expand its purchases of Agency debt and mortgage-backed securities as conditions warrant." Over the past few weeks, the Fed has purchased $13.4 billion of long-term Agency debt.