



Bond Market Weekly

Week of February 2, 2009 | Municipal and Corporate Review

Page 1 of 2

Market Overview

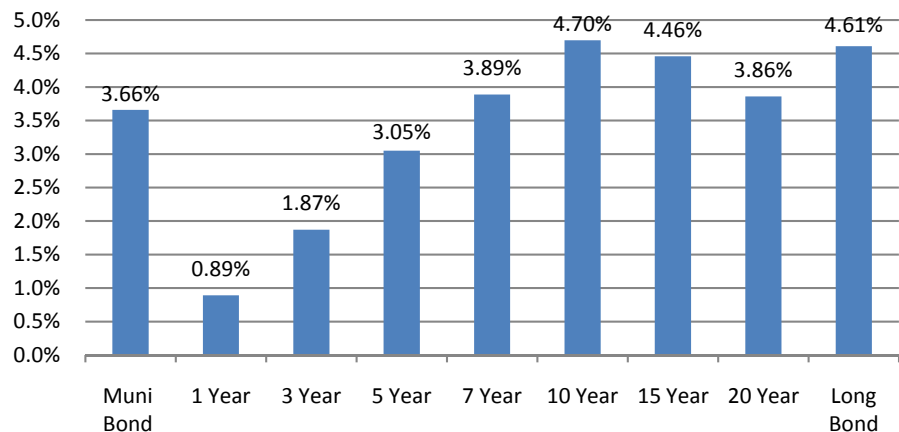
- The trend toward higher Treasury yields continued last week with the benchmark 10-year note rising 12 bps in yield to 2.84%. More angst over supply and stimulus in the form of a “bad bank” and pork-filled legislation continued to weigh on the market until late week indications of failures on both ends provided a respite from selling. The yield curve did steepen with 2- to 30-year spreads rising 7 bps to +189, while 2- to 30-year spreads moved 14 bps higher to +265.
- TIPS continued their recent outperformance in a big way with breakeven inflation rising 29 bps to +48 bps. Recall in late October of 2008 that this measure had a closing low of -58 bps. The 5-year forward measure is back up to +1.99% after falling to just +41 bps at year-end.
- Nothing terribly surprising came of the FOMC meeting with just one vote (Richmond President Jeffrey Lacker) for implementation of Treasury purchases. They did indicate a view that “inflation pressures will remain subdued over the coming quarters” and “downside risks” to their gradual recovery late in the year “are significant”. More of the same crisis management from the Fed with one step toward monetizing Treasury debt is now on the board. Check this week’s Barron’s for “Europe’s Growing Crisis Puts the Fed at Risk” article. This less covered aspect of Fed lending facilities has some worrying that the US is re-exposing itself to toxic assets thought to have been sold to the rest of the world.
- The highly anticipated Q4 GDP report surprised to the upside; however, details left the take much gloomier. The advanced (this number will be revised 2 more times) measure showed -3.8% growth over the quarter versus the expected -5.5%. The surprise lift came from a suspect inventory component which added 1.3 % to the figure. Many expected this component as drag of that magnitude. The take-away is either this fluky number will be revised in the upcoming release or Q1 and Q2 are likely to see a bigger drag from inventories that were expected to be felt in Q4.

Tax Exempt Markets

- The municipal bond rally was reignited last week with 10-year bond yields falling 12 bps to 2.80%, according to Municipal Market Data.
- January turned out to be an extremely positive month for the municipal market with the Barclays Capital 5, 10 and Long indices up 3.05%, 4.70% and 4.61%, respectively. Strong retail

Municipal Bond Indices MTD Total Returns

1/1/09-1/31/09; Source: Barclays Capital





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Page 2 of 2

Tax Exempt Markets

demand and a flight-to-quality away from stocks fueled demand for municipal bonds.

- ❑ Mutual fund inflows remained strong with \$289 million added during the week ending January 28th. This capped off an impressive month with close to \$2 billion deposited into municipal mutual funds, according to AMG Data.
- ❑ New issue volume was strong in January, up 22% over January of 2008, with \$22 billion sold during the month. This round of supply exhibited strong pricing and demand for high grade bonds did not hinder the market's rally.
- ❑ The calendar continues to be steady with the Bond Buyer 30-Day Visible Supply Index at \$10.8 billion. This week will see large new issues of \$610 million from the state of Georgia and \$950 million from the Los Angeles Unified School District.
- ❑ We focused on buying many new issues last week, including a Minnesota HFA issue, DC Water and Sewer, and Mecklenburg, NC. In addition, we were active in the secondary market with most purchases between 5 and 10-years.

Taxable Markets

- ❑ The corporate market had a strong week in part from a component of the stimulus bill making its way through Congress, and also due to technical factors. A portion of the stimulus bill defers income from the early retirement of issuers' buying their discounted bonds back in the open market, in effect, encouraging companies to use free cash flow to retire debt. Technicals were also in play as demand for debt has outpaced the lighter new issuance calendar relative to what had been expected. Companies sold \$46 billion of bonds last week, up from \$29.4 billion the week prior, but still it seems the new debt has not been as plentiful as last year's expectations.
- ❑ Spreads in the Barclays Capital U.S. Corporate Investment Grade Index tightened 29 bps to +481 OAS (option-adjusted spread) as the Industrials and Utilities sectors improved by 35 bps and 49 bps, respectively. Financials also saw an improvement of 10 bps to +603 OAS. Lower earnings and job cuts at companies such as Caterpillar and Boeing had little effect on spreads.
- ❑ Despite a big selloff Thursday, the MBS market held fairly steady on the week as the Barclays Capital U.S. MBS Index widened 8 bps to +107 OAS. Even with homes available for sale falling by 10%, the month's supply of unsold homes rose to a record of 12.9 months. It seems that despite housing affordability improving from lower prices and stabilizing mortgage rates, foreclosures are holding back the market. The National Association of Realtors reported that a substantial portion of December's 7.0% gain in single-family existing home sales were from distressed sales.
- ❑ The Fed reported that it has purchased \$26.3 billion of agency debt thus far with \$73.7 billion remaining to be purchased, although in the most recent FOMC statement it said FOMC stands ready to expand this purchase program as conditions warrant. The Barclays Capital U. S. Aggregate Agencies Index widened 5 bps on the week to +90 OAS.