



Bond Market Weekly

Week of February 23, 2009

Municipal and Corporate Review

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Market Overview

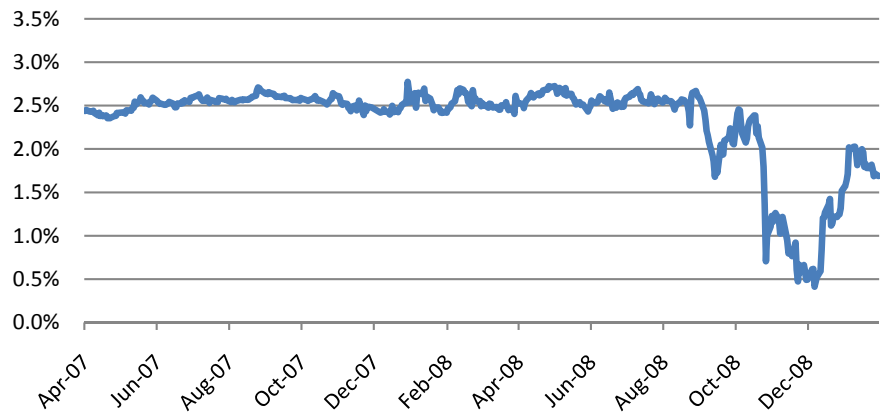
- US Treasuries traced a volatile week of trading as an again-reignited bout of global recession fears and upcoming supply competed for market attention. Ultimately, the benchmark 10-year note finished the week 10 bps lower at 2.79% as risky assets performed poorly (S&P500 -7% on the week). Buying favored long maturities the most as the yield curve flattened 7 bps to +185 from 2- to 10-year, while 2- to 30-year spreads dropped 9 bps to +262.

Also, reaffirmation from China on future purchases of US debt supported Treasuries. Given the large export share in China's economy, officials across the Pacific appear clear on the importance of shipping excess savings to the US.

- Breakeven inflation measures in the TIPS market moved lower across the board last week with the current 5-year horizon dropping 13 bps to +0.67%. The 5-year, 5-year forward measure moved slightly lower by 2 bps to 1.72%. FOMC minutes released from the January 28 meeting showed the Fed setting a targeted level of inflation at 2%. Given the stated benchmark, the preferred 5-year, 5-year forward measure offers decent litmus to the FOMC inflation temperament.
- Given most market watchers agree on the current severity of economic trouble, current data is largely inconsequential to market moves. Pricing data last week caught the eyes of some investors as PPI (Jan. headline +0.8% MOM vs. +0.3% estimate) and CPI (Jan core +0.2% vs. +0.1% estimate) surprised to the upside. But rather than stoke eventual stimulus related inflationary fears, investors largely dismissed the numbers as an aberration. Recent trading sessions seem to indicate that the market psyche is moving firmly back to the massive global economic malaise and away from theoretical inflationary costs of the clean-up.

U.S. 5-Year, 5-Year Forward Breakeven Measure

1/1/07-2/23/09; Source: Bloomberg



Tax Exempt Markets

- Municipal bonds weakened last week due to lackluster demand and a rally in the Treasury market. 10-year municipal yields rose 5 bps to 3.33%. Historically, March has been a weak month for municipal bonds. Investors have begun looking forward and reducing demand somewhat.
- New issues remain steady with the Bond Buyer 30-Day Visible Supply Index at a moderate \$11.6 billion. So far this year new issuance has stayed relatively steady and buyers have not been inundated with a flood of new issues. If this were to happen, market fundamentals could weaken considerably.
- Municipal bond mutual fund inflows continued to be positive with a \$534 million fund inflow last week, according to AMG Data. This retail demand could minimize any sell-off going forward, especially with the equity market's continued weakness.



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Tax Exempt Markets

- ❑ In bond insurer news, MBIA split off the public finance portion of its insurance company last week and put it into their existing MBIA Illinois, soon to be renamed National Public Finance Guaranty Corporation, which was rated AA- by S&P and Baa1 of positive watch by Moody's. MBIA will attempt to add capital to gain a stable AA rating and begin writing new business. Along the same lines, Ambac continues to try ramp up its Connie Lee insurance unit to do municipals only and has renamed it Everspan in the hopes of beginning to write new business. At the Bond Buyer conference last week, the President of newly formed Municipal Infrastructure Assurance Corporation (MIAC) spoke about this new entrant into the municipal market which expects to launch in the second quarter with AA or AAA ratings.
- ❑ Federal and municipal governments have also begun considering new forms of credit enhancement. Representative Barney Frank has put forth the idea of a federal bond insurer and the National League of Cities has proposed creating a mutual insurer to be funded by those municipalities utilizing it. The general consensus seems to be that the municipal market needs credit enhancement that it can trust in order to regain the liquidity that it has lost in the last 18 months.
- ❑ Trading was generally quiet last week as we only filled new accounts and specific needs in portfolios. We have become more cautious as yields have fallen dramatically in the last 45 days and are looking for relatively better points of entry.

Taxable Markets

- ❑ The Financial sector weakness dragged down the corporate market as investor concerns grew about the nationalization of U.S. banks. This sector of the index widened 44 bps to +643 option-adjusted spread (OAS). Overall, the Barclays Capital U.S. Corporate Investment Grade Index underperformed relative to Treasuries by 22 bps to +493 OAS. Industrials and Utilities also saw relative weakness with their OAS widening by 12 bps and 8 bps to +405 and +417, respectively.
- ❑ New issue demand continued to be strong for higher rated credit. \$33.9 billion of new investment-grade corporate debt was issued last week, up from \$11.8 billion the prior week. Demand was evident for strong names such as Swiss based Roche Holding (Aa1/AA-) and Honeywell (A2/A). However, lower rated credit saw poor demand. The high-yield market saw no new issuance as one company that tried to price a deal, Precision Drilling Trust, postponed its offering due to unfavorable market conditions.
- ❑ The MBS market was relatively unchanged for the week in the wake of the Obama administration's unveiling of the mortgage plan. The plan aims to raise the portfolio cap of Fannie and Freddie each by \$100 billion, provide refinancing for borrowers with loans-to-value in the 80% -105% range, and modify loans so that risky borrowers get to a 31% debt-to-interest target level. While the plan has been controversial, the impact to the overall MBS market has been muted as the Barclays Capital U.S. MBS Index widened 3 bps to +119 OAS.
- ❑ Agencies rallied by 4 bps to +78 OAS in the Barclays Capital U.S. Aggregate Agencies Index last week. Further capital commitment by the Treasury was exhibited with its increase to \$200 billion for both Fannie and Freddie and increasing the portfolio limit by \$50 billion for each.