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Bond Market Weekly

Week of April 13, 2009 | Municipal and Corporate Review

Market Overview

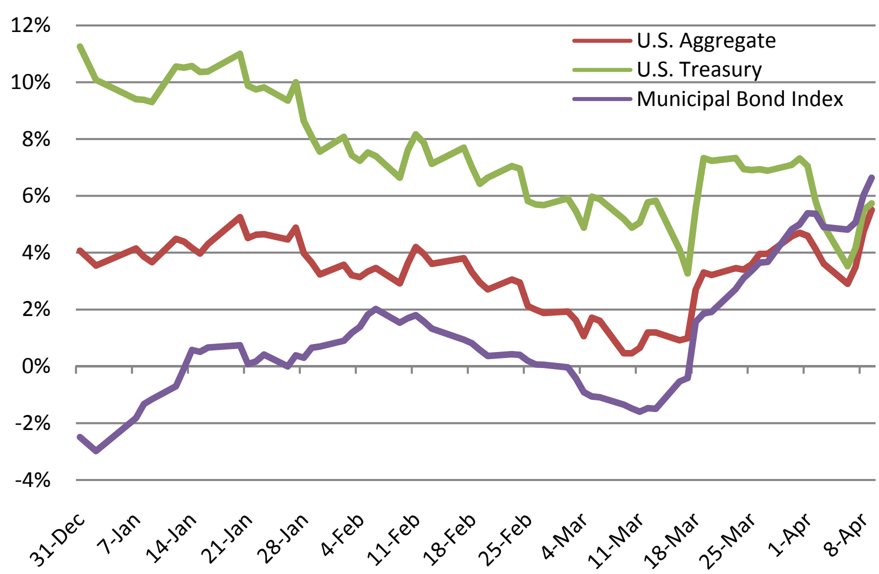
- Yields rose 3 bps on 10-year U.S. Treasury notes last week to close at 2.92%. The yield on the benchmark 10-year has remained within a 60 bps trading range (between 2.45% and 3.05%) since mid-January as concerns about substantial new Treasury borrowings have been offset by Fed buybacks, continued negative payroll reports and other weak economic news.
- The government sold $59 billion in notes last week to help fund disbursements to the states and other agencies as part of the American Recovery and Reinvestment Act of 2009.
- The TIPS break-even rate mostly unchanged on the week at 1.35%, which is up from near zero at the end of 2008 but well below the 5-year average of 2.25%.
- The Treasury market as a whole posted losses of 1.4% during the first quarter of 2009 which represents the worst start to a year for government debt since 1999.
- A "pre-announcement" by Wells Fargo of much stronger than expected earnings in the first quarter provided a boost to stocks and a firm bid for financial sector debt. Markets remain skeptical that other banks will follow with their own upside earnings news, but traders also remain encouraged that the unexpected profit could be an indication that the much-maligned financial sector is finally stabilizing.

Tax Exempt Markets

- Municipal bonds performed well last week with yields falling 1 bp on 10-year bonds to 3.42%. Activity was muted due to the holiday shortened week and the general lack of new issuance.
- Forward supply remains reasonable with the Bond Buyer 30-Day Visible Supply Index at $11.8 billion which should mitigate downward pressure on prices going forward. Highlighted new issues this week include $400 million for the state of New Jersey as well as an additional $400 million for the state of North Carolina.

6-Month Trailing Total Returns Trend Towards Parity

12/31/08-4/9/09; Source: Barclays Capital



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Tax Exempt Markets

- Retail continues to show strength in this market with the Investment Company Institute reporting that $1.09 billion of inflows were recorded in tax exempt mutual funds for the week ending April 1st.
- In bond insurer news, Moody's downgraded Berkshire Hathaway Assurance Corp. (BHAC) to Aa1 from Aaa. BHAC was the last insurer with Aaa ratings held by all of the ratings companies. The downgrade was the result of the guaranty weakness by the Berkshire subsidiary Columbia Insurance Company.
- Moody's assigned a negative outlook to the entire U.S. local sector citing weak economic fundamentals across the board and general budgetary stress. We do not find this terribly surprising given the current state of the economy. Moody's did, however, state that most issuers will not see a reduction to their credit rating. WSC view's this ratings shift as potentially beneficial for investors as local municipalities will have to focus more closely on transparency and good budgeting in order to maintain their credit ratings.
- Some small municipalities in Tennessee are coming under scrutiny (as are their financial advisors) for entering into complex derivatives agreements which have now saddled many local governments with large swap termination payments and rising interest payments. The state of Tennessee advocated presentations on derivatives to these communities who then took the word of the investment bankers that they were appropriate for the communities in question. It has come to light, much like in Jefferson County, Alabama, that these swaps were unjustified for municipalities without the sophistication or staff to analyze these instruments. The U.S. Congress in looking at regulating this industry. We will likely see more problems at the local level for issuers who got in trouble with swaps.
- Our activity was generally muted last week, but we did purchase new issues for Kent, WA and Honolulu, HI. Selling pressure was not evident and for the most part liquidity remains reasonably strong.

Taxable Markets

- The corporate credit market showed strength last week on the news that the Treasury may allocate TARP funds to life insurers and the Wells Fargo pre-announcement that its Q1 earnings will be much better than earlier consensus estimates. Corporate spreads tightened 13 bps in the Barclays Capital U.S. Corporate Investment Grade Index to +519 OAS. The financial sector outpaced gains of the other sectors with a 24 bps rally to +732 OAS from the rally in life insurers and bank names.
- Other signs of life in the corporate realm included Pulte Homes' announcement that it would acquire Centex and from Bed Bath & Beyond exceeding Q4 estimates.
- New issuance was very light with less than $4 billion of debt priced.
- The MBS market also experienced a significant rally last week with spreads coming in 22 bps to +74 OAS in the Barclays Capital U.S. MBS Index. Mortgage origination remains strong as rates have dropped recently, but it appears that it is being outpaced by the level of daily Fed buying.
- Agencies also participated in the rally with spreads 5 bps tighter to + 68 OAS, again on Fed purchases.