



Bond Market Weekly

Week of April 20, 2009 | Municipal and Corporate Review

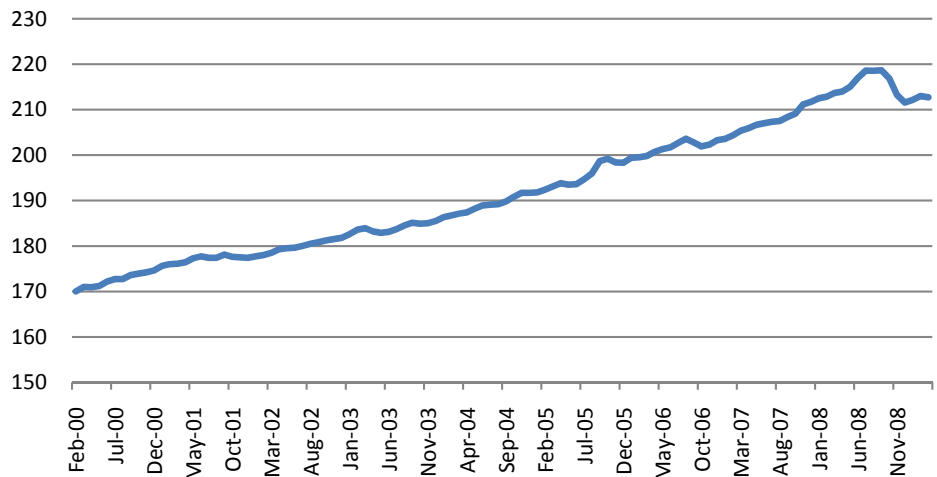
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Market Overview

- Yields on benchmark 10-year U.S. Treasury notes rose 3 bps last week to 2.95%, after falling as low as 2.77% on Wednesday following favorable inflation news. Better earnings from large banks and General Electric added to a generally upbeat sentiment in spread product with high-yield bonds showing particularly strong returns on the week.
- The CPI fell 0.4% year-over-year in March, the first such decline since 1955, according to the Labor Department. The drop in the CPI, combined with comments from Fed officials and market players, provided more fuel to the debate on the inflation outlook. In speeches on April 18, Fed Vice Chairman Donald Kohn and New York Fed President William Dudley said that the central bank's emergency lending programs won't lead to a surge in inflation. The speeches followed comments by Goldman Sachs that, "Deflation is a much bigger threat than inflation, at least for the next few years."
- The Treasury is expected to announce today how much it plans to raise in five-year TIPS during their scheduled auction on April 23.
- The Fed will buy Treasuries on Tuesday and Thursday of this week maturing between 2012 and 2019, according to the Fed's web site, as part of the previously announced \$300 billion Treasury purchase program designed to help lower consumer borrowing rates. Last week, 30-year fixed-rate mortgage yields fell to 4.82% from 4.87% a week earlier. The yield difference between mortgage rates and 10-year Treasuries of 1.91% is down from a 3.07% on December 19, 2008 which was the highest differential since 1986.

Consumer Price Index

1/1/2000-4/20/2009; Source: Bloomberg



Tax Exempt Markets

- Municipal bonds roared to life this week with yields on 10-year bonds falling 16 bps to 3.24% despite a rise in U.S. Treasury yields.
- Unlike previous weeks, new issuance was relatively slow while retail demand remained strong. Only \$4.6 billion of new issues were sold last week, down from the prior week's \$5.4 billion. Now that the April 15th tax date is behind us, the market's concerns of large secondary selling have diminished.
- Inflows into tax exempt municipal funds have been strong this year with a record \$13.9 billion added in the first quarter, according to AMG Data Services.



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Tax Exempt Markets

- ❑ The forward calendar remains somewhat muted with the Bond Buyer 30-Day Visible Supply Index at a manageable \$11.8 billion. New issues this week will include \$600 million for the New York MTA and \$600 million for the Miami Airport. The most anticipated deal will be \$3 to \$4 billion in taxable California State Gos, most of which will be Build America Bonds (BABs).
- ❑ This week will be highlighted by Build America Bonds, a program which allows issuers to sell taxable municipal bonds for new infrastructure projects and provides the issuers with a check for 35% of the coupon from the U.S. Treasury. This was successfully tested by the University of Virginia which sold 30-year bonds that tightened about 20 bps on the break. By our estimation, the university saved roughly 100 bps through the use of the BABs structure.
- ❑ Rep. Barney Frank continues his call for Federal support for the U.S. municipal market with an FDIC like guarantee for general obligation issuers. He believes that municipalities are paying too much to issue debt because they are underrated and that a Federal guarantee would solve this problem. While this could potentially lower yields on municipal bonds, it also introduces moral hazard risks whereby municipalities become more prone to fiscal excess and default because the Federal government is the only one harmed. How such legislation might ultimately be worded will be of utmost importance and these deliberations will be the focus of the market's attention for quite some time.
- ❑ We purchased a number of new deals last week, including a AAA rated Oklahoma Housing issue and bonds for the Santa Clarita, CA Community College District with a AA- issuer rating and insured by Assured Guaranty. We are finding some value in the California market as investors have shied away from credits in the state as a whole. Our belief is that many credits in California are being unduly penalized by the market and may provide good relative value going forward.

Taxable Markets

- ❑ The corporate market was much stronger on the week. Positive earnings announcements helped push spreads 36 bps tighter in the Barclays Capital U.S. Corporate Investment Grade Index to +483 OAS. The week started with JP Morgan and Goldman Sachs surpassing Q1 earnings expectations followed by releases later in the week from General Electric and Citigroup that also beat estimates. Both JPM and GS stated their intentions to pay back TARP money as soon as possible but JPM went one better by issuing debt without any FDIC backing.
- ❑ Corporate new issuance was highlighted by JPM's \$3 billion 10-year issue priced at +350 to yield 6.32%. On a stand-alone basis this was their first issue since August of 2008. The deal was partly symbolic since they could have funded more cheaply under the TLGP-FDIC program, but they proved they could raise capital on their own. Altogether, it was a quiet week in issuance with about \$12 billion of investment-grade paper priced. The issues in which we selectively participated were JPM, Portland General Electric 10-year first mortgage bonds at +325 and Emerson Electric 6-year bonds at +245.
- ❑ The MBS market was relatively quiet last week. Mortgage rates continued to drop. The FHLMC weekly survey of 30-year mortgages was 4.82% compared to 4.87% on April 9th. Prepays of agency MBS are expected to bring increased supply; however, this overhang should be partially absorbed by Treasury purchases which were \$30.4 billion for the week and \$529 billion YTD. For the week, spreads ended 4 bps wider to +78 in the Barclays Capital U.S. MBS Index.
- ❑ Agencies were mostly unchanged with spreads ending the week at +67 OAS compared to +68 OAS the prior week. TLGP issuance in April has been the lightest so far since the program started in November of 2008. We expect this number will increase after bank stress tests are revealed in early May.