



Bond Market Weekly

Week of May 11, 2009 | Municipal and Corporate Review

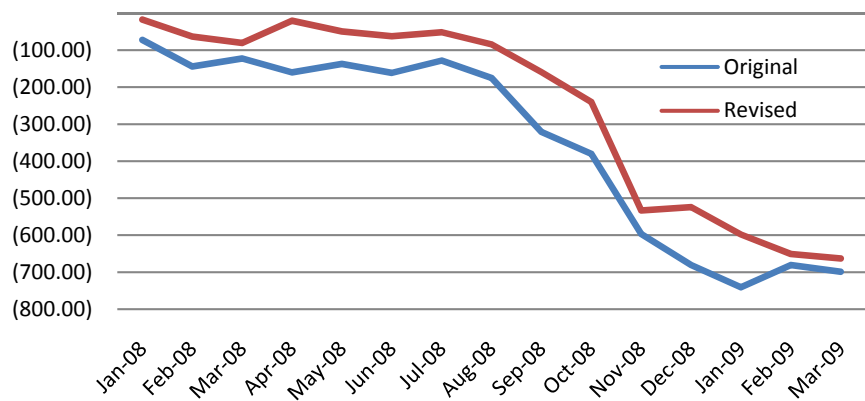
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Market Overview

- ❑ The end of a relentless 2-week period of new supply along with an ever growing “recovery” theme and stress test relief led US Treasuries to another down week. The benchmark 10-year yield rose 13 bps to 3.29% by Friday afternoon. The recovery theme continues to move the yield curve steeper with 2- to 10-year spreads rising 7 bps to +231, while 2- to 30-years rose 14 bps to +330.
- ❑ The absence of language supporting further Fed intervention beyond original intentions in the April FOMC statement, as well as Chairman Bernanke’s comments last week, signaled the Fed is not targeting a specific level of long rates and has knocked a significant leg out from under the market.
- ❑ TIPS yields countered nominals and moved lower on the week. Breakeven inflation by Friday afternoon had jumped 14 bps over the current 5-year horizon to 1.04% while the 5-year, 5-year forward horizon held steady at 2.23%. These measures indicate some improvement from the recent economic contraction; however, a longer-term low growth/moderate inflation recovery still seems likely.
- ❑ Last week’s economic data continued to improve and stoke the recovery euphoria. Most notable were employment data such as ADP Employment Change (April -491k vs. March -708k), Initial Jobless Claims (601k vs. 635k prior week) and Nonfarm Payrolls Change (Apr -539k vs. March -699k).
- ❑ Glass half-full analysis is winning the day across most markets recently but we offer some sober assessment. This downturn is unique in its consumer driver nature and therefore unemployment is likely not to be as lagging of an indicator as previous corporate driven recessions have shown. Thus an honest assessment of the employment data is necessary and telling.
- ❑ Nonfarm payrolls have on average been revised to 106,000 jobs lower than original estimates since July. Thus April’s 539,000 original print versus an estimate of 600,000 should be taken with a grain of salt despite the quick conclusions in the media. Ultimately, a truly improving consumer via jobs, income and deleveraging will be the core of recovery and reason for sustained stock and credit recovery.

Monthly Nonfarm Payrolls Change

1/2008-3/2009; Source: Bloomberg



Tax Exempt Markets

- ❑ Municipal bonds were essentially flat on the week with 10-year yields falling 1 bps to 3.28%. Municipals were able to hang on to gains from April despite significant weakness in the Treasury market.
- ❑ Last week saw about \$5.2 billion of tax exempt issuance and a smaller forward calendar. 30-Day visible supply stands at slightly less than \$10 billion down from \$13 billion last week.



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Tax Exempt Markets

- ❑ Tax exempt municipal flows remained strong this week with the exception of California specific funds which experienced modest outflows.
- ❑ News broke late Friday that Treasury Secretary Timothy Geithner wrote a letter to Representative Barney Frank stating the Treasury was “evaluating” ways to help state and local governments. Geithner explained, “We are in the process of evaluating whether there are additional actions we could take to help improve municipal debt markets.”
- ❑ Although absolute yields came in with April’s rally, credit spreads in the municipal market remain near record highs. According to the Municipal Market Data line, the spread between AAA and BBB rated securities is 340 bps.
- ❑ A report released from California’s Legislative Analyst office highlighted California’s ongoing budget issues. On the heels of a budget solution that closed a \$42 billion budget gap, it appears that the gap is re-emerging. State Controller John Chiang is now indicating that the State will face a \$8 to 22 billion budget gap in the current fiscal year depending on the May Special Election results. As California lawmakers consider various options, State Legislators have begun their lobbying in Washington as they seek U.S. Government debt guarantees. California has indicated that they have no current needs for the funds, but they do project a cash flow squeeze that will require additional debt issuance. In California the only payment senior to debt service coverage is K-12 education, which provides bondholders a certain level of comfort. States that are highly dependent on income tax, such as California are going to continue to have budget issues that require close attention. While California no doubt will remain prominent in the headlines, we continue to feel that they will make the needed budget adjustments that will get them through this difficult period.

Taxable Markets

- ❑ The corporate market was very strong last week. Spreads tightened 33 bps to +407 OAS in the Barclays Capital U.S. Corporate Investment Grade Index which correlated to the improvement in the equity markets. Financials were particularly strong as spreads tightened 62 bps to +570 OAS. As news of the much anticipated Treasury stress-tests for the biggest U.S. banks leaked to various media outlets, spreads compressed in relief of what many had feared would be much worse capital requirements. Concerns had been that the requirements would have been too great for non-government capital but that turned out not to be the case. A few banks that required additional capital were very quick to raise new equity such as Wells Fargo which raised \$8.6 billion within hours of the test results (\$1.1 billion more than targeted).
- ❑ Corporate new issuance was robust from such names as Bank of America, GE Capital, Proctor & Gamble, Husky Energy, and International Paper.
- ❑ The MBS market showed improvement as well with spreads 7 bps tighter on the week to +64 OAS. Prepayment speeds for April were released that showed prepayments that were less aggressive than expected. Despite average mortgage rates dropping from 5.09% to 4.93% aggregate speeds were up only 2% CPR. One theory for prepayments being less robust than prior refi spikes is because the refi process now entails more coordination with second lien lenders in order to bring down borrowers’ total loan-to-value balances than in prior periods.
- ❑ The most recent FHLMC survey last week showed a 6 bps increase in 30-year mortgage rates to 4.84%. The Fed purchased \$73.9 billion in agency-backed MBS bringing the total to \$704 billion YTD.