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Bond Market Weekly

Week of June 1, 2009 | Municipal and Corporate Review

Market Overview

- A tough early week for US Treasuries found salvage late as heavy mortgage convexity selling and $101 billion of new 2-, 5- and 7-year maturity supply gave way to disappointing economic data and press chatter of an attractive entry point for investors.
- The benchmark 10-year maturity finished just 1 bp higher in yield at 3.46%, or 28 bps better than the Wednesday close. The yield curve flattened by 2 bps over the week to +254 from 2- to 10-years, while 2- to 30-year spreads dropped 8 bps to +342.
- Shorter-term inflation expectations in the TIPS market continue to rebound from severely depressed levels with the current 5-year horizon measure rising 21 bps to +1.41%. The trend, however did not hold across the 5-year, 5-year forward period which dropped 8 bps to +2.43%. The latter is a peculiar move given the recent weak dollar trend. As a result of this rebound, and the likely push through of headline inflation to the core as the year wears on, the relative performance potential of TIPS appears to be facing increasing headwinds.
- The surge of "green shoot" anecdotes that has propelled the weakness in Treasuries appears to be fading a bit. Contrary evidence lined up this week in the form of poor underlying details of revised March and April durable goods orders (nondefense capital goods ex aircraft -1.5% April while March revise from +0.4 to -1.4%), a surge in the Mortgage Bankers Association delinquencies and foreclosures to 9.1% in Q1 (prime 6.1% vs. 5.1% in Q4), a significant lower revision in Q1 personal consumption (+1.5% vs. advanced estimate 2.2%), a disappointing Chicago Purchasing Manager survey (34.9 May vs. 40.1 April) and the eminent bankruptcy of General Motors.
- The week ahead provides more evidence via ISM Manufacturing data, personal spending, chain store sales and employment data. Expectations of 9.2% unemployment place it just 0.8% below the "stress test" banking assumptions and approaching very critical levels.
- Supply concerns do ebb a bit for Treasuries as well as the next round of 3-, 10- and 30-year maturities are set for auction the following week.

Tax Exempt Markets

- Municipal bonds sold off last week due to lack of demand and a weak Treasury market. 10-year bond yields rose 8 bps on the week to 3.26%.
- Despite the drop in municipal issue volume during the holiday shortened week, it is difficult to determine if the sell-off trend will continue.
- Forward new issue activity has begun to rise with the Bond Buyer 30-Day Visible Supply Index at $14.9 billion, the highest level since March 24th. Some market participants believe that much of the June 1st redemption money has been invested already, however the degree of foresight remains unclear.

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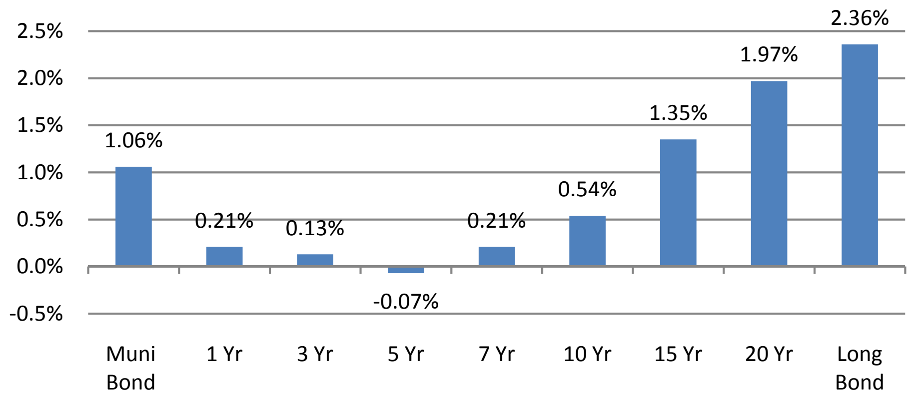
Tax Exempt Markets

Municipal Bond Index MTD Total Return
Source: Barclays Capital



- This week has a large slate of deals all over the country with $600 million for the NY TFA, $440 million for the Arizona Transportation Board and $310 million for the Washington Metropolitan Transit Authority. The high yield market will also be tested this week with $283 million in general obligation bonds for Guam which are rated B+ by Standard and Poor's.
- Municipal returns for May continued this year's trend as longer bonds outperformed shorter maturities. The attached chart shows the only portion of the curve to have negative performance for the month was the 5-year bonds, as investors become increasingly dissatisfied with the low absolute yields in the 5-year portion of the curve.
- Our activity was largely in the secondary market last week with a large purchase of 15-year bonds for the Collier County School system here in our own backyard. Bids have remained rather strong and we have had success offering bonds into the market at what we consider to be rather rich levels.

Taxable Markets

- Corporates had another strong week, but the same could not be said for the MBS market. Spreads in the corporate market continued their grind outperforming Treasuries. Participation was observed in each of the major index sectors with Financials leading the way tightening 45 bps to end the week at +463 OAS. Overall, the Barclays Capital U.S. Corporate Investment Grade Index outperformed Treasuries 30 bps for the week. YTD the corporate market has tightened 203 bps with a 5.44% total rate of return. As GM's bankruptcy loomed last week, the corporate bond market was unaffected.
- The MBS market ended slightly weaker after a volatile week, heightened by a sell-off Wednesday on top of the Treasury sell-off and its subsequent rally Friday. The Barclays Capital U.S. MBS Index ended the week 9 bps wider to +39 OAS. The rapid Treasury sell-off caused MBS buyers and servicers to rebalance for duration extension which was largely reversed during Friday's Treasury rally whereby MBS investors bought Treasuries to hedge for MBS refinancing risk. Overall, selling pressure this week reflected investor concerns that they may not be adequately compensated for negative convexity risks as volatility increases.
- Agencies were another 7 bps better for the week ending at a +46 OAS in the Barclays Capital U.S. Aggregate Agencies Index amidst the broad rally in spread products. The bulk of the strength came in the short end of the curve.