WASMER, SCHROEDER & COMPANY, INC.
Investment Advisors
600 5th Avenue South, Suite 210
Naples, Florida 34102
wasmerschroeder.com
T 239.263.6877
F 239.263.8146

# Bond Market Weekly

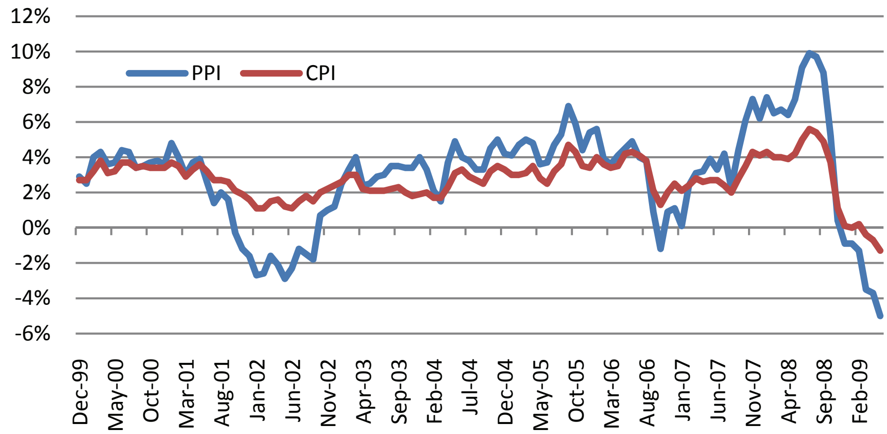
## Week of June 22, 2009 | Municipal and Corporate Review



## Market Overview

**PPI Index vs. CPI Index YoY**

*12/31/1999-5/31/2009; Source: Bloomberg*




- A choppy week of economic news and a respite from additional supply allowed US Treasury yields to hold their ground and in some maturities find positive performance. The benchmark 10-year was a weaker area of the yield curve with just a 1 bp drop to 3.78%.
- Both tails of the yield curve performed better than intermediate maturities which pushed the 2- to 10-year spread 4 bps higher to +257, while 2- to 30-year measure narrowed 7 bps to +331.
- A flattening of the TIPS yield curve countered the recent trend in inflation breakevens. The current 5-year horizon inflation breakeven rate dropped 12 bps to 1.57%, while the 5-year, 5-year forward horizon rose 14 bps to 2.43%.
- Markets seem to be at crossroads. Huge rallies in commodities, credit and equities as well as sell-offs in safe-haven US Treasuries, appear a bit exhausted and in need of further impetus beyond “green shoots” to continue. Thus trading has become volatile and disjointed as the markets await clear information on the second half of 2009 landscape.
- Economic data and corporate earnings will likely take center stage as market drivers. US Treasuries have a tailwind in inflation data as last week’s producer price index (PPI) and consumer price index (CPI) reports were better than expected. Headline CPI was -1.3% year-over-year in May, while the core measure dropped to 1.8% year-over-year. The PPI points to further pressure in downstream pricing (CPI) as the headline reported a -5% year-over-year. Crude goods used in the initial stages of production are lower 41% plus from the previous year. Using the flawed measure of “real” 10- year Treasury yields with trailing inflation places the 10-year Treasury “real” yield at a hefty 5.08%.
- The week ahead includes a fair slate of economic data but will likely center around supply digestion ($104 billion of 2-, 5- and 7-year maturities) and the FOMC meeting statement. Recall, US Treasuries began to find support in reaction to Chairman Bernanke’s “not monetizing the debt” comments a few weeks back. We will see more of the dance between appropriate Fed stimulus and hawkish rhetoric aimed at the “vigilantes”.

## Tax Exempt Markets

- Municipal bonds were slightly stronger on the week. 10-year municipal yields dropped 4 bps to 3.45% for the week, as the municipal bond market absorbed $9 billion in new issuance.
- The coming week will bring a number of new deals as $6.5 to $8 billion is scheduled to come to market. The Bond Buyer 30-Day Visible Supply Index stands at a healthy $13.2 billion, which will continue to pressure municipal yields. The pressure should be somewhat abated by a looming July 1 coupon and maturity reinvestment.

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## Tax Exempt Markets

- California's credit rating, already the lowest of all U.S. states, may be at risk for a downgrade by Moody's in the coming weeks. Last week, Moody's cited the Legislatures' lack of actions and dire cash situation while placing the State on Watch for Downgrade. Standard & Poor's and Fitch had put the State on watch earlier as California continues to haggle over a burgeoning budget gap. An update to Wasmer Schroeder's report on California can be found at http://www.wasmerschroeder.com/uploads/privatefiles/47.pdf.
- On Friday Everspan, Ambac's effort to launch a standalone municipal-only bond insurer was postponed indefinitely. Ambac was attempting to raise enough capital to quality for a strong credit rating from the ratings companies, which would allow them to write new business once again. The company was unable to raise the needed capital in the current market. David Wallis, Ambac's CEO said, "Postponing this strategic initiative was a difficult decision. We will closely monitor the capital markets and will revisit this opportunity when the economic environment has stabilized."
- This week the Virgin Islands Finance Authority will come to market with $250 million in Rum Tax bonds. The bonds are being issued to help Diageo finance a new distillery for the Captain Morgan brand. The bonds are backed by "matching fund revenue" which is a subsidy paid by the U.S. Treasury to the Virgin Islands Treasury based on the number of gallons of rum exported to the U.S. The money paid by the U.S. comes from rum excise taxes and used by the Virgin Island for capital improvements.

## Taxable Markets

- The MBS market had significant gyrations; however, by the end of the week netted a modest gain. Early in the week the 5% coupon MBS continued the rally that began the prior mid-week with yields falling about 50 bps. However, with the Treasury selloff on Thursday, these current coupons gave up about half of those gains. Conventional 30-year MBS yields ended the week at 4.77% (FHLMC 5% for July settle) and the Barclays Capital U.S. MBS Index ended the week 7 bps tighter at +35 OAS.
- The corporate market was fairly quiet despite developments regarding financials. Spreads remained unchanged at +307 OAS (Barclays Capital U.S. Corporate Investment Grade Index). The administration announced its plan to overhaul the regulatory framework of the financial system ,but the news had little effect on the market. In other news, pertaining to financials was the S&P action that downgraded 18 banks, mostly regionals, based upon structural changes to the industry such as tighter regulatory supervision and greater volatility during credit cycles.
- New issue corporate volume fell again last week to $17.5 billion according to Bloomberg with Comcast and Deutsche Telekom headlining the names (each rated Baa1/BBB+). Comcast sold $1.5 billion among 10- and 30-year issues each at +200 to comparable Treasuries. DT also sold $1.5 billion but among a 5-year at +225 and a 10-year at +237.5 to respective Treasuries. General Dynamics (A2/A) ended the week with a $750 million 2-year priced at +80 and which was reportedly 4 times oversubscribed.
- Agencies were slightly weaker as the 5-year part of the curve dragged performance. Freddie Mac issued $3 billion of a 5-year note that added to supply, pushing spreads out about 10 bps. Overall spreads were 3 bps wider ending the week at +44 OAS in the Barclays Capital U.S. Aggregate Agencies Index.