



Bond Market Weekly

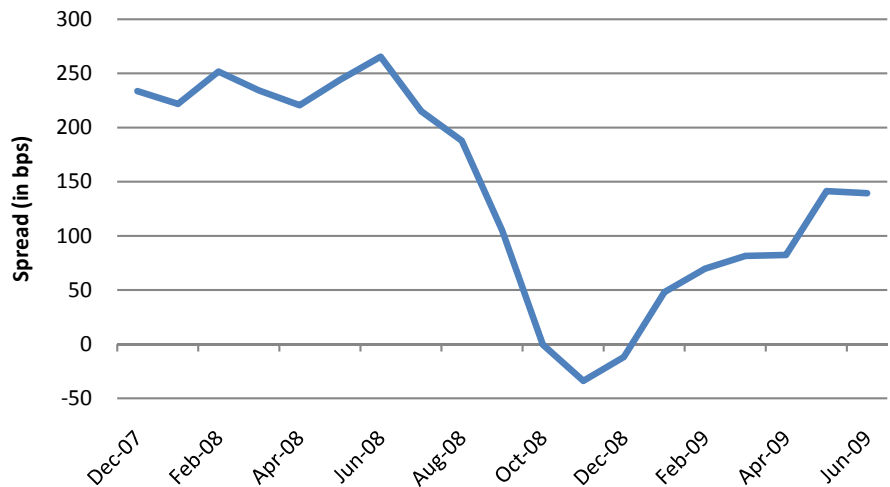
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Market Overview

- ❑ “Green shoot” euphoria gave way to concerns surrounding a second stimulus package as US Treasury bonds impressively digested supply. The benchmark 10-year note yield fell 21 bps to 3.30%, 66 bps lower than the recent high on June 10th. Pricing for a longer and more shallow recovery, the yield curve flattened by 12 bps from 2 to 10-years (+239) while 2 to 30-year spreads compressed by 4 bps (+330).
- ❑ The TIPS market significantly lagged the performance of nominal Treasuries driving the current 5-year horizon of breakeven inflation 21 bps lower to 1.10%. The longer term 5-year, 5-year forward period also fell, but only by 6 bps to 2.10%. Inflation fears appeared to be quite constrained over the week.
- ❑ Auction performance is the number one concern in the Treasury market these days with massive new issuance dominating fundamentals. Since the current supply picture came to focus, the auctions have improved progressively. Last week saw 10-year TIPs, 3-year, 10-year and 30-year bond auctions digested without problems. Wednesday’s \$19 billion 10-year auction topped the week’s performance with huge demand, a 3.28 bid to cover ratio and a 3.365% yield.
- ❑ With 2 full weeks ahead free of auctions, the market will look for a catalyst in the economic data. Last week’s calendar showed an improvement in initial jobless claims (565k vs. 603k prior); however, the July 4 holiday muted reaction. Friday’s drop in University of Michigan Confidence Index to 64.6 from 70.8 for June appeared to cement the Treasury market rally, furthering anticipation of more disappointing data.
- ❑ Several pieces of economic data will be released this week. PPI, CPI, retail sales, industrial production, various regional Fed surveys and June FOMC minutes all provide catalysts. Lower trending core PPI (+2.9% year-over-year) and CPI (+1.7% year-over-year) provided relief in June to supply led market weakness and a tailwind to current market strength.

5-Year Inflation Indexed US Treasury vs. 5-year US Treasury
12/31/2007-6/30/2009; Source: Bloomberg L.P.



Tax Exempt Markets

- ❑ High grade municipal bonds rallied on the back of Treasuries as 10-year municipal yields fell 14 bps, ending the week at 3.21%. The new issue calendar remained slow as state and local governments brought only \$3.6 billion to market, which was easily absorbed by July reinvestment needs. The volume was the lowest in a non-holiday week since December.



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Tax Exempt Markets

- ❑ The Bond Buyer 30-Day Visible Supply Index increased \$630 million week over week and currently stands at \$10.96 billion. Larger deals expected this week include Colorado (BABS), Illinois Electric, Iowa, NC Turnpike (BABS), and University of Missouri.
- ❑ California began issuing IOUs to vendors and other third parties last week (not employees or bond holders). The IOUs bear interest at a rate of 3.75% and are being accepted by both Bank of America and Wells Fargo for a very short period of time. Political pressure continues to build on lawmakers to break the impasse, but both sides appear to be dug in for a fight. As we have discussed in the past, debt service to bondholders is only subordinate to mandated educational expense. By most estimates the IOU issuance allows California to preserve their cash for items that IOU's cannot be used for, like debt service, until approximately October. For more about California, please see our State of California credit update and advisor talking points, available upon request.
- ❑ At least temporarily the New York Senate has resolved their legislative impasse as Senator Espada jumped back across the aisle and became the Democratic Minority Leader. Prior to his new position he was the Pro Tempore for the Senate Republicans. The resolution will allow the Senate to address pension reform legislation and local sales tax increases needed to balance municipal budgets. For more about New York, please see our State of New York credit update.
- ❑ Fitch downgraded Michigan to A+/stable from AA-/negative due to weakness in the auto industry. Michigan is rated AA-/Aa3 by S&P and Moody's, respectively.
- ❑ Given another slow week in primary issuance our activity was focused in the secondary market where we continue to find pockets of value.

Taxable Markets

- ❑ There was very little change in the corporate market last week. Spreads overall and within each sector were identical to the close of the week before. The Barclays U.S. Corporate Investment Grade Index ended each of the prior two weeks at +305 OAS. The highlight of the week might have been the kick-off to the earnings season with Alcoa's better than expected loss announcement. The company also made positive comments about stimulus plans within China and the U.S.
- ❑ New issuance volume was lower than the level from the previous holiday-shortened week. According to Bloomberg, investment-grade issuance was \$11.1 billion down from \$16.1 billion for the week ended July 3. Barclays Bank PLC (Aa3/AA-) led the offerings with 5-year issue at a spread of +287.5 bps to Treasuries.
- ❑ The MBS market showed strength, tracking the Treasuries rally and bringing yields on current coupon securities to 4.30%. The mortgage applications index showed upside last week after several weeks of decline with purchase applications up 6.7% and refinancing up 15.2%. The wider Barclays U.S. MBS Index strengthened 6 bps to Treasuries ending the week at +39 OAS.
- ❑ Agencies showed a 2 bps improvement for the week with the Barclays U.S. Aggregate Agencies Index ending at +39 OAS. FNMA issued a benchmark \$4 billion 3-year note which saw increased participation from commercial banks (above 20%) relative to prior issuance.