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Bond Market Weekly

Week of August 17, 2009 | Municipal and Corporate Review

Market Overview

- The US Treasury seesaw turned back toward lower yields last week, mostly bond-friendly economic data and a steady Fed pushed the benchmark 10-year yield 28 bps lower to 3.57%. Momentum from solid 3- and 30-year auctions overcame a messy 10-year auction on Wednesday which threatened reversal of early week gains.
- No discernable trend was found in the yield curve shape as 2- to 10-year spreads flattened 5 bps (+250) while 2- to 30-year spreads rose 5 bps (+335).
- The TIPS market lagged the rally in nominal Treasuries and as a result dropped the current 5-year horizon inflation breakeven 33 bps to 1.16%. The rate nears the recent low of 1.09% observed in early July, which followed a recent peak in June at 1.86%. The 5-year, 5-year forward measure dropped as well last week, falling 27 bps to 2.46%.
- The 2-day FOMC meeting this week largely came and went with little fanfare. The funds rate appears on hold indefinitely at the emergency zero to 0.25% range. The Fed did change the conclusion date for their mortgage and Treasury purchase program to late October to allow for a gradual unwind.
- Despite the Fed meeting, the real catalyst for trading last week was economic data. Better than expected employment in the week prior gave way to leaping productivity gains (+6.4% Q2) and plummeting unit labor costs (-5.8%) and set a reversal in tone for the week.
- Advanced retail sales (-0.1% headline, -0.4% ex. auto and gas) for July confirmed the recovery is nonexistent in consumer spending.
- CPI was lower than expected with the headline down 2.1% year-over-year and ex. food and energy just +1.5%. Indeed, inflation data look to be a near-term tailwind for the bond market.
- Friday's surprise report of a drop in consumer confidence via the University of Michigan survey (63.2 vs. 69 expected) was the straw that broke the risk asset market's back. This surprise hit squarely in one of the recent recovery indicators and provided a noticeable sentiment shift across markets.

Tax Exempt Markets

- Municipal bonds rallied last week, although not nearly to the degree of U.S. Treasuries, with 10-year yields falling 2 bps to 3.17%.
- Demand from retail continues to dominate the municipal landscape with tax exempt mutual funds inflow of $2.18 billion for the week ending August 5th, according to the Investment Company Institute. It seems there is no stopping of demand for the municipal bonds from individuals with potentially rising tax rates and a fear of the equity markets, municipals are a safe alternative.
- This week will see a large issue calendar with over $7 billion in new deals expected to be sold. This number is somewhat misleading for those investing in tax exempts, because over $3 billion will be in taxable Build America Bonds.
- The Bond Buyer 30-Day Visible Supply Index ticked up slightly last week to $12 billion, but as the market digests this week's supply, we will likely see a substantial drop in forward supply.

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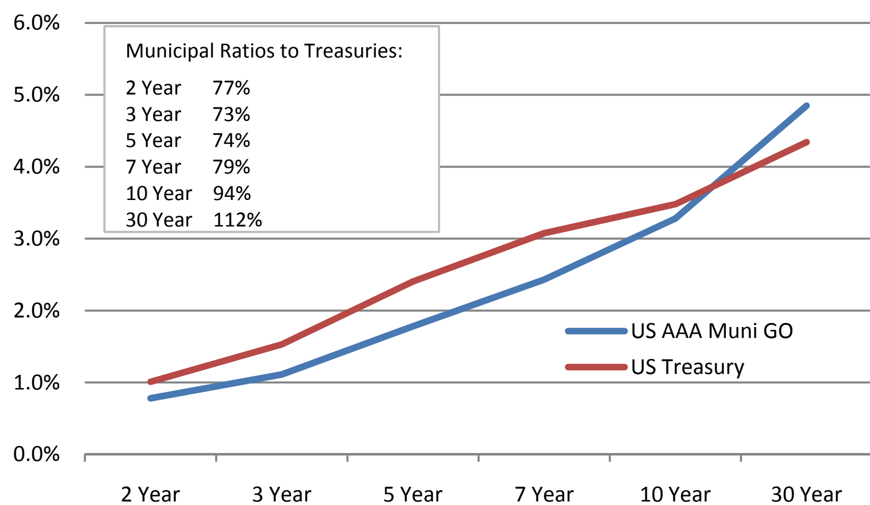
Tax Exempt Markets



- Highlighted tax exempt deals this week include $490 million in Houston, Texas GOs and $640 million for the New York State Dormitory Authority.
- With municipal bonds continuing to firm, muni-to-Treasury ratios have fallen significantly this year. The current levels seem more in line with pre-2008 norms and reasonable for a low inflation, high tax environment. What the chart does not exhibit is the currently high historical credit spread levels, especially in A and BBB rated bonds.
- We purchased a number of new deals last week including Wellstar Health in Georgia, Hesperia School District in Michigan and the Alaska State Housing Authority. We were also busy in the secondary market with purchases across the curve especially in the 7-12 year area of the curve.

Taxable Markets

- Activity in the corporate market abated somewhat last week in terms of new issuance and in the pace at which spreads have been tightening. Corporate spreads overall were just 3 bps better bringing the Barclays U.S. Corporate Investment Grade Index to +234 OAS, continuing a string of weekly consecutive spread compressions going back to June 26th. The rally has lost some of its steam though. New issues that had been well oversubscribed have not been as eagerly purchased in comparison to prior weeks.
- New issuance by investment-grade companies amounted to $18 billion versus $21.7 billion the prior week. Larger issuers were Deutsche Bank (Aa1/A+) with a $1 billion 5-year priced at +128 and GE Capital (Aa2/AA+) with a $1.5 billion 3-year at +180. Two inaugural issues were also placed by Blackstone Group (A by S&P) with a 10-year at +312.5 and Raymond James Financial (Baa2/BBB) with a 10-year at +500.
- MBS modestly outperformed the rally experienced in Treasuries with a 2 bps tightening in the Barclays U.S. MBS Index ending the week at +24 OAS. Current coupon MBS yields are now around 4.5% after seeing levels of 4.8% last week. The FHLMC survey, however, showed 30-year mortgage rates up slightly to 5.29% up from 5.22% the prior week.
- Agencies were off by 1 bp to end the week at +38 OAS. The pace of agency buying by the Fed has slowed recently, averaging $2.2 billion per week since early July compared to $3.2 billion weekly from March through June. This week's FOMC statement affirmed its target for a total of $200 billion in agency buying.