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Bond Market Weekly

Week of August 24, 2009 | Municipal and Corporate Review

Market Overview

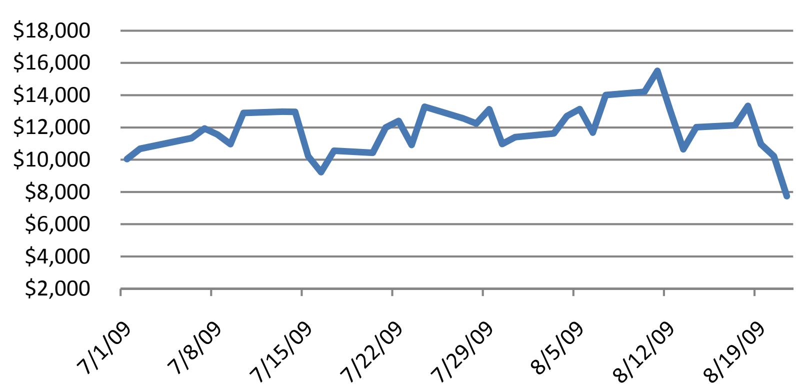
- A largely quiet August week for the markets netted a small gain for US Treasuries as the benchmark 10-year yield finished unchanged at 3.57%.
- A notable flattening trend in the yield curve was felt during the week with the 2- to 10-year spread falling 5 bps to +247 while the 2- to 30-year measure dropped 9 bps to +328. The move is consistent with a recent Merrill Lynch hedge fund research piece that exhibits a crowded short position in the hedge fund universe in long US Treasuries and a crowded long position in 2-year notes. Merrill finds good contrarian indications in these crowded trades.
- TIPS outperformed long nominal Treasuries. Breakeven inflation jumped 23 bps across the current 5-year horizon to 1.39%. The longer-term 5-year, 5-year forward period saw just a 8 bps rise on the week.
- An otherwise vacation muted week, trading was largely inspired by overnight Asian market activity, the knock-on effects in US risk markets. A resilient US equity market managed a significant rebound late week, despite Asian equity weakness, and took major steam out of the recent US Treasury rally. The 10-year Treasury closed 14 bps lower in yield Thursday before Friday's reversal.
- Economic data lacked top-tier attention on the week but some indicators were notable. Both Philly Fed (+4.2 vs. -7.5 prior) and Empire Manufacturing (+12.08 vs. -0.55) data crossed into expansion territory and reaffirmed the theme of an ongoing inventory rebuild in the sector. Bond friendly data could be found in the Producer Price Index change in July which showed a now -6.8% drop year-over-year at the headline level and a narrowing +2.6% core change.
- The week ahead will also likely be muted with Labor Day approaching. However, the calendar does pick up with another look at a recent dip in consumer confidence surveys on Tuesday and Friday along with personal income (+0.1% July exp.) and spending (+0.2% July exp.) and personal consumption pricing data (+1.3% YoY PCE Core expected).

Tax Exempt Markets

- Municipal bonds continued to grind higher with 10-year bonds yield falling 3 bps to 3.14% on the back of continued strong demand from investors, despite a large calendar this past week.
- Retail investors continue to plow money into the market with $1.98 billion in tax exempt bond fund inflows for the week ending August 12th, according to the Investment Company Institute.

Bond Buyer US 30-Day Visible Supply Index

7/1/2009-8/24/2009; Source:Bloomberg



- Looking forward, municipals could continue to rally solely due to the lack of new issue supply. The Bond Buyer 30-Day Visible Supply Index fell to a 2009 low of only $7.7 billion with much of this issuance being taxable Build America Bonds. With such small supply and September 1st payment date coming up quickly it will be difficult, without a major sell-off in US Treasuries, for municipal bonds to face much weakness.

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Tax Exempt Markets

- This week will see $200 million for Harris County, Texas, $335 million for the LA County Transit Authority and $705 million for the Dallas County, Texas Hospital Authority, which will consist primarily of taxable Build America Bonds.
- In positive ratings news, the state of West Virginia was upgraded last week to AA based on the state's ability to weather the recession due to cost cutting measures they have taken. West Virginia is the third commodity rich state to be upgraded in recent weeks by Standard & Poor's following both Texas and North Dakota.
- Our purchases were focused on 1- to 12-year bonds in the secondary market and we bought new deals for the NY State Personal Income Tax and the Louisiana Housing Authority, both rated AAA.

Taxable Markets

- For the first time in 8 weeks, weekly corporate spreads widened. The Barclays U.S. Corporate Investment Grade Index ended the week at +240 OAS, 6 bps wider than the previous week. Although the recent rally seems to be running out of steam, Q2 earnings announcements are nearing their completion, there were still some upside surprises – mostly driven by lower costs not revenue growth.
- Corporate new issuance was almost half the volume of the previous week with $9.9 billion investment-grade debt priced but was met with good demand. American Express and News America (part of News Corp.) came with $1 billion+ issues. American Express (A2/BBB+) issued a 5-year at +275 and the News Corp unit (Baa1/BBB+) priced an 11-year at +223 and a 30-year at +265. Several weaker credits also receptively priced with household names such as Yum! Brands (Baa3/BBB-) 6-year at +187.5 and Viacom (Baa3/BBB) 10-year at +225.
- MBS received some sobering data during the week for Q2 with mortgage delinquencies increasing to 9.2% from the 9.1% level in Q1. Prime delinquencies were 6.4% and subprime posted delinquencies at 25.4%. The Fed reported $25 billion in net purchases of agency MBS, higher than recent weekly activity, bringing the program total to $766.6 billion. Data showed that the MBS Purchase Application Index increased 3.9% while the Refinance Index decreased 6.9%. The Barclays U.S. MBS Index widened 2 bps to +26 OAS.
- Agencies widened 2 bps to +26 OAS on profit-taking in the short end of the curve and in conjunction with widening among spread product in general.