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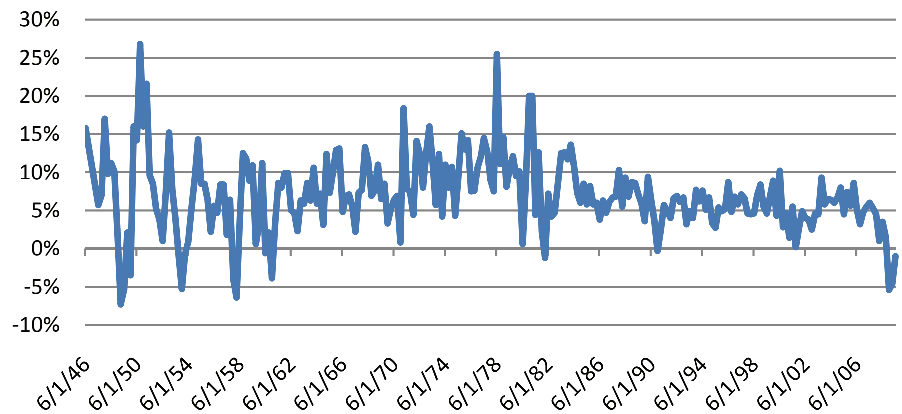
Bond Market Weekly

Week of August 31, 2009 | Municipal and Corporate Review

Market Overview

GDP US Nominal Dollars QoQ

6/30/1946-6/30/2009; Source: Bloomberg



- Early week strength in Treasuries held through Friday as the benchmark 10-year note netted a 12 bps rally to close at 3.45%.
- The recent flattening bias in the yield curve continued with the 2- to 10-year spreads falling 4 bps to +243, while the 2- to 30-year measure dropped 9 bps to +319.
- The stalled rallies in risky asset markets, combined with general concern about a sustainable growth picture, led lower breakeven inflation measures in the TIPS market. The current 5-year horizon dropped 13 bps to 1.26% while the 5-year, 5-year forward horizon sank 18 bps to 2.37%.
- Economic data on the week largely came and went without fanfare. Durable goods orders showed a huge Cash For Clunkers boost at the headline level of 4.9% in July. Ex-transportation was more muted at a 0.8% gain, but the inventory rebuilding story remains consistent with this data.
- Revisions to real Q2 GDP showed a more benign contraction of 1% vs. the -1.5% in the advance estimate. The mix still points to an inventory adjustment that will likely result in substantial growth in Q3 with some estimate running as high as +3-5%. Nominal growth in Q2 was also -1% which marked the 3rd straight quarter in negative territory – the first occurrence since 1953.
- On the pricing side of the data PCE (Personal Consumption Expenditures) Core dipped another tenth of a percent to an annualized +1.4% gain. This remains one of the Fed's key pricing metrics with an unofficial target of 1 to 2%. The Fed will be watching closely over the remainder of 2009 for this measure not to test the 1% level. The 2001 recession sparked a dip to just 1.1% and rang many deflation alarms.

Tax Exempt Markets

- Municipal bonds continued to rally last week, although mostly in the long end of the curve, with 10-year bond yields rising 1 bp to 3.15% and 30-year yields falling 3 bps to 5.02%.
- Retail demand continued unabated with tax exempt bond funds experiencing $2.39 billion in net inflows for the week ending August 19th, according to the Investment Company Institute.
- Supply continues to be constrained and this week will not see much of an improvement with just $1 billion or so in new deals on the calendar. Due to the upcoming Labor Day holiday, it is unlikely that new issue supply will pick up much over the next two weeks. The Bond Buyer 30-Day Visible Supply Index stands at a measly $8.2 billion, foretelling that potential for further price gains in municipal bonds.

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Tax Exempt Markets

- Municipal bonds will likely have their best August performance in five years, according to the Merrill Lynch Master Index, which was up 1.8% through Thursday of last week.
- The City of Detroit was downgraded this past week to Ba3 from Ba2 by Moody's Investors Services. Moody's cite continued weakness in the local economy, rising budget deficits and a citywide unemployment rate that rose to an astounding 17.1% in June. In more positive news, the State of California was taken off Negative Watch by Fitch based on the State finalizing a budget in recent weeks.
- We purchased bonds along the yield curve with much of our focus in the 7- to 10- year area. We have also lightened up on pre-refunded bonds in some cases due to the extremely low yields and the ability to pick up significant additional yield in non pre-refunded bonds. We purchased new deals for the Tennessee Housing Authority and Purdue University, both rated Aa1/AA+.

Taxable Markets

- Corporate spreads inched tighter after a brief widening from the prior week. Spreads improved 7 bps to +233 OAS according the Barclays U.S. Corporate Investment Grade Index. Economic data continued to show improvement which had a mildly positive effect on corporate debt and the equity markets.
- New issuance in corporate debt fell a bit as the summer winds down. $8.6 billion of new debt was priced, down from $9.9 billion the week prior. Proctor & Gamble (Aa3/AA-) was the largest issuer with a $1 billion 2-year priced at +38 and a 6-year priced at +75. Their coupon on the 2-year was a meager 1.35%. Praxair (A2/A) brought a $400 million 6-year and a $600 million 10-year priced at +85 to the 5-year Treasury and +78, respectively. Duke Energy (Baa2/BBB+) also priced $1 billion equally split between a 5-year at +145 and a 10-year at +160.
- The MBS market overall underperformed Treasuries by 6 bps putting the Barclays U.S. MBS Index at +32 OAS despite increased buying from the Fed. For the second week in a row Fed buying amounted to $25 billion, up from around $20 billion in prior weeks. Mixed signals for the buy program came from the Fed presidents of Atlanta and St. Louis about the future of the program. As it now stands, the Fed has authority to purchase $458 billion until it reaches the $1.25 trillion level.
- Agencies tightened to +38 OAS, 4bps better on the week. Trading volume for the week was pretty low with primary dealer volume averaging about $70 billion per day, down from $80+ billion for much of 2009. In the agency debt buy program, the Fed still has the ability to purchase up to $80 billion.