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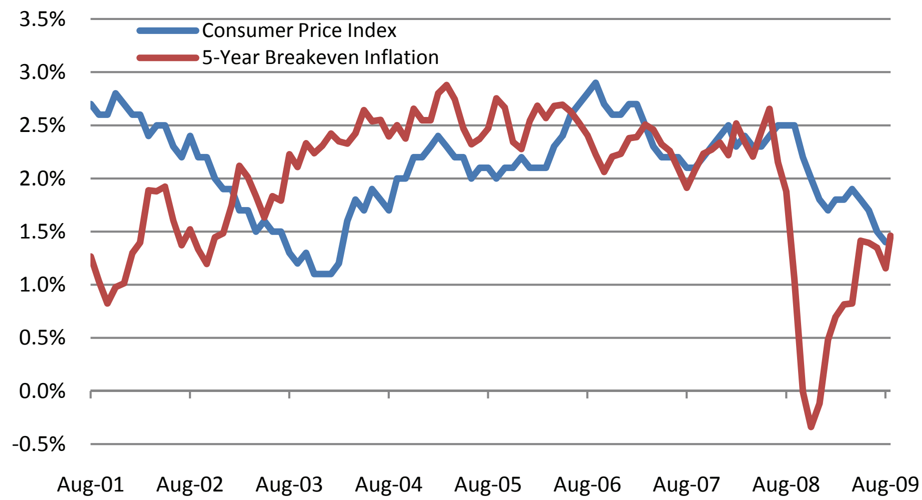
Bond Market Weekly

Week of September 21, 2009 | Municipal and Corporate Review

Market Overview

Consumer Price Index vs. 5-Year Breakeven Inflation
8/31/2001-9/18/2009; Source: Bloomberg



- The Treasury market remained largely range-bound last week as the benchmark 10-year note gave back prior week gains and finished 12 bps higher in yield at 3.47%. A rise across much of the yield curve resulted in modest changes in shape as 2-to 10-year spreads rose 4 bps to +248 while 2- to 30-year spreads fell 4 bps to +323.
- TIPS yields rose more gradually on the week. The current 5-year horizon of breakeven inflation rose 6 bps to 1.50%. The period 5-years, 5-years forward also rose 6 bps and finished at 2.34%.
- Producer and consumer price reports provided slight upside surprises to expectations but trends remain intact. Headline year-over-year consumer price deflation eased to -1.5% in August from -2.1% in July while core readings dipped further. Year-over-year consumer prices less food and energy increased just 1.4% in August versus 1.5% in July. This marks a significant reduction from the 1.9% April 2009 level. Note that the rate of change in core inflation is now below the current 5-year breakeven inflation.
- A busy week of economic data also included a solid retail sales report. Including “cash for clunker” auto sales, headline sales rose 1.1% in August. Away from autos and gas, sales rose 0.6% in August and debunked the fear that auto sales would cannibalize other sales. The August retail report was a rare signal of strength on the consumer side of the economy and sets the stage for heavy anticipation of data confirming its sustainability. An indefinitely weak consumer remains a widely held assumption in the markets and further countering data could shake the bond market which universally sits at low yields.

Tax Exempt Markets

- Municipal bonds rallied and gained on the week despite increased supply. 10-year municipal yields fell 3 bps to 3.02% while 30-year bonds fell 3 bps to 4.84%.
- Investors continue to pour money into municipal bond funds which received $1.95 billion of inflows for the week ending September 9, according to the Investment Company Institute. Interestingly, domestic equity funds saw their fourth week of outflows and the possibility that investors could further shift away from equities and into municipal bonds could further strengthen the market.

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Tax Exempt Markets

- While supply was heavy last week with $1 billion in Utah GO's sold, among other issues, forward supply had fallen back to the lower levels we have observed lately with the Bond Buyer 30-Day Visible Supply Index at only $8.2 billion.
- New deals this week include $226 million for Kent State University in Ohio as well as $335 million for the Los Angeles County Transit Authority.
- Interestingly, the Barclays High Yield Municipal Bond Index was up 1.37% on Wednesday, the highest one day return since the Index has been tracked in mid-2003. The Index is up 6.02% month-to-date as the high yield market has rallied 36 of the last 37 days. Clearly, with falling absolute yields, investors are reaching for yield by going down on the credit curve.
- We heavily purchased bonds in the 7- to 12-year sector, both in the secondary and primary markets. We purchased the New York Dormitory Authority issue as well as a large number of 10-year North Carolina Eastern Municipal Power bonds that sold this week.

Taxable Markets

- Corporate spreads tightened to Treasuries last week on the continued strength of the Financial sector. Overall, the Barclays U.S. Corporate Investment Grade Index was 11 bps tighter to end the week at +212 OAS (option-adjusted spread) as Financials improved 22 bps. There were more positive surprises in the economic releases such as the Empire Manufacturing Production Index, positive revisions to housing starts, and better-than-expected jobless claims. In addition, Citigroup and the Treasury reported to have been in discussion to unwind the government's equity ownership in the bank.
- With Treasury yields low and risk appetite strong, investment-grade debt issuance was a very robust $34.4 billion, up from $24.1 billion the prior week. Morgan Stanley (A2/A) brought a $3 billion 10-year at +225. A division of Royal Dutch Shell (Aa1/AA) also priced $3 billion via 2-year fixed and floating rate notes (+37.5 bps on the fixed) and a 10-year at +90. Citigroup (A3/A) priced an FDIC-backed issue under the TLGP program and a non-FDIC backed 5-year offering which was priced at +325. Several weaker BBB-rated companies also brought debt such as Textron Inc and Newmont Mining.
- In MBS news, the Mortgage Purchase Application Index decreased 10.3% last week. Some lawmakers view this as an indicator that with the first-time homebuyer tax credit expiring November 30th, recent home sales activity could begin to experience significant declines. Legislative discussion has begun to extend the program timeframe and further broaden it. Also, the Federal Reserve bought $25.5 billion MBS for the week ending September 16 bringing total purchases to $861.9 billion.