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Bond Market Weekly

Week of September 28, 2009 | Municipal and Corporate Review

Market Overview

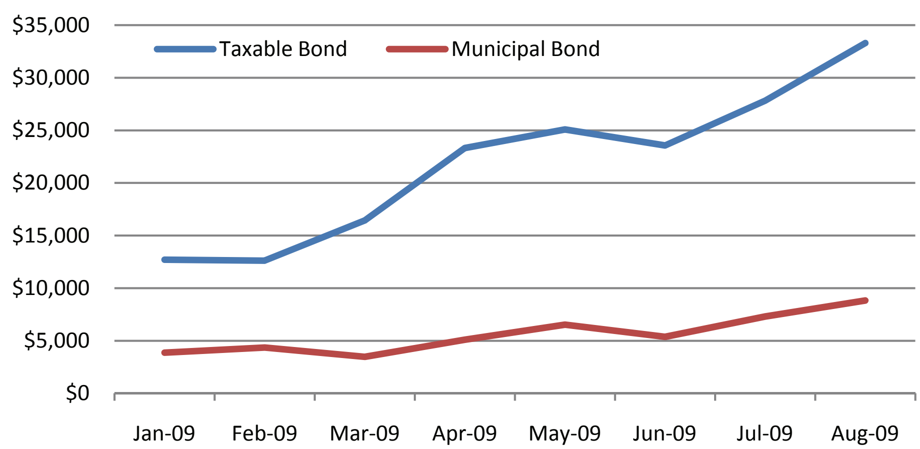
- A mixed week of economic data and decent Treasury auction demand back-dropped a consistently strong bid for US Treasuries last week. The result was a 15 bps drop in the benchmark 10-year yield to 3.32% and a flatter yield curve.
- Spreads from 2- to 10-year Treasuries dropped 14 bps to +233 while 2- to 30-years spreads dipped 12 bps to +310. This marks the flattest yield curve since May and April, respectively.
- Inflation expectation priced in the TIPS market also fell; the current 5-year horizon fell 4 bps to 1.42% while the longer-term 5-year, 5-year forward period sank 6 bps to 2.29%.
- The flattening of the yield curve and falling inflation breakevens both saw most of their moves in Friday's session where trading was influenced by a poor durable goods orders report and hawkish words from Fed Governor Warsh in the Wall Street Journal.
- Calling the Fed's job "only half over", Warsh's words were more noteworthy in their timing than content, they highlighted the already communicated importance of the Fed's "exit" strategy but just after the September FOMC's status quo meeting and statement. Perhaps this is more of the same from the Fed who intends to hold policy accommodative for some time, but is focused on tamping down any increase in inflation expectations priced into the markets. If so, the Fed has seemingly accomplished their mission thus far.
- On the economic data front, last week saw Leading Indicators produce another significant increase of 0.6% in August. Jobless Claims too were a bright spot as they fell to 530k from 551k. However, tepid homes sales (new +0.7%, existing -2.7%) and durable goods orders (-2.4% overall, 0.0% ex. transportation, -1.9% nondefense ex. transportation) negated the tone of the early week data and provided the first real shake up in the trend of rebounding economic data spanning from spring to summer.

Tax Exempt Markets

- In line with expectations municipal bonds rallied again last week with 10-year bond yields falling 4 bps to 2.97%. Specialty state AAA paper was tighter with a 10-year Maryland new issue pricing last week in the competitive market at 2.60%.
- Retail demand for municipal bonds continues to be immense with tax exempt mutual funds inflows of $2.51 billion for

Month-to-Month Taxable & Municipal Bond Fund Inflows

1/1/09-8/31/09; Source: Investment Company Institute



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Tax Exempt Markets

the week ending September 16th. Without a break in these massive inflows, it will be difficult for municipal bonds to have any serious increase in yields.

- Tax exempt supply remains muted, both from an absolute amount and from the increasing market share of Build America Bonds issuance. The Bond Buyer 30-Day Visible Supply Index stands at $8.3 billion, well below its average of $12.51 billion for 2009 so far.
- The $8.8 billion California RAN's new issue that priced last week went extremely well with over $6 billion in orders from retail alone. The issue matures in May and June of 2010 with yields of 1.25% and 1.50%, respectively. Note that only a few months ago the market was unsure whether they would be able to sell bonds at all, much less at yields over 1%.
- This week will see new issues from Cedar-Sinai Medical in California for $535 million as well as $1.6 billion in refunding bonds for the Los Angeles School District.
- According to the Bond Buyer 11-Bond Index, municipal yields are the lowest since May of 1967. This has created a quandary for many investors who are concerned rates may have fallen as far as they can despite many indicators such as inflows, low inflation and higher tax rates which could presage even lower yields. The curve continued to flatten as investors reach for yield and credit continues to tighten. How much further the market will fall is the big question investor's are contemplating.
- We were active across the curve this past week. We sold some BBB bonds as spreads have tightened to absolute levels that we do not believe reflect the underlying risks of the credits. Additionally, we purchased a new issue for the New York Housing Authority as well as secondary bonds mostly in the 7- to 15-year portion of the curve.

Taxable Markets

- There was very little change last week in taxable market spreads. Corporates took a pause after rallying for several weeks. The Barclays U.S. Corporate Investment Grade Index ended 2 bps wider for the week to finish at +214 OAS (option-adjusted spread). The economic news had a more negative tone than in previous weeks, primarily the disappointing housing data and weaker durable goods orders.
- New issue supply was nearly half of the previous week's supply. According to Bloomberg, $16.5 billion of new issue U.S. investment-grade was priced. A pattern has emerged among companies taking advantage of the steep yield curve by issuing 6-year issues priced to the 5-year Treasury benchmark. For example, Kroger & Co. (Baa2/BBB-) sold $500 million of the notes at +158 bps to the 5-year Treasury as their existing 5-year debt had traded at +115/5. Strong demand and the steepness of the curve have allowed companies to save interest cost by pricing to the lower coupon Treasuries.
- The Fed announced that it would extend the timing of its purchase plan for agencies and agency-backed MBS to the end of 1Q10 from year-end of 2009, but there was a slight change in their language regarding the size of the purchases. The Fed stated they "will purchase a total of $1.25 trillion" of agency MBS from "up to $1.25 trillion" and "up to $200 billion of agency debt", leaving open the possibility that they may not reach the agency debt target. Agencies ended the week 2 bps tighter at +35 OAS in the Barclays U.S. Aggregate Agencies Index and their U.S. MBS Index was 1 bp wider to end the week at +36 OAS.