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Bond Market Weekly

Week of October 5, 2009 | Municipal and Corporate Review

Market Overview

- Treasury prices rallied back to their May highs after a poor Nonfarm payrolls report triggered a flight-to-quality and eased fears of inflation. The Bureau of Labor and Statistics' Nonfarm Payroll report revealed the US shed 263,000 jobs in September, surpassing analysts' estimates of 175,000 jobs. This and other data pointing to a slower recovery resulted in a 10 bps drop in the benchmark 10-year Treasury yield from a 3.32% to a 3.22% on the week.
- Spreads from 2- to 20-year Treasuries dropped a mere 2 bps to +231 while 2- to 30-year spreads dropped 1 bp to +309.
- Inflation expectations priced in the TIPS market fell; the current 5-year horizon fell 3 bps to 1.39% while the longer-term 5-year, 5-year forward period dropped 11 bps to 2.18%
- Economic data released last week revealed the US continues to lose jobs. The unemployment rate now stands at 9.8%, the highest level since 1983. This does not bode well for consumer spending in the months ahead.
- Confidence of US consumers fell more than expected in September. The Conference Board's survey also revealed expectations for six months ahead fell. The data came in stark contrast to economists' expectations of positive numbers revealing a boost in confidence. Data continues to suggest a protracted period of slow growth and low inflation.

Tax Exempt Markets

- Unsurprisingly, municipal bonds rallied last week with 10-year bond yields falling 2 bps to 2.95% and 30-year bonds 4 bps to 4.74%.
- Many market participants are increasingly worrying about the low absolute level of municipal bond yields. The fact remains that mutual fund inflows continue to be extremely robust with the Investment Company Institute reporting $2.66 billion of net inflows into tax exempt bond funds.
- On the supply side it seems that the supply/demand imbalance may be a little more favorable for buyers. The Bond Buyer 30-Day Visible Supply Index stands at $14.51 billion, although it is likely that much of this issuance will be taken up by Build America Bonds issuance.
- New issues this week include a mix of tax exempt and taxable bonds such as the $4.5 billion in California State GOs, $596 million for the New York Metropolitan Transit Authority and $531 million for the City of Phoenix.
- Interestingly, although absolute yield levels have been falling with the rally in Treasuries, on a relative basis, especially inside of 10-years, municipal bonds are a bit cheaper than they have been in previous weeks as exhibited by the chart on the following page. Whether this portends a further rally remains to be seen.

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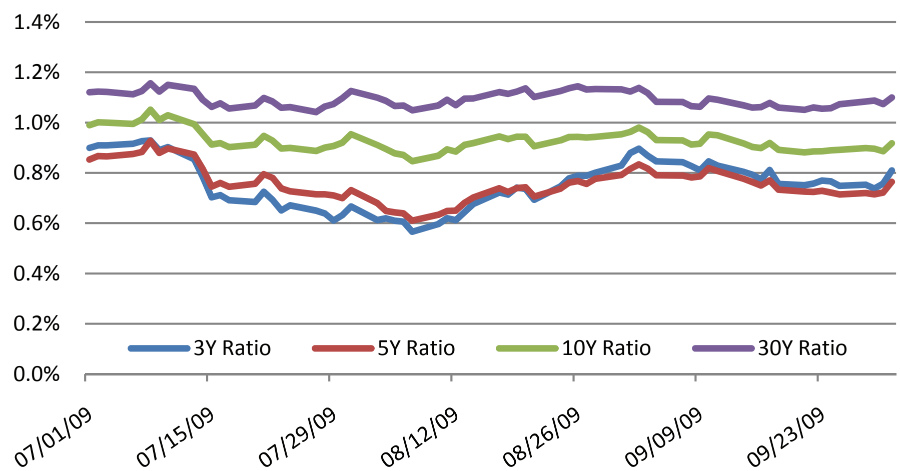
Tax Exempt Markets

Muni/Treasury Ratio
7/1/2009-10/1/2009; Source: Bloomberg



- Despite State of Michigan's economic woes, including the fact that the State has yet to pass a budget, Standard & Poor's affirmed the State at AA- this week. The affirmation was mostly due to proactive funding of future debt service payments for both GO and appropriation bonds which has been sent over to the trustees.
- Much of our buying was in the 7- to 10-year area of the curve, a range we believe offers solid relative value. We also bought bonds for the Virgin Islands, the first addition of a BBB credit in quite awhile. The remainder of our purchases focused on the short end of the curve.

Taxable Markets

- Spreads in the corporate bond market widened last week mostly on weaker than expected economic releases. The Barclays U.S. Corporate Investment Grade Index closed at +224 OAS (option-adjusted spread), 10 bps wider than the previous week. However as Q3 ended, the Index showed an 88 bps spread compression. Year-to-date spreads have improved 337 bps, providing a total return of 17.11% to 9/30/09.
- Corporate new issuance was $21.25 billion, up 29% from the previous week. Non-traditional issuers such as Brazil and Enel, an Italian electric utility, tapped the US dollar market to take advantage of investor demand. Citibank and GE Capital also utilized the TLGP program with the backing of the FDIC to issue a total of $5 billion and $3.5 billion, respectively. Investment-grade issuance has been $877 billion YTD through Q3 compared to $809 billion for all of 2008.
- Agencies spreads were unchanged for the week with a +35 OAS reading on the Barclays U.S. Aggregate Agencies Index. This sector posted a total return of 1.82% for Q3 and 1.63% through September 30 of 2009.
- MBS benchmark spreads also remained unchanged last week at +36 OAS (Barclays U.S. MBS Index). Mortgage rates broke below the 5% level again last week with the Freddie Mac national survey on 30-year fixed rates at 4.94%. The MBA Weekly Survey showed the Purchase Application Index decreased by 6.2% as the window is closing quickly to take advantage of the first time homebuyers' tax credit.