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Bond Market Weekly

Week of October 12, 2009 | Municipal and Corporate Review

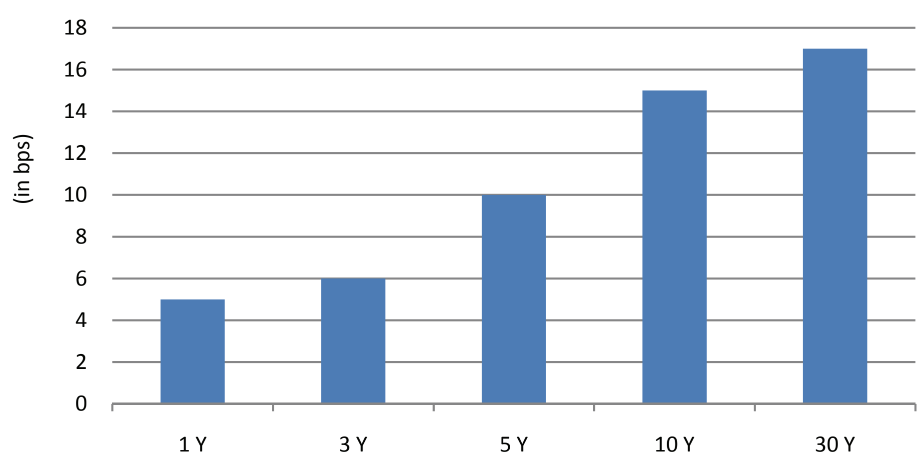
Market Overview

- A late week sell-off in US Treasuries pushed the benchmark 10-year note yield 16 bps higher to 3.38% after better than expected economic data and lower than anticipated demand for a $12 Billion 30-year auction.
- Weakness was most pronounced on the long end of the yield curve where 2- to 10-year Treasury spreads jumped 6 bps to +241 while 2- to 30-year spreads spiked 12bps to +325.
- The steepening yield curve was consistent with a jump in inflation expectations as the current 5-year horizon rose 10 bps to 1.49% in the TIPS market. Looking further out to the 5-year, 5-year forward horizon, expectations rose 9 bps to 2.43%.
- Thursday's release of jobless claims data eased the earlier fears of jobs relapse as initial claims fell to 521,000, the lowest level since November while continuing claims dropped back to April levels of 6.04 million.
- The International Council of Shopping Centers reported a slight gain of .01% (-1% expected) in September chain store sales and compounded the negative tone for Treasuries.
- With the incessant weak dollar drumbeat and better economic data in the backdrop, the 30-year auction failed to meet the strength of prior placements. Despite a decent depth in bids, the auction tailed 3 bps higher than the yield beforehand and spooked a market that had come a long way.
- On an intraday basis, the long bond covered 50 bps of ground since late July in the face of major weak dollar sentiment and all time highs in gold prices. The divergence was hard to reconcile and one way or another further rationalization between the markets should be looked for in the quarters ahead.
- Next week's calendar includes September CPI which is expected to show a -1.4% headline increase with a +1.4% gain at the core level. This data should continue to be a key catalyst for the fixed income markets as inflation debate roars.

Tax Exempt Markets

- For the first time in recent memory, municipal bond prices fell last week. 10-year yields rose 15 bps to 3.10% and 30-year bonds rose 17 bps to 4.91%. These yields, quoted by Municipal Market Advisors (MMA), are subject to much variability due to the holiday weekend. The lack of trading on Friday may have masked the true weakness that exists in the current market.

AAA GO Yield Curve Change Week of 10/5/2009



Source: MMA; 10/2/2009-10/9/2009

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Tax Exempt Markets

- Despite rising yields, the long-term fundamentals still look strong with $2.2 billion in tax exempt mutual fund inflows for the week ending 9/30, according to the Investment Company Institute. With rising yields, the unabated demand from retail investors may continue and cap the severity of any sell-off.
- Visible supply remains relatively stable with the Bond Buyer 30-Day Visible Supply Index at $13.9 billion with a good portion consisting of Build America Bonds (BABs). Last week we saw a few refunding deals get pulled after rates rose and made them no longer feasible. Also, the California State GO deal was repriced 34 bps cheaper in 20-years from the retail to institutional order periods. Interestingly, the BABs portion did extremely well once they broke for trading showing a disconnect between the taxable and tax free markets.
- This week will see few new deals due to the shortened week, although Hawaii will be issuing $625 million in GO bonds and the Atlanta, GA Wastewater Authority will be selling $433 million in bonds. It will be interesting to see how this particular deal sells in light of the widening lower credit quality bonds, although they are insured the bonds are rated Baa1 by Moody's.
- We were extremely busy in the latter half of the week by taking advantage of the first weakness in the municipal market in quite some time. Much of our buying was in the 10-year area of the curve as this seemed to have the largest number of sellers and price concessions. We purchased a number of strong issuers at prices that in previous weeks would have been unheard of including New York City, Charlotte, NC and the MARTA system in Atlanta.

Taxable Markets

- Corporate markets improved last week as spreads resumed their compression to Treasuries seen for much of this year. Better-than-expected economic data such as the initial jobless claims number, better September retail sales, and Alcoa's earnings release that set a positive tone for the earnings season led to the market's advancement. The Barclays U.S. Corporate Investment Grade Index closed at +217 OAS (option-adjusted spread), 7 bps tighter to Treasuries for the week.
- New corporate supply fell 41% from the previous week with just $12.5 billion of investment-grade debt issued. Financial companies comprised the majority of the issuance with such names as New York Life (Aa2/AA) that priced a $1 billion 30-year surplus note at +275 and Boston Properties (Baa2/A-) with a $700 million 10-year priced at +262.5 bps.
- Overall, MBS improved also. The Barclays U.S. MBS Index closed the week 10 bps tighter to finish at +26 OAS. News-worthy items for the week were a 13% surge in new home purchase applications, perhaps driven by the near-expiring first time homebuyer tax credit and the FHLMC survey showing 30-year conventional mortgage rates at 4.87% nearing the record low last seen this past spring. The Fed bought $20 billion of agency-backed MBS putting the cumulative volume at $920 billion of their $1.25 trillion target.
- Agencies tightened 3 bps to end the week at +32 OAS. The Fed bought $2.57 billion last week reaching $136 billion purchased so far of their $200 billion target.