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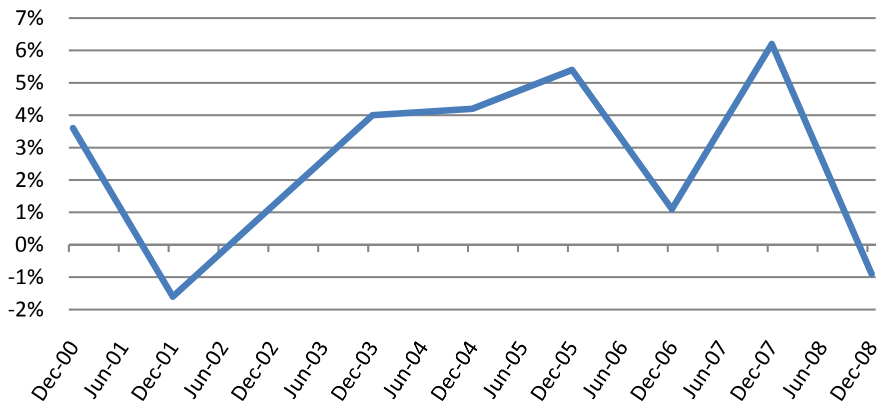
Bond Market Weekly

Week of October 26, 2009 | Municipal and Corporate Review

Market Overview

Producer Price Index YoY

12/31/2000-12/31/2008; Source: Bloomberg



- The benchmark 10-year Treasury note traced recent ranges last week and ultimately finished 6 bps higher in yield at 3.47%.
- The shape of the yield curve was relatively unchanged with a minor 2 bps rise from 2- to 10-years and no change between 2- and 30-years.
- TIPS fared a bit worse than nominal Treasuries on the week which brought the current 5-year horizon breakeven inflation down 4 bps to 1.59%. The 5-year, 5-year forward horizon measure, however, did creep higher with a 6 bps gain to 2.62% which matched the recent high set on Thursday of the prior week.
- The combination of a weak dollar, rapid gains in risky asset prices and TIPS breakevens slowly approaching the high points of the recent ranges appears to have some Fed officials growing uncomfortable about the indefinite signal of low rates and other accommodative policies. Friday's article in the Wall Street Journal highlighted a robust internal debate on the timing of the shift in the current stance. Indeed, this shift could bring volatility across most markets which have enjoyed a stiff tail wind of Fed liquidity for multiple quarters.
- Economic data released last week were mixed. Initial jobless claims jumped again to 531k from 520k in the prior week while continuing claims fell. Leading indicators showed a jump of 1% in September after 0.4% rise in August and continue to indicate strong recovery prospects. But bond friendly readings in producer prices of -1.6% MoM and -4.8% YoY helped put a lid on bond yields which are enjoying the benefits of economic recovery yet little pricing power. Goldilocks for now in the bond market.

Tax Exempt Markets

- Municipal bonds halted their sell-off last week with 10-year bond yields falling 3 bps to 3.18% and 30-year bond yields falling 1 bp to 5.00%.
- Despite the large number of new deals last week, the sizable amount of cash on the sidelines was more than enough to absorb the new issues with few problems. Many new deals had their scales bumped based on strong demand by investors. Interestingly, we saw the most weakness in the 12- to 20-year sector of the curve. A Clark County, NV GO deal sold competitively and bonds inside of 10-years sold almost immediately whereas the 12- to 20-year portion had numerous balances. This may be a precursor to some curve steepening in the municipal market over the coming weeks.
- Future supply continues to be heavy with the Bond Buyer 30-Day Visible Supply Index at $13.8 billion. Many of these deals are coming with Build America Bonds portions and, as we have observed in the past couple of weeks, many of the refunding deals are extremely rate sensitive and have been pulled from the market when the rates are too high.

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Tax Exempt Markets

- This balance between large new issue supply and investor demand will likely keep rates range bound in the near-term. However, as reported by the Investment Company Institute, investor demand may be waning somewhat as tax exempt mutual fund inflows were only $361 million for the week ending October 14th, a far cry from the $2 billion+ of inflows we have seen in recent months. This may be due to quarterly tax payments, low absolute rates or the strength in the equity markets. We will be watching to see if overall investor demand for municipal bonds becomes negative in the coming weeks.
- This week will see many large new issues including $320 million for the State of Florida, $300 million for the Port Authority of New York and New Jersey as well as $200 million in Louisiana State GOs.
- New York governor David Patterson announced this week that if Legislators do not agree to close their budget deficit soon the State could face a cash squeeze in December. If this occurs, New York would have to dip into their reserve funds as well delay payments in some cases. As for bond holders, Matt Anderson of the Division of Budget said the State would not default on its debt. While these deficits are not of California magnitude, New York will need to make some tough decisions which will likely lead to higher taxes and fees as well as lower spending for services.
- We were heavily involved in both the primary and secondary markets last week and have found a good relative value in the 7- to 10-year portion of the curve where the curve is steepest. In many cases, we believe the yield pickup between 5- and 8-year bonds of 90 bps compensates us for the added duration. We purchased new issues for the Houston Independent School District, the Miami Parking System as well as Clark County, Nevada.

Taxable Markets

- The corporate market was calm enough for an airline pilot to nap and let auto-pilot take the helm. Spreads compressed 8 bps to +205 OAS (option-adjusted spread) in the Barclays US Corporate Investment Grade Index. Earnings announcements continued to hold investors' focus with results providing encouragement for the most part to the bottom line and in some cases the top line. Of the first 122 of the S&P 500 companies reporting, 76% beat expectations while 14% missed. Some even reported upward revisions to outlooks. Caterpillar was one such company with a 10% to 25% increase in their 2010 revenue forecast.
- Corporate new issuance declined 45% from the previous week to $12.5 billion. Boeing Capital (A2/A) brought $1 billion from a 5-year priced at +95 to Treasuries and a 10-year priced at +130. A few banks like BB&T and JPMorgan issued trust preferred securities as risk appetites have grown.
- Agencies were unchanged relative to Treasuries as weakness in the 2-year part of the curve was offset by tightening in the 10-year maturities. Fannie Mae issued a $3.5 billion 5-year and Freddie Mac issued $3.5 billion of a 2-year benchmark, putting pressure on spreads because of supply. The Barclays US Aggregate Agencies Index stood at +31 OAS at week's end.
- MBS resumed its rally with spreads of the Barclays US MBS Index tightening 5 bps to reach +21 OAS. With the home buyer's tax credit soon to expire (unless extended by Congress), the National Association of Realtors reported existing home sales jumped 9.4% during September. The annualized rate was 5.57 million which the highest rate in two years.