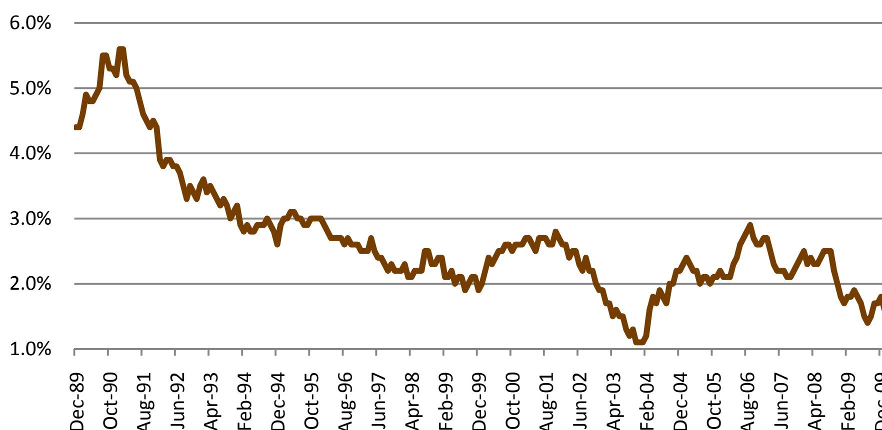
WASMER, SCHROEDER & COMPANY

INVESTMENT ADVISORS

BOND MARKET WEEKLY | WEEK OF FEBRUARY 22, 2010

MARKET OVERVIEW



- Last week's holiday shortened trading calendar saw selling momentum continue in U.S. Treasuries. The benchmark 10-year yield rose 8 bps to 3.78%. Again, much of the weakness was in real interest rates (10-year TIPS yield +5 bps for the week, +23 bps in February) where sovereign credit risk is the topic du jour.
- With short yields also rising, the Treasury yield curve slope was unchanged from 2- to 10-year at +286 while the 2- to 30-year measure flattened 3 bps to +379.
- Yields on 5-year TIPS jumped 10 bps but allowed breakeven inflation to edge 2 bps higher at 2.19%. The longer-term 5-year, 5-year forward period increased 2 bps as well to a breakeven inflation of 2.54%.
- Greece and EU issues remained in the background throughout the week without much resolution. News of China falling behind Japan as the largest holder of U.S. Treasuries provided no comfort for a market wary of huge supply. Rather than outright selling, China appears to have reduced reinvestment of maturing holdings over the quarter.
- Friday's CPI data brought the market off its lows for the week with a less than expected .2% gain in January (+2.6% YoY) and very surprising .1% drop in the core measure (+1.6% YoY). Core weakness was centered in new autos, apparel, shelter, and transportation services.
- After the Fed signaled its intention to normalize the discount rate's relationship with the funds rate, the Fed took a step on Thursday to raise the rate by 25 bps to 75 bps. Along with the closing of some temporary facilities, this is one more initial step in unwinding emergency measures. The trend in core inflation noted above will be a key input in the timing of the more controversial, and catalytic, move in the Fed Funds rate.

TAX EXEMPT MARKETS

- Municipal bonds treaded water this week with both 10- and 30-year yields rising 1 bp to 3.05% and 4.50%, respectively.
- The market faced a heavy calendar last week with approximately $6.8 billion in new issues, about 20% of which were taxable. This week will not see quite the supply of last week, but is still relatively healthy at $4.1 billion.
- Fund flows continue to be positive with mutual funds inflows of $1.38 billion for the week ending February 10th. Demand remains strong and most new issues were oversubscribed with bumps across the curve.
- New issues for the upcoming week include $470 million for Energy Northwest, $600 million for Miami-Dade Water and Sewer as well as $466 million in Indiana Local Improvement bonds, most of which are structured as taxable Build America Bonds.
- In ratings news one of our large holdings, Citizens Property Corporation in Florida, was taken off negative watch by Moody's due to recent legislative changes in favor of the insurer. The bonds have rallied significantly over the past several months, largely due to their relatively wide spread for an A rated credit.

TAX EXEMPT MARKETS (CONT.)

- We note that over the past 30 years, March is the only month that has shown an overall negative return for the Barclays Municipal Bond Index. Interestingly, the 10-year portion of the curve has had the highest negative return, although this has not been consistent as 1998 to 2001 had consecutive positive March returns while 2004 to 2007 saw four consecutive negative years. In our estimation this year's performance will largely hinge on not only supply, but also whether or not individuals have large tax bills for which they will need to raise funds. Please be aware that many times liquidity suffers during March, therefore, the sooner we are notified about cash needs for tax bills the more flexibility we will have in selling.
- We were active in both the primary and secondary markets last week. On the primary side we purchased new issues for Memphis Electric, Los Angeles School District, the University of Pittsburgh Medical Center, and Henry, Georgia among others. We also purchased a significant number of bonds between 9- and 15-year maturities in the secondary market.

TAXABLE MARKETS

- Corporate spreads ended the week with its first rally in three weeks. The Barclays U.S. Corporate Investment Grade Index ended the week at +174 OAS (option-adjusted spread), 6 bps tighter than the previous week's close. Sovereign contagion fears abated somewhat helping all credit markets. Financials further rebounded from recent weakness (spreads were 9 bps tighter for the week) as the political winds against the industry have slowed. Despite the tightening, there were a few developments that credit markets still need to be aware of: M&A activity (the SPG takeover proposal of GGP and WAG's bid for Duane Reade) and stock buyback announcements (from PM, SLE, and PEP).
- New corporate issuance was up last week, but it was nothing to cheer about. $3.8 billion of investment-grade debt was priced, up from $2.9 billion the prior week. The bulk of the issuance was from UBS (Aa3/A+) which sold $2 billion of a 2-year floater at LIBOR +110.
- MBS spreads widened after the Fed's announcement it would raise the discount rate. Other news affecting the market was a report from the Mortgage Bankers Association that seasonally-adjusted single-family home delinquencies declined to 9.47% in 4Q09, down 17 bps from 3Q09 and a report of higher than expected January housing starts from the Census Bureau. The Barclays U.S. MBS Index ended the week at +24 OAS, 5 bps wider from the prior week.
- The Fed bought $946 million of agency debt last week. Since the Fed's purchase program began in November 2008, it has brought the cumulative total to $168 billion nearing its $175 billion target. Spreads tightened 3 bps last week in the Barclays U.S. Aggregate Agency Index to finish at +28 OAS.

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