



MARKET OVERVIEW

- Trading activity in the US bond market was generally quiet last week with well received 10- and 30-year auctions leaving the benchmark 10-year Treasury just 2 bps higher in yield at 3.70%.
- Short maturities continued a gradual grind higher in yield (2-year at 0.96%) and pushed the yield curve flatter by 5 bps from 2- to 10-years (+274) and 9 bps from 2- to 30-years (+366).
- Breakeven inflation rose again in the TIPS market across the current 5-year horizon with a jump of 6 bps to 2.20%. Conversely, longer-term 5-year, 5-year forward expectations slipped 1 bp to 2.51%.
- The economic calendar was relatively lacking in catalysts with one exception – retail sales. February saw 0.3% rise overall and a solid 0.9% spike ex. volatile autos and gas measures. This follows a depressed December and slightly better January performance and offers a glimmer of hope for this important measure going forward.
- The offset to the optimistic retail sales data, however, is a “sticky” plateau in initial and continuing jobless claims. The recent measurement week saw 462,000 new initial claims – down slightly from previous weeks but still unhealthy. The sagging consumer confidence survey also diminished the sales take-away with a decrease in March to 72.5. Overall, no clear catalysts last week for the US Treasury market.

TAX EXEMPT MARKETS

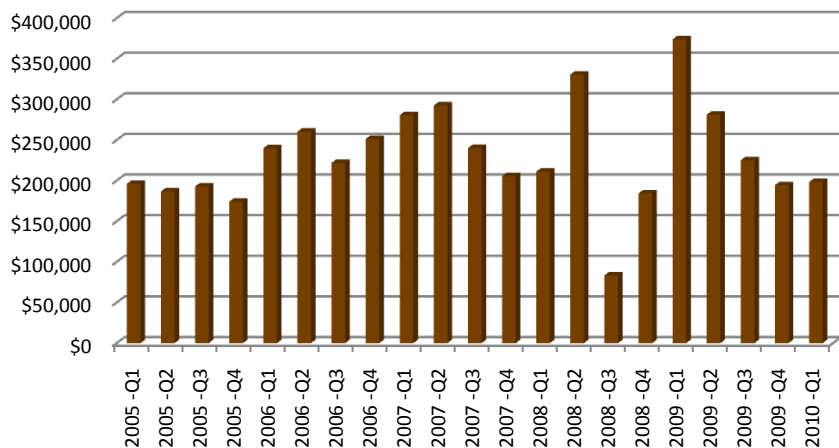
- Municipal bonds remained firm last week with yields on 10-year bonds falling 2 bps to 3.00% and 30-year bonds remaining flat at 4.45%.
- Despite all the new deals last week, investor demand was strong up and down the curve. Many deals had significant bumps with the \$2 billion California GO deal not only being tightened but also upsized to \$2.5 billion on the back of strong retail demand. Once bonds were free for trading, they were quickly bid up in the secondary market.
- While new issue volume was high last week with the deluge of new deals sold, the calendar has dropped considerably with the Bond Buyer 30-Day Visible Supply Index at only \$8.28 billion, much of which will likely be issued as taxable Build America Bonds (BABs).
- This week will see new issues for the California State University system (\$354 million), Chicago Transit Authority (\$550 million), and a huge Citizens Property Insurance Corporation issuance (\$2 billion) which will consist of tax exempt and taxables as well as floating and fixed rate bonds. We are big holders of this name and are curious to see how this “A” rated issuer prices.
- Mutual fund inflows continue unabated with the Investment Company Institute reporting \$1.34 billion for the week ending March 3rd. We have seen no signs so far of the typical March sell-off, but with two weeks to go it still remains a possibility.
- There has been a lot of press in recent weeks about the growing wage and benefit gaps between the public and private sector. We have included our thoughts below on this issue as an additional supplement.
- We were active in both the primary and secondary markets and bought a large chunk of bonds for the Polk County School District in Florida. These bonds were “A” rated and wrapped with insurance. Their 10-year bonds priced at 4.00%.



TAXABLE MARKETS

- Corporate investment grade new issues totaled \$28.4 billion last week, 66% higher than the prior week, with \$22.3 billion coming in the first 2 days. The largest issues were by: Novartis (Aa2/AA-), Medtronic (A1/AA-), and DirecTV (Baa3/BBB-) – each in multi-part maturities. For comparison of the 10-year notes for each of these companies, Novartis came at +78, Medtronic came at +75, and DirecTV came at +150.

US Investment Grade Corporate Debt New Issuance by Quarter
\$ in billions; Source: Bloomberg



- Investment-grade spreads were 6 bps tighter last week. There was little economic data for the market to digest, but it was generally positive.

Demand for corporate debt continues to be strong as shown by the success of new issues. Along with substantial demand, low volatility helped contribute to the gain in corporates. The Barclays US Corporate Investment Grade Index ended the week at +160 OAS (option-adjusted spread). Financials were 10 bps tighter after media reports that indicated some items in the financial overhaul proposal to be released this week will be more favorable than originally thought.

- The MBS market outperformed Treasuries. The MBA survey of mortgage applications showed a healthy rise for the second straight week with a 5.7% increase in purchase applications. RealtyTrac also released data that showed the pace of foreclosure filings subsiding. February filings were 2% lower than January (although still up 6% from February 2009). The Barclays US MBS Index finished the week at +12 OAS, 8 bps tighter than the previous week.
- The Fed bought another \$10 billion of agency MBS bringing them up just beyond their \$1.2 trillion target. They also bought another \$1.5 billion of agency debt to bring their total for this program to \$171 billion of their \$175 billion target. Each of these programs were started by the Fed in November 2008.

PUBLIC VS. PRIVATE PAY

One of the “hot topics” in the news lately has been public sector payrolls and pensions. The spotlight has grown brighter as states and municipalities struggle with unbalanced budget and private sector unemployment remains high.

The Bureau of Labor Statistics reports that private businesses fired 8.7 million workers since the beginning of the recession in December 2007, a period that saw public payrolls grow by 101,000 people. Recently, Los Angeles City Council approved the firing of 3% of its workforce and indicated that they were considering cutting an additional 9%. It is something that we have increasingly seen across the country as the public sector attempts to deal with decreased revenues and, as we enter budget season, we expect that we will see additional trimming of payrolls.

While payrolls have remained elevated in the public sector, it is the pay and benefit packages that continue to garner the most headlines. USA Today recently reported that the “average” federal employee earned 12.7% more than their private sector peer. When factoring in benefits received, that differential increases to 55%, a differential that has the ability to siphon off productive workers from the private sector and reduce economic growth. Even state and local government employees exceed private wages when factoring in benefits. The upheaval over unfunded pension obligations is valid and a story that has been building for 40 years. According to the Pew Center on the States, twenty-four state pension funds have funded 80% or less of their accrued liabilities. While the unfunded liability figure is substantial, we do not view it as a near-term credit negative. We view the current spotlight being shown upon the situation to be a positive as legislators are forced to justify some of these programs.

**PUBLIC VS. PRIVATE PAY (CONT.)**

We are seeing states increase employee contribution rates, adjusting age and service requirements, and decreasing post-retirement benefits. Each of these actions will serve to close the gap and bring benefits more in line with the private sector. While a greater breadth and depth of reform is needed, the actions taken are positive steps in addressing the situation.

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