



BOND MARKET WEEKLY

WEEK OF APRIL 19, 2010

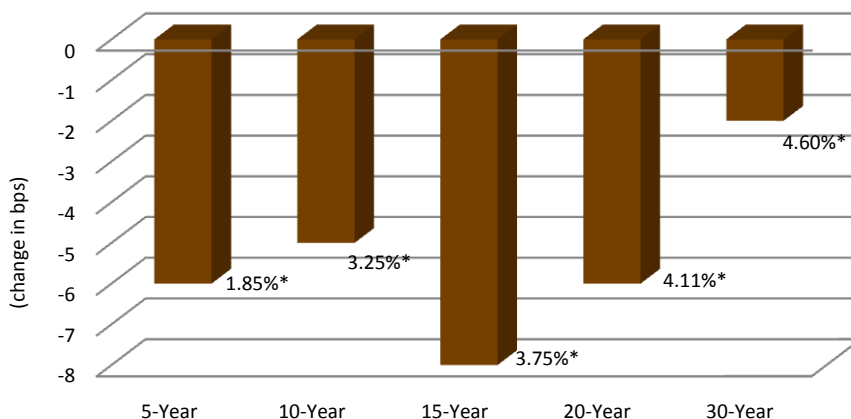
MARKET OVERVIEW

- After a week of primarily consensus-confirming economic data, a mild bond market rally became turbocharged going into Friday's close with news of SEC fraud charges against Goldman Sachs. The benchmark 10-year note ended Friday down 10 bps in yield to 3.78% and marked two straight weeks of relief rallies after nearing a 4% yield.
- A modest shift in the shape of the U.S. Treasury curve moved the 2- to 10-year spread 1 bp lower to +281 while 2- to 30-year spreads rose 4 bps to +372.
- The TIPS market performed largely in-line with the nominal Treasury rally with breakeven inflation falling 3 bps across the current 5-year horizon to 2.24%. The longer-term 5-year, 5-year forward horizon priced in just 1 bp of higher inflation at 2.65%.
- March CPI data released Wednesday showed a continued deceleration in U.S. pricing pressure with month-over-month readings falling to just 0.1% and 0% on headline and core inflation, respectively. Year-over-year core inflation dipped to just 1.1%; an even faster deceleration than the most dovish forecasts after posting 1.8% for 2009.
- While JPMorgan's Jamie Dimon announced solid earnings and a view of strong recovery last week, Chairman Bernanke remained cautious on economic growth and inflation pressures in his testimony before the Joint Economic Committee. Bernanke's sanguine outlook on inflation parallels the downtrend in most inflation measures as well as a beginning trend of money supply shrinkage.
- Indeed, the M2 measure of money supply fell in 5 of the last 6 weeks and is a major concern for some economists and perhaps a key driver of resistance at the Fed to mirror the V-shape recovery excitement creeping into Wall Street forecasts. There is a potential risk to the broader economy if we begin seeing weaker signals. After all, the Fed has little cover at the moment to reverse the money supply issue with a quantitative easing restart.

TAX EXEMPT MARKETS

- Municipal bonds rallied this week extending the gains that began at the end of the previous week. All portions of the curve were stronger with 15-year bonds posting the biggest price gains (see attached chart).
- With a slowing need for tax sales and a diminishing calendar, demand outstripped supply on the week. The Bond Buyer 30-Day Visible Supply Index is \$8.4 billion; with May 1st calls and maturities around the corner it looks as if municipals are poised for relatively strong performance in the short-term.

MMA Indices Change in Yield from 4/9 to 4/16/2010



*Numbers shown are yields as of 4/16/2010; Source: Bloomberg

- According to Barclays Capital, for the May to July period when examining future calls, maturities, and income against expected new issuance net supply is **-\$63.4 billion**. If mutual fund inflows remain reasonably strong municipals could rally once again.



TAX EXEMPT MARKETS (CONT.)

- As for mutual fund flows, the Investment Company Institute actually revised the weekly inflows for the week ending 3/31 from positive \$6 million to **-\$117 million**, which helps explain the sell-off at month end. For the week ending April 7th inflows rebounded to \$352 million.
- This week has a relatively small number of tax exempt new issues coming to market of reasonable size. The Puerto Rico Electric Authority will be issuing \$275 million in tax free bonds and the Los Angeles Unified School District plans on issuing \$154 million.
- The city of Los Angeles settled its dispute with the Department of Water and Power (LADWP). The city will get \$73.5 million transferred to their general fund while LADWP will get the 4.5% rate increase they were looking for. This will take some of the near-term pressure off of Los Angeles' finances while giving longer term flexibility to LADWP.
- This week will see the beginning of Moody's recalibration of municipal bond ratings. They will recalibrate a new set of ratings each week over the next month. We have already seen some spread tightening in the "A" and "Baa" rated sectors as their returns were actually positive for the month of March and have outperformed so far in April.
- Our buying was mostly in the secondary market last week with purchases mostly in the 7- to 15-year portion of the curve. Liquidity has begun to improve as buyers are stepping in and dealers are light inventory.

TAXABLE MARKETS

- Up until Friday, the corporate market had been having a very strong week but took a small step backward overall with the SEC's securities fraud case against Goldman Sachs. Spreads in the financial sector last week had tightened 11 bps through Thursday but gave back 2 bps on Friday, so the spillover to other credits was minimal. Goldman 6% of 5/1/2014 had traded at +70 to 5-year Treasuries late Thursday, but on Friday had traded as wide as +111 on large block trades well after the news. WSC sold our position in this issue at +92 early on Friday. The Barclays U.S. Corporate Investment Grade Index ended at +139 OAS (option-adjusted spread), 6 bps tighter for the week.
- Earnings announcements for Q1 so far have mostly exceeded expectations. Bellwether names like Bank of America, CSX, GE, Intel, and JPMorgan have posted better than expected numbers. Investor focus appears to be more on revenues this quarter than the bottom line number as they look for signs of an economic recovery in businesses.
- Corporate new issuance was \$17.3 billion, the bulk of which was from Yankee banks again. One notable domestic name that came was Lowe's Companies (A/A) with \$500 million each in 10-year and 30-year issues at spreads of +80 and +110, respectively.
- Fannie Mae issued a \$4 billion 2-year benchmark note with the distinction of increased commercial bank participation. Banks bought 20% of this deal up from nearly zero in the previous benchmark deal. The Barclays U.S. Aggregate Agencies Index ended 3 bps wider at +26 OAS.

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