



BOND MARKET WEEKLY

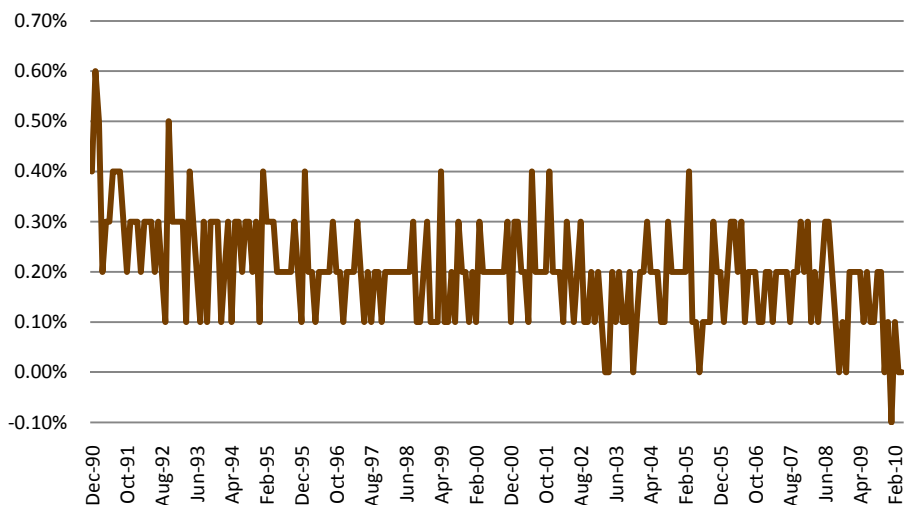
WEEK OF MAY 24, 2010

MARKET OVERVIEW

- More global shifting away from risk and back to the safety of the U.S. dollar was the primary story last week resulting in a sharp drop of 26 bps in the benchmark 10-year Treasury note yield to 3.20% (opened this morning at 3.17%.) Before U.S. equities found a mild rebound Friday afternoon, the 10-year reached a low of 3.10%, a level not seen since May of 2009.
- The prospects of global risk contagion and a prolonged slump, combined with zero or near zero readings in PPI and CPI reports, drove bond demand into long maturities. As a result, the U.S. Treasury curve flattened 22 bps from both 2- to 10-year (+245) and 2- to 30-years (+333).
- TIPS felt the brunt of selling as the inflation story turned back to deflation concerns and crude oil prices swooned on a rallying U.S. dollar. The breakeven inflation measure over the current 5-year horizon plummeted 27 bps to 1.59% while the 5-year, 5-year forward sank 31 bps to 2.47%.
- Aside from the Greek/Euro story, the lack of movement in U.S. prices garnered much attention in the bond market this week. Headline consumer prices fell -0.1% for the first time since March 2009 while core consumer prices remained unchanged in April and up just 0.1% over the last 6 months. Even at an optically low level of 3.20%, nominal 10-year U.S. Treasuries supplied a whopping real yield of 3%+ over the current run rate.
- Bond bulls had more data beyond pricing to support their case last week. Empire (19.11) and Philly (21.4) manufacturing surveys halted a solid improving trend in May while mortgage applications (-1.5%) fell, initial jobless claims (471k) relapsed higher, and the index of leading indicators hit negative territory (-0.1%) despite a continued huge boost from the yield curve slope.
- News from the FOMC meeting minutes showed the group mostly united in a desire to sell assets held on the Fed balance sheet as soon as possible, but most believed a more solid economic footing and a higher funds rate should precede any action. Also, and ironically in the throes of the EU/sovereign crisis, we also saw the Fed upping their economic forecasts.

US CPI Less Food & Energy MoM

12/31/1990 - 4/30/2010; Source: Bloomberg



TAX EXEMPT MARKETS

- Municipal bonds rose this week, but lagged U.S. Treasuries overall. Taking a cue from U.S. Treasuries, AAA rated municipals rallied with 10-year yields falling 3 bps to 3.11% and 30-year yields falling 3 bps to 4.49%.
- In the face of ongoing global uncertainty, demand for municipal bonds continues to be strong. The Investment Company Institute reported that \$550 million flowed into tax exempt bond funds, while taxable bond and equity funds experienced \$1.54 billion and \$12.33 billion in outflows for the week ending May 12th.



TAX EXEMPT MARKETS (CONT.)

- Forward supply remains manageable with the Bond Buyer 30-Day Visible Supply Index at \$9.38 billion. In the secondary market, demand continues to be good with bid lists being bid fairly aggressively.
- New York City Transitional Finance led issuers last week as about \$10 billion arrived in the primary market versus \$7.5 billion the prior week. With 10-year AAA tax exempt rates at their lowest level since March, issuers appeared to be accelerating planned deals to take advantage of the low rates. On a relative basis, the Municipal/US Treasury ratio widened to 93%, the widest level since December 2009, as U.S. Treasuries continued to be well bid due to the flight to quality associated with global turmoil.
- Arizona voters approved a tax increase, the first in 10 years. By a margin of 64 to 36 voters approved a temporary one cent sales tax increase, which analysts estimate will raise \$1 billion per year. The tax has been approved for 3 years.
- In what is turning out to be the first showdown with the Democrat controlled Legislature, Gov. Christie of New Jersey vetoed an income tax increase aimed at residents earning \$1 million or more. Currently lacking the required 2/3 majority needed to override the veto; Legislature Democrats have threatened to pass the bill a second time to send a message to the Governor.
- Much of our activity was focused in the secondary market last week, although we did participate in the New York Dorm Authority deal. The issue was part of the school district financing program with the supporting revenue being derived from Government grant funds, Ad Valorem taxes and miscellaneous revenues. The deal was 3rd party wrapped by Assured Guaranty and had underlying ratings of A+/A1. The final scale had the 5-year serial at 1.97%, 10-year at 3.65%, and the 20-year at 4.44%.

TAXABLE MARKETS

- Life as a corporate bond investor recently resembled the life of Bill Murray's character in the movie "Groundhog Day". One kept reliving fears of the European sovereign crisis and the imminent legislation on financial regulatory reform for weeks now. Spreads widened 13 bps in the Barclays U.S. Corporate Investment Grade Index to finish the week at +179 OAS (option-adjusted spread).
- While it still needs to be reconciled with the House, the Senate's version of regulatory reform (S.3217) has significant concerns for the markets. One of the largest is an amendment by Maine's Senator Collins which would require banks to spin off their swaps operations. Another concern of the Collins' amendment was a provision that would require banks to revise the definition of Tier 1 capital to exclude trust preferred securities which would create the need for some banks to raise more common equity.
- Investment grade new issuance was under \$4 billion with the highlight of the week, Franklin Resources Inc. (A1/AA-), a name that had not come to market since 2003. Franklin raised \$900 million via 3-, 5-, and 10-year issues at +75, +95, and +115 to their respective Treasuries. Orders for the mutual fund company were reported to be \$5.5 billion.
- The Mortgage Bankers Association's weekly report on mortgage applications showed supporting evidence of the tax credit demand pull-forward effect. While the overall index only showed a decline of 1.5%, purchase (separate from the refinancing component) applications experienced a 27.1% decline. The Barclays U.S. MBS Index finished at +21 OAS, up 1 bp from the prior week.

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