



## BOND MARKET WEEKLY

WEEK OF JUNE 1, 2010

### MARKET OVERVIEW

- Sovereign debt fears eased slightly last week and took a bit of the flight to safety demand out of U.S. Treasuries. The result was a retreat higher in the 10-year benchmark yield by 5 bps to 3.29%. Despite volatility in yields during the week, short maturities virtually unchanged pushed the 2- to 10-year spread 5 bps higher to +255 and 2- to 30-year spreads 10 bps higher to +343.
- Coming off a terrible prior week, TIPS recovered a bit this week and pushed breakeven inflation 13 bps higher over the current 5-year horizon to 1.73% while the 5-year, 5-year forward period edged 4 bps higher to 2.50%.
- After the U.S. bond market closed Friday, Fitch cut Spain's AAA rating to AA+. As the market opens this week we will be watching to determine what extent this refreshes global sovereign debt concerns.
- After robust demand drove a global spike in demand for the safe-haven of U.S. Treasuries during the prior week, last week's 2-, 5-, and 7-year Treasury auction could not quite match the most recent strings of supply given the low yields. Marginally weaker demand in each auction helped Treasury yields spike higher Wednesday and Thursday but ultimately found demand and prices rebound heading into the long holiday weekend.
- Strong economic data which had been pushed off the headlines by the Euro crisis is now showing some cracks. Stronger housing and consumer confidence (58.5 April vs. 63.3 May) remain intact, but durable goods ex. transportation (-1% April), initial jobless claims (460,000), and personal spending (unchanged in April) all have downshifted from the improving pace.
- The growing deflation/disinflation theme was reinforced last week with the Fed's favorite core personal consumption expenditure pricing measure showing just a 1.2% year-over-year increase. If the Fed's balance sheet were not already so inflated, this depressed level would be garnering much more debate about necessary action.
- This week's calendar is the heaviest for the month with ISM Manufacturing and employment data due out Friday. ISM is expected to fall back after most regional Fed surveys have retreated of late. Payrolls (+505,000) are expected to get a huge boost from Census hiring but the unemployment rate is only predicted to fall to 9.8%.

### US Personal Consumption Expenditure Core Price Index YoY

1/31/1960 - 4/30/2010; Source: Bloomberg



### TAX EXEMPT MARKETS

- It was a volatile week in the market, but when it was all said and done municipal bonds were virtually unchanged. AAA rated municipals saw the 10 year yield increase 1 bp to 3.12% and 30-year yields fall 2 bps to 4.47%.
- Despite ongoing uncertainty in the Euro zone and geopolitical tensions in Asia, demand for municipal bonds continues to be strong. The Investment Company Institute reported that \$913 million flowed into tax exempt bond funds, while taxable bond and equity funds experienced \$729 million and \$6.67 billion in outflows, respectively, for the week ending May 19<sup>th</sup>. From April 24<sup>th</sup> to May 19<sup>th</sup> tax exempt mutual funds have seen \$3.3 billion of inflows.



## TAX EXEMPT MARKETS (CONT.)

- Forward supply remains manageable with the Bond Buyer 30-Day Visible Supply Index at \$8.62 billion. In the secondary market, the demand this week was a bit bumpy as high quality issues on the bid list were being bid fairly aggressively and less liquid issuers were spotty.
- Build America Bond (BABs) issuance was approximately \$3 billion, the most robust week to date. The sales came as Florida said the State would no longer issue BABs because they feel that the U.S. Treasury could not guarantee the subsidy without offsets. BABs is the fastest growing segment of the \$2.8 trillion municipal market. On Friday the House approved an extension in the BABs program through 2012 with the Federal subsidy to issuers declining from 35% currently, to 32% in 2011 and 30% in 2012. The Senate is expected to consider the Bill, which is part of a larger Jobs Act, when it reconvenes on June 7.
- In what is turning out to be another heated budget season, the California Legislature has proposed raising taxes \$5 billion to curb proposed spending cuts by Governor Schwarzenegger. The Governor has proposed \$12 billion in spending cuts, which the Democrats consider “draconian”, and has vowed to not raise taxes. With the fiscal year beginning in July we expect that we will be hearing much more from the Golden State.
- Once again we were finding good value in the secondary market, where we were very active. In the primary market we participated in the Illinois Finance Authority deal. The Authority brought a tax exempt deal for The Art Institute rated A+/A1 (stable). The deal only had two terms with the 5-year pricing at 2.51% and the 30-year pricing at 4.93%.

## TAXABLE MARKETS

- It was a volatile week for corporate spreads. Early in the week spreads widened as tensions intensified between North and South Korea and from continued concerns over the Senate’s financial regulatory reform bill. By Wednesday, the mood regarding financials turned positive after S&P’s statement that it did not intend to change any bank ratings until they are in a position to fully analyze final legislation and its implementation which they implied could take place in late 2010 – possibly 2011. The Barclays U.S. Corporate Investment Grade Index ended the week at +187 OAS (option-adjusted spread), 8 bps wider than the previous Friday.
- Year-to-date, corporate pricing has strengthened from 4.73% on 12/31/09 (YTW) to 4.46% on 5/28/10, however spreads have widened 15 bps relative to U.S. Treasuries. For the month of May, spreads were 44 bps wider with absolute yields (YTW) out 19 bps.
- Abbott Labs (A1/AA) priced \$3.0 billion of new debt, the highlight of the week’s new issuance. Their 5-year came at +70, the 10-year at +90, and the 30-year at +122 to the respective Treasuries. For the week, total investment-grade issuance was \$10.3 billion which brought the total for the month of May at \$25.2 billion and \$329 billion YTD.
- The Mortgage Bankers Association weekly data showed a 17% increase in their mortgage loan refinancing index to the highest level since October 2009. The average 30-year fixed rate mortgage loan was 4.78%, the lowest rate posted this year on the strength of the Treasuries rally. The Barclays U.S. MBS Index total return was 3.30% YTD, outperforming Treasuries by 61 bps and 1.12% for the month of May, 2 bps better than Treasuries of equal duration.

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