

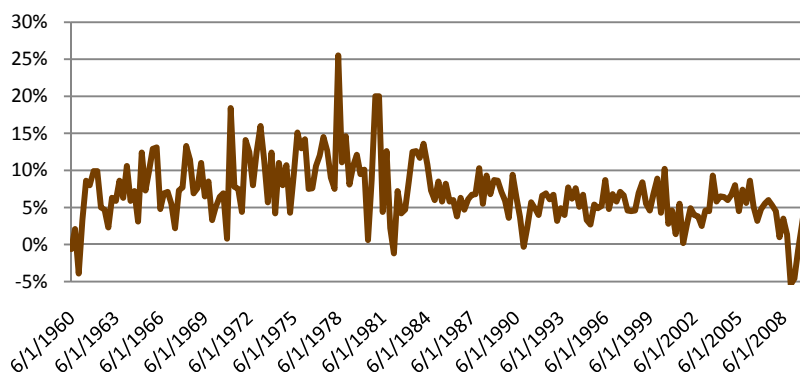


MARKET OVERVIEW

- US market sentiment grew more bearish last week, stoked by disappointing housing data and a slightly less optimistic Fed meeting statement. With high quality, long maturity assets providing a backstop for bears, the benchmark 10-year Treasury enjoyed an 11 bp drop in yield to 3.11%.
- Demand for long-term fixed rate safety drove the yield curve flatter, with 2- to 10-year spreads dropping 5 bps to +245 and 2- to 30-year spreads 1 bps lower to +342.
- The breakeven inflation measure across the immediate 5-year horizon dropped 4 bps to 1.67% and settled into a modest range well below the 2.20% trend over the first third of the year; inflation hawks were quieted by the week's releases. Further out, the 5-year, 5-year forward horizon breakevens dropped 5 bps to 2.51%. At this level, expectations are at the midpoint of a range exhibited during much of the last 2+ years – with the exception of during and immediately following the Lehman crisis.
- Existing and new home sales, down -2.2% and -32.7% MoM in May, respectively; set the bearish economic tone early in the week. Suddenly, we seem to be experiencing a growing consensus of double-dip performance in the sector, but debate remains on its ultimate impact to the broader economy.
- Initial jobless claims eased the trend of retracement toward the upper-400,000 range with a pullback to 457,000 last week and did provide some relief in the data.
- Meanwhile, durable goods orders posted a solid 0.9% gain May. Indeed, it appears that the inventory cycle and cash-rich US corporations are providing growth via capital expenditures at the moment. What is disappointing, however, is the picture from the Q1 GDP report which showed just 2.7% real growth and 3.8% nominal growth. The cyclical forces of inventory (2.1%), personal consumption (1.8%) and capex (0.7%) were the only significant contributors to Q1 GDP where Final Sales only registered a 0.8% gain. Indeed, the White House is likely worried about Larry Summers' "escape velocity" in these data amid a growing fascination with "austerity".

GDP US Nominal Dollars QoQ

6/30/1960 -3/31/2010; Source: Bloomberg



TAX EXEMPT MARKETS

- Municipals rallied on the back of a strong Treasury market this week with 10- and 30-year yields falling five and two basis points, respectively, to 3.14% and 4.55%.
- With low supply and cash continuing to flow into tax exempt mutual funds, the supply/demand fundamentals seem to be supporting municipals for the short term. While slower than the previous few weeks, The Investment Company Institute reported \$242 million of inflows to tax exempt mutual funds for the week ending June 16th. Coupled with rapidly approaching July 1st calls and maturities which are coming quickly, it seems there is plenty of cash to buy bonds.
- Visible supply continues to drop with the Bond Buyer 30-day Visible Supply Index at a meager \$6.1 billion. With a holiday week fast approaching, there is likely to be a lull in new issuance for the next few weeks.



TAX EXEMPT MARKETS (CONT.)

- This coming week will see new deals from the Los Angeles Community College District for \$1.2 billion, and \$500 million for the Massachusetts Water Authority. The State of Illinois postponed their \$900 million BABs deal again until at least the first week in July.
- The demise of the jobs bill in the Senate last week adds more uncertainty to a possible extension of BABs. While it seemed that lawmakers on both sides of the aisle support a BABs extension it will need to wait for another bill. Without an extension of BABs by the end of this year they will expire on December 31st. This would eliminate an extremely popular form of financing by state and local governments as well as threaten the price stability of tax exempt bonds, especially in maturities longer than fifteen years.
- We were relatively quiet last week as the summer doldrums have come to the municipal market and little was trading. We bought along the curve with a continued emphasis on the 7- to 10-year portion of the curve that we believe currently provides the best relative value.

TAXABLE MARKETS

- In an odd twist, the corporate, agency, and MBS markets as measured by the Barclays indices, all ended last week with unchanged OAS's (option-adjusted-spreads) that were +191, +26, and +6, respectively.
- As the week came to a close, committee members of the House and Senate came to an agreement on the final version of the financial regulation bill. It included the Volcker Rule, which sets limits on large firms trading with their own funds, and Senator Lincoln's amendment. This amendment as now written would allow banks to retain more pertinent bank derivative trading, such as interest rate and foreign exchange swaps, while the riskier derivatives would need to be set up in separate affiliate companies. Congress will vote on the bill as early as Tuesday.
- Corporate issuance slowed a bit from the prior week to \$15.9 billion. There were quite a few 144a private placement issues, but the volume was driven by a couple of large banks, GE and Shell. A finance arm of Royal Dutch Shell (Aa1/AA) priced \$2.75 billion via a 5-year at +150 and a quarterly floater at Libor +35. GE Capital (Aa2/AA+) came with a \$1 billion 5-year at +150.
- LBO chatter became a topic of discussion this week as a private equity group approached Hasbro (\$6.4 billion market cap) for a possible buyout. Hasbro management dismissed any interest in pursuing the transaction.
- The FHLMC national average survey of 30-year mortgage rates showed a 7 bps decline this week to 4.69%. The MBA index posted a -5.9% decline last week (with purchases down -1.2% and refinancing down -7.3%).

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