



BOND MARKET WEEKLY

WEEK OF AUGUST 2, 2010

MARKET OVERVIEW

- The benchmark 10-year US Treasury yield fell back toward recent lows last week as the Fed's Beige Book report took a weaker turn and Q2 GDP disappointed forecasts. At 2.90%, the 10-year sits 2 bps above the low set on 7/21/10 and appears poised to settle into a range not seen since early 2009.

- Comments by Fed officials on the possibility of more Treasury purchases also helped the yield curve flatten from 2- to 10-years by 5 bps (+236), but the 2- to 30-year spread (+343) was unchanged.

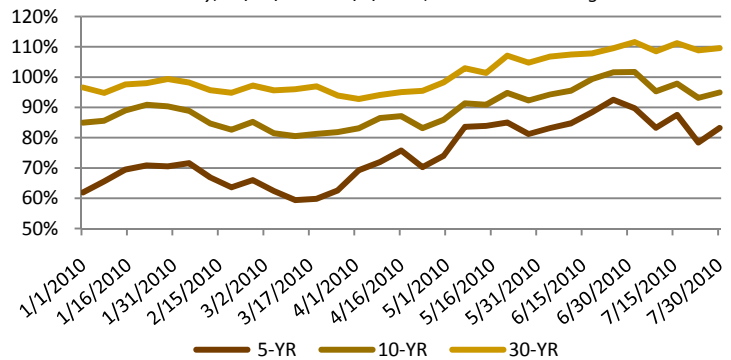
- Oddly, breakeven inflation measure in the TIPS market rose despite the dour tone, with the current 5-year horizon rising 7 bps to 1.49% and 5-year, 5-year forward jumping 5 bps to 2.40%.

- Economic data was largely a non-factor early in the week with the biggest mover, new home sales, jumping 23.6% in June on the expiring stimulus tax cut measures and a very low base. Durable goods orders, despite the poor headlines, were steady at the core nondefense and aircraft level at +0.2% in June.

- Data toward the end of the week, which notably the Beige book reporting growth "stalling" in 2 districts and "slowing" in 2 others, helped the bond market regain a firm tone. Initial jobless claims are now pulling out of the distorting auto retooling period and remained stubbornly high at 457,000. Finally Q2 GDP was reported up just 2.4% (2.6% was expected) while personal consumption remained depressed at 1.6%.

Year to Date Muni/Treasury Ratio

Weekly, 12/31/2009 - 8/2/2010; Source: Bloomberg



TAX EXEMPT MARKETS

- Municipals were flat last week with 10- and 30- year bonds unchanged, although the shorter portion of the curve tightened slightly.

- Demand continues to be strong with supply constrained. The Investment Company Institute reported \$992 million of inflows for tax-exempt mutual funds for the week ending July 21st.

- The Bond Buyer 30-day visible supply index stands at a paltry \$6.94 billion with much of that issuance likely to be BABs. Additionally, we have started a new month of coupon payments and maturities so there will be plenty of additional cash to invest. There seems to be little that will stand in the way of the market's continuing strength over the short term.

- While many investors are experiencing "rate shock," especially when looking at the short end of the curve where we have seen four year pre-refunded bonds offered at yields below 1%, the ratios to Treasuries are well within historical norms (see attached chart). Without a sell-off in US Treasuries there is little we see that will force the municipal market to ease off of its current strength.

- Democrats in the State of California are planning to introduce a new budget to erase the State's \$19.1 billion deficit this week. One of the most interesting provisions is a hike in the State income tax rate by 1% for all those but the highest earners. At the same time, the State sales tax would be reduced by 2.5%. According to estimates, this "tax swap" would bring in an additional \$3 billion a year in tax revenue. The Republicans are already criticizing the bill so it will likely take many more weeks or months before an actual budget is passed.



TAX EXEMPT MARKETS (CONT.)

- We continued to reduce our “A” rated credit weightings last week as liquidity in the market has been strong and bids have generally been quite good. We have favored high coupon callable structures in the “AA” and “AAA” ratings categories as the best source of value in the current market.

TAXABLE MARKETS

- The steady rally continued in the corporate market. Spreads were 3 bps tighter for the week (as measured by the Barclays U.S. Corporate Investment Grade Index) to finish at +175 OAS (option-adjusted-spread). For the month of July, spreads tightened 15 bps.
- Within the corporate index, financials did particularly well, having tightened 23 bps in July as a result of several factors. Financial regulation reform finally passed with easier restrictions than feared and Q2 results indicated that bank balance sheets are improving.
- Investment-grade new issuance slowed 9% from the previous week to \$16.1 billion. AT&T (A2/A) was the dominant issuer with a \$2.25 billion 5-year issue priced at +77. McDonald’s (A3/A) also made a rare appearance to the market with 10- and 30-year notes totaling \$750 million. The MCD issue was notable because the 10-year note came at a 3.50% coupon, the lowest coupon on record for a 10-year index eligible corporate bond (according to BofA Merrill Lynch Global Research).
- In MBS, the market was buzzing about the prospect of a government sponsored refinancing of agency-backed mortgages. Although this idea is only Wall Street gossip (a concept re-circulated from 2008 when rates were higher and less plausible), it did get traction among traders. The thought: with 37 million mortgages where the ultimate obligor is the government anyway (FNMA, FHLMC), why not have an across the board refinancing of those mortgages to make the payments more affordable thereby stimulating the economy. Premium MBS appeared to sell off on this talk. Overall though, the Barclays US MBS Index finished 2 bps tighter on the week and 16 bps tighter for the month of July.

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