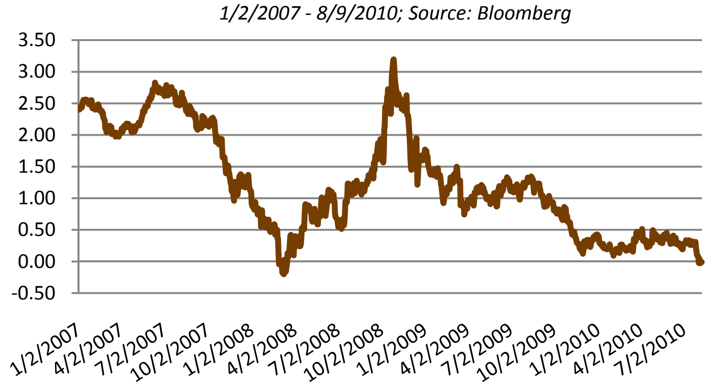
WASMER, SCHROEDER & COMPANY
INVESTMENT ADVISORS

BOND MARKET WEEKLY | WEEK OF AUGUST 9, 2010

MARKET OVERVIEW

US Treasury Inflation Protected 5 Year Yield

1/2/2007 - 8/9/2010; Source: Bloomberg



- Last week the benchmark 10-year yield pushed through the low for the year at 2.82% as deflation and double-dip recession talk grew on the heels of continued weak employment growth in July. The recent move caps an 18 bps rally over the last two weeks and a whopping 117 bps since early April.
- As investors price in a longer period of rock bottom short rates and marginal capital moves out the curve, 2- to 10-year spreads have narrowed. Last week saw a 4 bps drop to +231. However, inflation concerns over the longer term persisted despite the latest round of pessimism and kept the spread between 2- and 30-years wide. Indeed, spreads here increased last week 5 bps to +349.
- Negative TIPS yields (without inflation component) moved out the yield curve to 5-years last week. Much of the recent rally in Treasury rates has been on the real side and even moved the 5-year breakeven inflation rate higher last week by 4 bps to 1.53%. The longer term 5-year, 5-year forward period also pushed 3 bps higher to 2.42%.
- Beyond solid corporate earnings announcements, the markets got decent news on the economic data front. ISM Manufacturing held steady at 55.5 in July while the Nonmanufacturing survey solidified as well at 54.3. Perhaps these reports are the foundation of the bullish camp that supports a resilient US equity market (+1.81% last week).
- Negativity, however, was rampant in the bond market and Friday's employment report showing a loss of 131,000 jobs overall and a gain of only 71,000 private payrolls fueled the fire. State and local government losses had been feared for some time as resource rationalization hits a frenzied clip in the sector. July's employment report showed public sector losses of 48,000, up from 27,000 in June and the numbers are likely to grow.

TAX EXEMPT MARKETS

- Municipal yields followed Treasuries lower in the first week of with 10- and 30- year yields falling 3 bps and 4 bps basis points to 2.83% and 4.36%, respectively.
- Demand remains unabated as municipal investors continue to search for yield. A number of non-rated and below investment grade deals are expected to come to market including Chino Hills RDA in California and US Airways which did a tax exempt issue at yields of over 8%.
- Mutual funds again saw strong inflows with the Investment Company Institute reporting $987 million in inflows for the week ending July 28th. Without some let up in investor demand and/or a weakening Treasury market, there seems little that will stop municipal bond strength even as investors fret over falling yields.
- Supply remains muted with the Bond Buyer 30-day visible supply at $6.46 billion. New issues this week include $119 million for the Michigan Housing Development Authority, $451 million for the Ohio Water Authority and $710 million for the Phoenix airport in Arizona.
- In ratings news last week the city of Chicago was cut by Fitch one notch to "AA" and by Moody's to "Aa3". With a $654 million budget gap for 2011, rapidly depleting reserves, and growing pension obligations it is no surprise that they were downgraded. The market barely reacted to the news as Chicago GO's had already been trading like low "AA" or high "A" rated bonds.

TAX EXEMPT MARKETS (CONT.)

- We continued to put client's cash to work across the curve. As mentioned last week, high coupon callable bonds seem to offer the most value to investors as many people are chasing the convexity that non-callable bonds offer. With the calendar being as light as it has been, we have only participated in the secondary market recently.
- Last week a Treasury Department advisory committee determined that the municipal market "appears to be in reasonably good condition." Their comment cited a risk to market access for issuers if BABs were not extended. On the credit side they mentioned that, "municipalities still have a low probability of default."

TAXABLE MARKETS

- The MBS market was swirling again last week on rumors that first surfaced at the end of July. The original rumor - across the board refinancings for government-backed mortgages (FNMA, FHLMC, FHA) - was taken a step further with talk of reducing the outstanding principal of "under-water" mortgages in efforts to stimulate the economy. This possibility was emphatically denied by the Treasury Department.
- Mortgage rates continued their descent - Freddie Mac's 30-year national mortgage rate was 4.49% on Friday, 5 bps lower for the week. Although mortgages have become more affordable, subsequent refinancing has not been as robust (refinancings were only up 1.3% according to the MBA).
- Investment-grade corporate new issuance was very strong with $33.4 billion priced – double the amount of the previous week. The large issuers were Citigroup (A3/A) and MetLife (A3/A-) with $3 billion each. IBM (A1/A+) issued $1.5 billion 3-year notes with a 1% coupon, the lowest coupon among all 3,474 securities in the Barclays U.S. Corporate Investment Grade Index.
- Demand for new issuance was very strong as most deals were over-subscribed five to eight times the size of the deal. Underwritings have also been in the tight range of price talk and spreads for most of the issues emerged with further compression in the secondary market.
- The overall investment grade index showed slight improvement. The Barclays U.S. Corporate Investment Grade Index finished the week 3 bps tighter at +175 OAS (option-adjusted-spread).

About the Firm: Wasmer, Schroeder & Company, Inc. (WSC) is an independent and employee-owned owned Florida S-Corp. WSC was incorporated in 1987 and registered as an investment advisor in 1988 with the U.S. Securities and Exchange Commission. The Firm's corporate headquarters are in Naples, Florida, where the tax exempt Portfolio Management team, Client Services, Operations, IT, Accounting, Compliance, Marketing and Administration reside; our taxable Portfolio Management team is located in Cleveland, Ohio; and Client Relationship offices in Philadelphia, Pennsylvania and Portland, Oregon. Specializing in fixed income separate account portfolio management for high net worth individuals, wealth management groups and institutions, including foundations, endowments and retirement plans, WSC has over $3.57 billion in assets under management, as of 6/30/10. The Firm works with clients and their advisors to construct taxable and tax exempt fixed income portfolios tailored to their preferences and constraints and typically include a mix of cash and fixed income securities.