

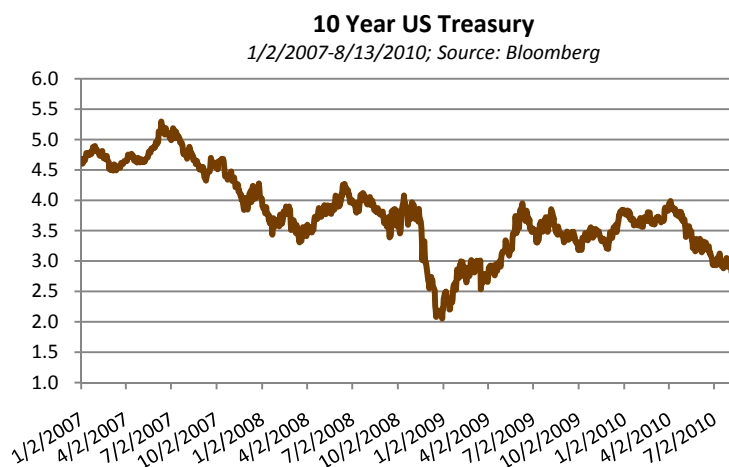


BOND MARKET WEEKLY

WEEK OF AUGUST 16, 2010

MARKET OVERVIEW

- US Treasuries were catapulted higher last week by a notable shift in tone out of the FOMC meeting and the committee's decision to reinvest mortgage redemptions into Treasuries. As a result, investors moved out the yield curve and ultimately sliced 13 bps off the 10-year yield which closed at 2.68%.
- What had been an increasing acceptance of risk in the 10-year area of the yield curve seemed to grow to all long dated Treasuries. Spreads from 2 to 10-years dropped 15 bps to +215 while 2 to 30-year spreads followed with a fall of 12 bps to +334. While still steep, these spreads are 76 and 52 bps, respectively, off their peaks from early 2010.
- TIPS dramatically lagged the rally in nominal Treasuries and even rose outright in yield in 5-years, which resulted in breakeven inflation moving 12 bps lower to 1.41%. The longer term 5-year, 5-year forward period fell all the way to 2.13% or 28 bps lower than the previous week, as the Fed capitulation appears to have backfired on economic expectations.
- Fed watching at this point is becoming critical as the "zero bound" is forcing never before tried initiatives into the debate and leaving huge uncertainty for markets. The action to reinvest MBS proceeds into Treasuries appears to have backfired given the immediate reaction, and may have been the last straw that spurred Kansas City Fed President and FOMC voting member Thomas Hoenig to take the offensive in defending his dissent. In a speech Friday, Hoenig made the case that the net effect of zero percent rates and quantitative easing is to reinforce economic uncertainty and drag risk taking lower. Increased acceptance in this sentiment could result in a flatter yield curve ahead. There was indeed correlation in the timing and ferocity of Friday's Treasury rally and Hoenig's speech.
- On the economic data front, the NFIB Small Business Optimism survey remained depressed at 88.1 in July while jobless claims grew closer to recessionary levels at 484,000. CPI largely was reported as expected, with headline at 1.2% year-over-year and core hovering at 0.9% year-over-year. Retail sales in July show a consumer still cautious, down 0.1% in July outside of auto and gas sales.



TAX EXEMPT MARKETS

- Municipals continued their furious rally in the wake of the strong Treasury market, with 10- and 30-year yields falling 11 and 7 bps to 2.72% and 4.29%, respectively.
- At risk of sounding like a broken record, new issue supply remains constrained and investor demand insatiable, especially on maturities ten years and shorter. The Bond Buyer Visible Supply Index remains at a paltry \$8.8 billion with roughly one-third expected to come as BABs.
- On the demand side, mutual funds saw their largest inflows with \$1.2 billion for the week ending August 4th, one of the highest prints so far this year. It seems, despite the ever falling yields, that investors have few other good alternatives for their money.
- This week will see new issues from the recently downgraded city of Chicago, IL (\$154M); Forsyth, NC GO's (\$200M); and the Pennsylvania Turnpike (\$600M).



TAX EXEMPT MARKETS (CONT.)

- In ratings news the Commonwealth of Kentucky was affirmed by Moody's with a "Aa2" rating, but put on negative outlook. Interestingly, Kentucky retired the last of their GO debt in 1995 and only uses appropriation lease agreements for financing. Moody's cited the reliance on non-recurring budget balancing measures as a key component, combined with their weak economy, as reasons for the negative outlook.
- We are still finding that high coupon callable bonds offer attractive value in this market. Additionally, we have continued to reduce our "A" rated holdings in the face of great liquidity and strong demand for bonds with incremental yield. While the short end of the curve is showing signs it may be somewhat overbought, intermediate maturities still remain fairly valued.

TAXABLE MARKETS

- Unlike the municipal market, new corporate issuance continues to be very active. Below investment grade issuance was strong last week as new deals totaled \$14.4 billion, the highest level of 2010. Demand kept pace as investors search for ways to increase their yield due to low treasury rates.
- Investment grade new issuance was strong also with \$19 billion coming last week. Johnson & Johnson ("AAA"/"AAA") was the biggest name and the deal came at +43/10-year and +68/30-year. These were both the lowest interest rates ever done for 10-year and 30-year debt.
- The investment grade corporate bond market could not keep pace with the rally in the Treasury market as the flight-to-quality trade into the safety of government bonds left corporate credit spreads slightly wider on the week. The Barclays US Corporate Investment Grade Index finished the week with an average option-adjusted spread of +179 bps, which was 4 bps wider than the previous week's close. However, the average yield-to-worst for the Index fell by 3 bps to close at 3.83%.
- The big announcement came from the Federal Reserve who said they would keep the target federal funds rate unchanged at 0.00%-0.25% for an extended period. They also said that as their \$1.5 trillion in MBS securities pay down, the Fed will reinvest the proceeds in US Treasuries, continuing the quantitative easing put in place during the financial crisis.
- Mortgage rates continue to be lower this week with Freddie Mac's 30-year national mortgage rate falling 5 bps to 4.44%. Refinancing remains relatively slow showing only a 0.6% increase this week according to the MBA. Premium coupon MBS underperformed relative to current coupons as investors are concerned that refinancing might pick up. In addition, there have been many ideas floated recently in Congress that has caused considerable uncertainty among MBS investors. These ideas range from outright principal forgiveness to speedy refinancing for people with above market rates. It is possible that both of these potential modifications to the MBS market will be a drag on this market for the foreseeable future.

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