

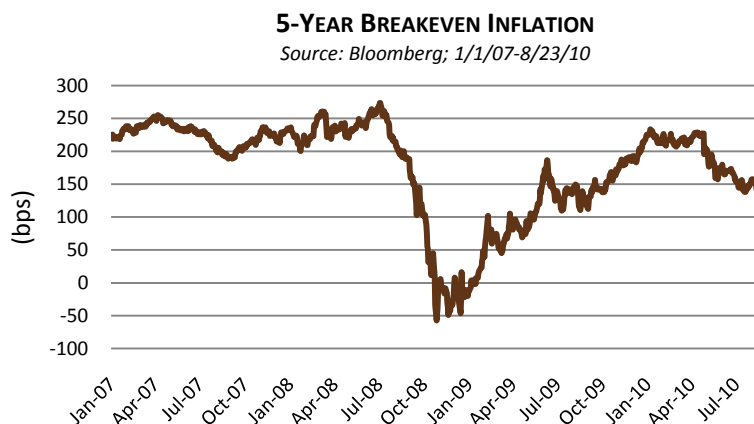


BOND MARKET WEEKLY

WEEK OF AUGUST 23, 2010

MARKET OVERVIEW

- Failure to find significantly bullish indicators in the US economic data and weakness across global equity markets allowed momentum in US Treasuries to continue last week. The benchmark 10-year note yield dropped another 6 bps to 2.61%.
- The flight continued to cover shorts and lock yields in long-term Treasuries after a prolonged period of dramatic curve steepness. This week's action pushed 2- to 10-year yield spreads down 2 bps to +212 while the 2- to 30-year spread plummeted 16 bps to +317. Indeed, the 30-year portion of the Treasury yield curve was the best supported throughout much of the week.
- Breakeven inflation in the TIPS market continues to sink. Last week the current 5-year horizon fell 11 bps to 1.29% while the 5-year, 5-year forward dipped 10 bps to 2.02%. The latter had been above 3% as recently as May.
- The economic data calendar lacked big catalyst releases but on net did nothing to reverse the growing pessimism. Empire Manufacturing survey was slightly better in August (7.10), but the Philly Fed sinking to -7.7 solidified the fear of sagging manufacturing rebound story. The Fed's Senior Loan Officer Survey did show some uptick in lending by the largest banks but failed to move sentiment that the banking system continues to be a net deleverager in the economy.
- Initial jobless claims were surveyed during the same week as the August payroll survey garnering heightened attention. Climbing back to 500,000 (where typically they lie during recessions), they further failed to relieve the bearish momentum.
- Overall, the dog days of summer have set in for markets and trading volumes are light. Moves in either direction have been magnified due to the light volume and it will not be until after Labor Day when we see the full focus of investors and traders digest the recent turn for the worse. Next week's data calendar does offer a revision on Q2 growth. Consensus being revised to 1.4% from 2.4% originally, but some see a risk of a troubling deceleration to 1.0%.



TAX EXEMPT MARKETS

- Municipal bond yields continued their march downward last week with 10- and 30-year yields falling 8 and 9 bps to 2.64% and 4.20%, respectively.
- Despite last month's strong gains in the market this month so far has seen better performance with the Barclays Capital Municipal Bond Index up 1.65% month-to-date through August 20th versus 1.25% for the month of July.
- Investors continue to pour money into bond funds despite falling yields with the Investment Company Institute reporting \$1.38 billion in inflows for the week ending August 11th.
- Supply remains paltry with the Bond Buyer 30-Day Visible Supply Index at \$6.58 billion. Without a sell-off in Treasuries or massive shift in investor demand it seems unlikely that the strength in the municipal market will disappear.
- New deals this week include \$229 million in Houston, TX GO's, \$181 million for the New Mexico Finance Authority, and \$533 million for Southern California Power.



TAX EXEMPT MARKETS (CONT.)

- Despite all the talk about the bad economy and California in particular, one large issuer, the Southern California Power Authority, was upgraded to “AA-” by Standard and Poor’s due to the strength of the member cities’ purchasing power as well as adequate protections to ensure rate increases and high debt service coverage ratios.
- We continued to favor high coupon callable bonds last week in the “AA” or higher ratings categories. Our non-callable purchases tended to be between 7- to 10-years where the curve is the steepest.

TAXABLE MARKETS

- New issue investment-grade corporates had lower volume as the typical “dog days of summer” advanced. For the week, volume was \$12.7 billion compared to \$19.3 billion the prior week. Prominent issues were \$1.5 billion 30-year deals each from Baker Hughes (A2/A) and Apache Corp (A3/A-) at +150 and +140, respectively. The Apache deal was issued to partially fund the planned \$7 billion assets purchase from BP.
- Yankee bank deals continued their strong pace with a 3-part \$3.6 billion deal issued by Royal Bank of Scotland (Aa3/A+).
- Investor demand exhibited continued vitality with the deals heavily oversubscribed. This trend is further seen by the premium paid by investors for new issues (new issues compared to comparable existing debt) having grown to 12 bps (according to Barclays data).
- Corporate spreads tightened 2 bps leaving the Barclays US Corporate Investment Grade Index at +177 OAS (option-adjusted spread). Fundamentals may have contributed to the spread compression as 96% of the S&P 500 companies (by market cap) have reported Q2 earnings. According to Morgan Stanley, earnings have beat estimates by 8.4%, the third best on record (after the most recent periods of 1Q10 and 4Q09).
- MBS had a rough week as concern persisted over fears of a potential policy shift to government sponsored refinancings. The Barclays US MBS Index widened 24 bps to +35 OAS.
- The Freddie Mac national survey of 30-year mortgages improved 2 bps to 4.42%. The lower rate trend helped to push the MBA Refinancing Index up 17% last week.

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