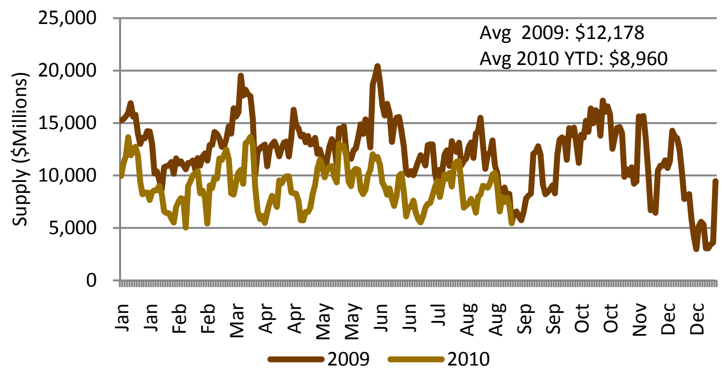
BOND MARKET WEEKLY | WEEK OF AUGUST 30, 2010

MARKET OVERVIEW

BOND BUYER 30-DAY VISIBLE SUPPLY INDEX

Source: Bloomberg; January 2009 - August 2010



- After rallying most of the week on poor economic data, a stiff-lipped Jackson Hole speech by Fed Chairman Bernanke took the steam out of the flight to quality trade and more than reversed gains for the week. The 10-year Treasury yield rose 4 bps on the week to 2.65%, its highest weekly close since 8/13/10.
- More weakness in the rock bottom yielding 2-year Treasury resulted in a flatter yield curve by 3 bps from both 2- to 10-years (+209) and 2- to 30-years (+314). Despite last week's move, the slope of the yield curve remains relatively steep and continues to offer substantially more yield than one would historically expect given current growth trends.
- TIPS outperformed nominal Treasuries last week after a recent run of underperformance. Breakeven inflation rose 6 bps to 1.36% over the current 5-year horizon while the longer-term 5-year, 5-year forward period rose 4 bps to 2.04%.
- Jobless claims were the only significant positive in a week of soft economic data. Initial claims fell to 473k from an alarming 500k the prior week, while continuing claims edged lower again to 4,456k.
- The other economic reports last week were disappointing, fueling the bond market before the Bernanke speech. Existing (-27.2%) and New (-12.4%) home sales fell dramatically in July. Durable goods orders (+0.3%) fell outright in July when stripping out volatile transportation and defense sectors, and signaled that corporate spending, which enjoyed a bounce early in the year, is rolling over.
- Friday's revised GDP report beat expectations but was still revised down from the initial 2.4% estimate to 1.6% - hardly concerning for bond bulls. It appears that the Street is also assuming downward revisions to Q3 and Q4 GDP estimates. We note some prognosticators are discussing an outright contraction in Q3. Meanwhile, Chairman Bernanke attempted at Jackson Hole to reverse the negative tone the Fed has projected of late by reiterating a likelihood of sustainable growth down the road. His comments should be considered carefully as this Fed has shown that it can turn rhetoric into action on a dime.

TAX EXEMPT MARKETS

- Municipals rallied again last week with 10- and 30- year bond yields falling 3 and 5 basis points to 2.61% and 4.15%, respectively. However, municipal yields did rise about 3 basis points on Friday, the first time we have seen prices decline in recent memory. It is hard to predict whether Friday's move was the beginning of a trend, or a blip. We note that September 1st is quickly approaching and another slew of calls and maturities will be bringing cash to the market.
- Mutual fund inflows continue to remain strong with $1.38 billion for the week ending August 18th according to the Investment Company Institute (ICI), virtually identical to the previous week. The ICI also reported that through June, bond funds attracted more assets than equity mutual funds for 30 consecutive months.
- Supply has also remained relatively low with the Bond Buyer 30-day Visible Supply Index at a meager $5.46 billion, well below its $8.96 billion average for 2010 so far. 2009 had an average visible supply of $12.19 billion showcasing the massive reduction in new issues we have seen so far this year. (See chart above)

TAX EXEMPT MARKETS (CONT.)

- Large new deals are few and far between this week on the tax exempt side. North Carolina Eastern Municipal Power is issuing $169 million in bonds and was upgraded to A- by Fitch in anticipation of the new deal. Also, the Denver school district will be selling $124 million and the Harris County, TX Flood Control District will sell $205 million.
- Governor Arnold Schwarzenegger wrote a critical editorial article in the Wall Street Journal on Friday regarding the state of public employee pay and benefits in the state of California. He clearly outlines the serious problems that the state has on the expense side of their income statement. From our point of view, this continues to demonstrate the willingness of politicians to tackle the thornier issues facing municipalities, which is certainly a positive.
- We continued to find value in the high coupon callable market last week. With rates falling as much as they have we have begun tweaking duration down slightly, which more closely matches our benchmarks. Liquidity has been extremely strong and in many cases we sold bonds at prices well above levels indicated by the pricing services.

TAXABLE MARKETS

- Weaker economic data evoked concerns about slower growth in the corporate bond market, which was tempered by a lack of supply. The net result was a 5 bps widening of the Barclays U.S. Corporate Investment Grade Index to +182 OAS (option-adjusted-spread).
- With the rally in Treasuries, only 3% of the bonds within this index are trading below par versus 13% on 1/1/10. The result of rising prices has helped push demand for new issues as price-sensitive investors experienced sticker shock.
- According to Bloomberg, total investment grade issuance was $6.6 billion last week and met with heavy oversubscription, which was the lowest weekly number since May of this year. After the summer ends, new issue volumes are expected to be very strong with yields as low as they are.
- Utilities took advantage of lower rates to refinance. Notable issuers were FPL, Georgia Power, San Diego Gas & Electric, Southern California Edison, and Virginia Electric & Power. Their general tenor was longer dated issues.
- MBS spreads were better paced by the Treasury rally. The Barclays U.S. MBS Index ended the week 7 bps tighter at +28 OAS. Current coupon collateral reached a low near 3.3% before Friday's Treasury selloff, ending the week near 3.4%.
- The FHLMC survey of 30-year mortgages was 6 bps lower at 4.36%. Lower rates helped maintain a trend of higher refinancings. The weekly MBA Index for refinancing was up 5.7%, compared to a 17.1% increase the prior week. The overall index which includes new purchases as well as refinancing was up 4.9% for the week.
- There was encouraging news regarding mortgage delinquencies. For the second quarter, mortgage delinquencies declined 21 bps to 9.85% and mortgage foreclosures dropped 6 bps to 4.57%.

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