

Centerpoint Advisors Fixed Income Fourth Quarter 2010 Overview

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Overview

The fourth quarter featured a whirlwind of activity in the fixed income markets. We entered the quarter with the 10 year Treasury yield at 2.49%. Up to that point the market had rallied (higher prices/lower yields) in anticipation of a second Quantitative Easing Program (QE2) by the Federal Reserve. On November 3rd the Federal Reserve announced it would purchase up to \$600Bn in Treasuries, mostly in the short to intermediate part of the curve. The combination of a somewhat anticipated size and maturity range of the purchases to be made caused the longer end of Treasury curve to start to sell off. As the quarter marched on skepticism as to the need for QE2, along with pressures from the other countries on the impact of a weaker US Dollar on their economies, caused the longer end of the Treasury curve to move lower (price). The final blow came as the treasury began its December auctions of treasuries in the short to intermediate part of the curve. The additional supply on top of an already nervous market pushed yields on Treasuries higher with the 10yr yield touching a high of 3.53% before closing the quarter at 3.295%. At the moment, treasuries seem to have settled into a reasonable trading range while awaiting the next market moving event or piece of data.

Taxable Market

The backup in treasury yields was somewhat offset by a tightening in credit spreads (the spread at which corporate bonds trade over treasuries) as higher overall yields offered institutional investors an opportunity to push money out on the curve that had been previously kept very short. Retail investors who had watched the NAV on many of their bond mutual funds drop redeemed their shares consistently throughout December. During the quarter corporate issuers piled into the market as it appeared that the lower interest rate environment may be coming to an end. Some of the higher profile names that issued are noted in Table 1. As a result of historically low interest rates and tighter credit spreads, corporate issuers have been able to finance debt with very low stated coupons (Microsoft .875% due 9/27/13, Walmart .75% due 10/25/13, etc). Many of these issues now trade at a discount and could trade down quicker than a premium coupon from the same issuer as rates trend higher. We would encourage investors to focus on higher coupons to help offset the effects of rising interest rates. It should be noted that spread tightening does have a limit and should we see another leg up in Treasury yields, corporate bond prices could be impacted more negatively.

Table 1: Select New Corporate Bond Issues Q4 2010

Issuer	Issue Date	Rating	Issue Size	Coupon	Maturity
Coca-Cola Co.	11/4/2010	Aa3/A+	1 Bn	1.50%	11/15/2015
Procter & Gamble	11/15/2010	Aa3/AA-	1 Bn	1.80%	11/15/2015
IBM Corp.	12/6/2010	Aa3/A+	1 Bn	2.00%	1/5/2016
Ebay Inc.	10/21/2010	A2/A	500MM	3.25%	10/15/2020
Wal-Mart	10/18/2010	Aa2/AA	1.75 Bn	3.25%	10/25/2020

Source: Bloomberg

Tax-Exempt Market

We noted in our November 19th Market Note that municipal bond funds had begun to see heavy redemptions during November. The redemption frenzy continued throughout the month of December and into January, pushing yields higher across much of the entire municipal curve. The biggest impact was felt in the longer end of the curve (Table 2), where (for the most part) the natural buyers of tax exempts are individual investors (via bond mutual funds). There were a few events which gave investors cause for concern – yields in treasury securities had begun to move higher, the Bush era tax cuts that where the focus of debate were extended for all taxpayers for two years (thus making tax exempt income less attractive), the Build America Bond Program was

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Tax-Exempt Market (continued)

not extended (essentially guaranteeing that most of future issuance in municipals would be in the tax exempt form – more supply), and continued headlines on municipalities fiscal troubles (highlighted by former high profile banking analyst, Meredith Whitney) all contributed to a weak market. While we do not feel the municipal market will face the level of pain forecasted by the aforementioned analyst, we continue to be very selective in this sector. As such, we continue to maintain very high credit quality in our portfolios, keep average maturities short, and maintain high diversification by issuer. Overall, we expect the debate on the future of the municipal market to continue for some time as there is no quick fix to the deficit problems facing municipalities.

Table 2: Select Municipal Bond Yields

Generic State General Obligation Municipal Bonds AAA Rated	Yield to Maturity as of		
	9/30/2010	12/31/2010	1/13/2011
2yr General Obligation due 2012	0.49%	0.79%	0.73%
5yr General Obligation due 2015	1.21%	1.75%	1.80%
10yr General Obligation due 2020	2.51%	3.44%	3.42%
30yr General Obligation due 2040	4.11%	4.90%	5.02%

All yields sourced from Bloomberg.

Our Portfolios

We continue to feel that investors will be rewarded by sticking with a short/intermediate duration high quality strategy. I indicated in a previous note that an increase in interest rates on a 30-year bond can have an enormous impact on the market value of that bond – something many individual investors ignore when reaching for yield. On the taxable side, we continue to invest in high quality corporate, agency and, when available, taxable municipals. Interestingly, we have been able to source high quality tax exempt municipals on the very short end at absolute levels in excess of taxable bonds. While this is rare and only available on the very short end, we think this strategy offers a cushion should rates move higher as tax exempts historically trade at a fraction of treasury yields and not a multiple thereof (i.e they should back up slower should rates on the short end move higher). On the tax-exempt side we continue our focus on state level and major city general obligation debt, essential revenue bonds, and pre-refunded bonds. We continue to like cushion bonds as a means of adding yield in a potentially rising interest rate environment. We also continue to focus our purchases on higher coupon bonds (typically 4-5% or better if possible). Higher coupon debt offers some cushion to investors should rates move higher. Finally, we do prefer to maintain a slightly higher cash position (including very short liquid instruments) given the current environment, as we feel there will be opportunities (especially in the tax-exempt market) from headline risk over the next several months.



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