

Centerpoint Advisors Fixed Income Third Quarter 2009 Overview

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Overview

Fixed income markets during the third quarter remained very strong. The driving factor behind much of the strength continued to be the unabated flow of funds out of money market funds and into short and intermediate bond mutual funds. During the quarter, taxable bond funds saw inflows of \$104.9 Bn versus \$3.6 Bn in Q3 2008.¹ Tax exempt funds saw inflows of \$27.6 Bn versus \$4.3 Bn in Q3 2008.¹ Keep in mind the capital flows here do not even take into consideration the effect of Bond Exchange Traded Funds (ETFs) which as of the end of August held \$86Bn, up 52% from the end of 2008.² With money market rates at near zero levels (approximately 78% of taxable money market funds offer annualized yields of .1% or less³), it is no surprise that retail investors are looking elsewhere for higher yields. The question at this point is whether another bubble is being created in the fixed income market (i.e. too much cash chasing too few bonds).

Taxable Market

Treasury yields fluctuated somewhat during the quarter, but did not display the same amount of volatility witnessed in the first half of the year. The benchmark 10yr treasury traded in a range of 3.29% to 3.85%. Our previous quarter's commentary discussed the performance of AT&T 5.50% due 2/1/18 which, as of 6/30/09, traded at approximately +174bps over the 10yr treasury. As of 9/30/09 these bonds had tightened in an additional 29bps and were trading at +145bps over the 10yr treasury. The demand for corporate bonds by funds is not going unnoticed by issuers. Consider this: back in the first part of the year, it would not be unusual for a 10yr corporate bond priced at say 350bps over the 10yr treasury to immediately begin trading in the secondary market at 310bps or tighter. At that time, issuers were desperate to get their deals done and were willing to offer a large new issue concession (excess spread) to buyers as an incentive. Recently, new deals in the corporate bond market have begun to price deals "at the market" thus providing virtually no new issue concession to managers who are now flush with cash (that must be invested). Some of these deals in recent weeks are actually trading wider than where they were issued. It will be interesting to see how much longer the shoe stays on the other foot (issuers). For now, investors continue to plow money into bond funds, driving corporate spreads tighter. (See Diagram 1).

Diagram 1: Selected Key Rates

| Treasury Yields | | Yield to Maturity | |
|---|-----------------------|-----------------------|----------|
| | | 10/9/2009 | 7/7/2009 |
| 2yr - 1.125% coupon due 6/30/11 | | 0.79% | 0.95% |
| 5yr - 2.625% coupon due 6/30/14 | | 2.25% | 2.39% |
| 10yr - 3.125% coupon due 5/15/19 | | 3.39% | 2.84% |
| 30yr - 4.25% coupon due 5/15/39 | | 4.23% | 3.70% |
| Corporate Issuer | Rating Moody's/S&P | Approximate Offer YTM | |
| | | 10/9/2009 | 7/7/2009 |
| Goldman Sachs 5.125% coupon due 1/15/15 | A1/A | 4.10% | 4.83% |
| JPMorgan Chase 4.65% coupon due 6/1/14 | Aa3/A+ | 3.55% | 4.40% |
| Hewlett-Packard Co. 4.75% coupon due 6/2/14 | A2/A | 3.03% | 3.50% |
| General Electric Co. 5.00% coupon due 2/1/13 | Aa2/AA+ | 3.08% | 3.39% |
| Pepsi Bottling Group 4.625% coupon due 11/15/12 | Aa2/A+ | 2.05% | 2.34% |
| Money Market Fund Yields | | 7-Day Current Yield | |
| | | 10/9/2009 | 7/7/2009 |
| Fidelity Cash Reserves Fund (FDRXX) | | 0.25% | 0.48% |

All yields as of October 9, 2009 and July 7, 2009, respectively, and sourced from Bloomberg.

¹ http://www.ici.org/pdf/flows_data_2009.pdf

² <http://online.wsj.com/article/SB125478769535366203.html>

³ As of 9/16/2009; <http://online.wsj.com/article/SB125330719871723837.html>

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Municipal Market

Municipal yields continued to march lower, driven by the same bond fund buying that has impacted the taxable market. Unfortunately for municipals buyers, a lack of supply during the quarter compounded the problem (although since I began drafting this piece, we have seen the supply picture improve and as a result rates have backed up. In fact, we recently had a situation where the Treasury market rallied significantly, but the municipal market sold off – an indication that municipals had gotten ahead of themselves). At quarter end, 10yr AAA State General Obligation issues approximated 2.93% or 87.57% of 10yr Treasury yields (this compares to 3.52% or 98.80% of Treasuries at the beginning of the quarter). The most significant drop in yields can be seen in the short/intermediate part of the curve. Again, this coincides with fund flows into short/intermediate tax exempt bond funds.

Diagram 2: Selected Municipal Key Rates

| Generic State General Obligation Municipal Bonds AAA Rated | Yield to Maturity as of | | AAA Municipal as % of Current US Gov't Securities | |
|---|-------------------------|-----------|--|-----------|
| | 9/30/2009 | 6/30/2009 | 9/30/2009 | 6/30/2009 |
| 2yr General Obligation due 2011 | 0.75% | 0.97% | 79.56% | 90.86% |
| 5yr General Obligation due 2014 | 1.67% | 2.18% | 70.78% | 85.67% |
| 10yr General Obligation due 2019 | 2.93% | 3.52% | 87.57% | 98.36% |

All yields sourced from Bloomberg.

Our Portfolios

On the taxable side, we maintain our focus on high quality names. While we continue to evaluate corporate issues, the significant tightening in the sector has resulted in fewer values. As a result, we have begun to look more heavily at the agency market for our portfolios. On the municipal side, we continue to compare municipal yields to their fully taxable counterparts (corporates/agencies) to determine the highest taxable equivalent yield for the client. We feel it is just a matter of time before interest rates begin to move higher and continue to keep our portfolios on the shorter side.

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