

# Centerpoint Advisors Fixed Income Fourth Quarter 2009 Overview



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## Overview

The fourth quarter continued to witness significant strength in virtually all sectors of the fixed income markets. The flow of funds into bond funds continued into the fourth quarter at a record pace. Bond fund managers who had new cash to invest had few options but to buy bonds which had already rallied significantly over the last year.

## Taxable Market

During the quarter, the benchmark 10 year treasury traded in range of 3.18% to 3.83%. The most noticeable change in the treasury market can be seen in the steepening of the yield curve. As of September 30th the spread between the 2 year and 10 year treasury approximated 2.35%, and as of December 31st this spread widened to 2.83% (it currently stands at 3%). The steepening of the curve is typically an indication that investors are concerned that long term yields will either be eroded by inflation, or are poised to go higher due to other events (such as supply). The question on most investors' minds as we enter 2010 is "where will interest rates go from here?". Diagram 1 shows where various firms see the 10 year treasury trading as of year end. While the median and average forecast don't seem far from where we are now, the range in forecasts is quite significant. As noted above, corporate spreads continue to march forward. The corporate benchmark we have been using, the AT&T 5.50% due 2/1/18 entered the quarter trading at a spread of +145 bps over the 10 year treasury. As of quarter end, this spread had compressed to +95 bps. Keep in mind that since the 10 year treasury yield backed up by 53 bps during the quarter (3.30% to 3.83%), the spread tightening was almost completely offset by the selloff in treasuries.

**Diagram 1: 10-Year Treasury Bond Yield  
Forecast for Q4 2010**

Forecasting Firm	Yield
Median Forecast	4.10%
Average Forecast	4.09%
High Forecast	5.50%
Low Forecast	2.50%
Bank of America	4.25%
Barclays Capital	4.50%
Credit Suisse Group	3.75%
Deutsche Bank AG	4.50%
Goldman Sachs	3.25%
JPMorgan Chase	4.50%
Morgan Stanley	5.50%

All data sourced from Bloomberg. Average based on survey of 68 firms.

## Municipal Bonds

Municipal yields as a percentage of treasuries dropped during the quarter. As of quarter end, yields on 10 year AAA State General Obligation issues approximate 3.26% or 83.09 % of treasuries. Bond fund inflows, a lack of supply, and the perception that income taxes are going higher are all factors contributing to the rally in municipals. As we enter 2010 we see opposing factors impacting yields in the municipal market. On one side we have a lack of supply in tax exempts (taxable bonds issued as Build America Bonds could approach \$130 Bn in 2010 – issues that would normally have come in the form of tax exempt debt), the perception that income taxes (at least for the higher wage earners) will have to increase in order to pay down the bulging federal deficit, and the unabated flow of funds into mutual funds will keep municipal yields down. On the other side we have the overall level of interest rates potentially moving higher and the continued deterioration of states' financial condition (resulting in potential downgrades) moving yields on municipals up. With regard to the last comment on states financial conditions, just in the last week comments were made by Governor Paterson of New York and Washington State Treasurer Jim McIntire about the significant fiscal problems and cash deficits facing their states. These are comments on top of the almost daily comments we are hearing on the fiscal problems in California. Should we see a state require support from the federal government, it is probably safe to say that it will not be just one state in line for a handout. If this happens, state coffers may get a shot of capital, but it will be at the expense of our federal balance sheet and would therefore put pressure on treasury yields.

## Centerpoint Advisors Fixed Income Fourth Quarter 2009 Overview Continued

**Diagram 2: Selected Treasury, Municipal, and Money Market Key Rates**

Selected Treasury Yields		Yield to Maturity as of			
		9/30/2009	12/31/2009		
2yr - 1% coupon due 9/30/11		0.95%	1.01%		
5yr - 2.375% coupon due 9/30/14		2.31%	2.56%		
10yr - 3.625% coupon due 8/15/19		3.31%	3.83%		
30yr - 4.50% coupon due 8/15/39		4.05%	4.64%		
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	12/31/2009	9/30/2009	12/31/2009	
2yr General Obligation due 2011		0.75%	0.62%	79.56%	53.84%
5yr General Obligation due 2014		1.67%	1.66%	70.78%	61.29%
10yr General Obligation due 2019		2.93%	3.26%	87.57%	83.09%
Money Market Fund Yields		7-Day Current Yield			
		10/9/2009	1/12/2010		
Fidelity Cash Reserves Fund (FDRXX)		0.25%	0.08%		

Treasury and Municipal yields as of September 30, 2009 and December 31, 2009, respectively, and sourced from Bloomberg.  
 Money Market yields as of October 9, 2009 and January 12, 2010, respectively, and sourced from Bloomberg.

### Our Portfolios

On the taxable side, we continue to keep our portfolios on the shorter end. Spreads in corporate paper are indicating that a recovery is well underway... if that is the case, treasury yields are sure to rise (and possibly in a dramatic manner). A move in the 10 year treasury from 3.83% to 5.50% (see Diagram 1) in one year would result in a drop in market value of principal of approximately of 11.50%. Municipal bonds are a tougher call. While it is possible that yields remain low and demand for bonds strong, we are concerned that the fiscal issues facing states will get worse, which could have a negative impact on the market. As such, we continue to keep our portfolios relatively short, diversified, and in high quality names.

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