

Centerpoint Advisors Fixed Income Second Quarter 2010 Overview



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Overview

The second quarter got off to a rather uneventful start in the fixed income markets. Yields on treasuries remained relatively narrow range, with 10 year treasuries trading in close to a 10bp range for almost all of April (the yield actually spiked up close to 4% on April 5th.) However, as April came to a close a few stories began to catch the focus of fixed income investors; Greece's worsening financial condition (something that made headlines in Q1) began to move into the crisis phase with concerns that if a concerted bailout by all members of the European Union could not be reached, defaults by other nations holding Greece's debt might become a reality (Portugal, Spain, etc) and concern that several major European banks who held Greek bonds might be at risk should the country default. As a result of these issues the euro began to accelerate its decline versus the dollar as money flowed out of euro and found safe haven in the dollar. It was also in late April that an explosion on the Deepwater Horizon oil rig in the Gulf of Mexico (which killed 11 people) triggered the worst oil spill in U.S history.

Taxable Market

As mentioned, the 10yr treasury traded in a relatively narrow range for most of April. However, as we entered May and the dollar strength versus the euro continued, yields on 10yr treasuries begin to move lower. Yields opened the month at 3.68% and by month end stood at 3.29% (as of quarter, end the yield dropped further to 2.93% as investors began to focus less on issues in Europe and more on weak economic data released in the U.S.

- see Diagram 1). In the corporate market, spreads at which bonds traded over treasuries were slightly tighter in most sectors for the quarter, with certain exceptions. Corporate spreads in the bank and finance sector widened out considerably during the quarter as concerns over the Financial Regulation Bill and its impact on these institutions caused investors to push bond spreads wider. Also, a lawsuit filed by the SEC against Goldman Sachs relating to its role in certain CDO transactions forced their bond spreads to widen further, pulling the rest of the financial sector with them. The energy sector was another significant underperformer of the quarter. As the events of the Deepwater Horizon oil rig explosion unfolded the bond spreads of companies who had some involvement in the rig widened. The owner of the rig, British Petroleum (BP) saw its

Diagram 1: Select Bond Yields

Selected Treasury Yields	Yield to Maturity as of		Change	
	6/30/2010	3/31/2010		
2yr - 1% coupon due 3/31/12	0.53%	1.02%	-0.49%	
5yr - 2.50% coupon due 3/31/15	1.68%	2.55%	-0.86%	
10yr - 3.625% coupon due 2/15/20	2.93%	3.83%	-0.90%	
30yr - 4.625% coupon due 2/15/40	3.89%	4.71%	-0.82%	
Selected Corporate Bond Yields	Spread vs. Comparable Treasury		Change	
	6/30/2010	3/31/2010		
BPLN (BP) 3.875% coupon due 3/10/15	+582 Bps	+43 Bps	+539 Bps	
GS (Goldman Sachs) 5.375% coupon due 3/15/20	+256 Bps	+168 Bps	+88 Bps	
AMGN (Amgen) 4.50% coupon due 3/15/20	+57 Bps	+67 Bps	-10 Bps	
Generic State General Obligation Municipal Bonds (AAA Rated)	Yield to Maturity as of		AAA Municipal as % of Current US Gov't Securities	
	6/30/2010	3/31/2010	6/30/2010	3/31/2010
2yr General Obligation	0.58%	0.73%	92.01%	72.08%
5yr General Obligation	1.70%	1.80%	94.61%	70.48%
10yr General Obligation	3.09%	3.27%	104.34%	85.05%
Money Market Fund Yields	7-Day Current Yield			
	7/21/2010		4/16/2010	
Fidelity Cash Reserves Fund (FDRXX)	0.10%		0.01%	

Treasury, Corporate, and Municipal yields as of June 30, 2010 and March 31, 2010, respectively, and sourced from Bloomberg. Money Market yields as of July 21, 2010 and April 16, 2010, respectively, and sourced from Bloomberg.

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Taxable Market continued...

bonds widen the most. As an example, the BP 3.875% coupon due 3/10/15 traded on April 21st (pre-explosion) at a dollar price of 104.854 to yield 2.80%; the same issue traded on June 25th at 82.05 to yield 8.60% (Diagram 2). Bonds have since recovered to around 92.5 or 5.74% as there appears to be progress in capping the flow of oil from the broken pipe.

Diagram 2: BPLN 3.875% coupon due 3/10/15



Source: Bloomberg

Tax Exempt Market

Municipal bonds did not participate to the same degree in the rally (lower yields) as did the treasury market. While yields on the 5 year treasury dropped by approximately 91 bps during the quarter, 5 year AAA General Obligation yields dropped by only approximately 10 bps. Part of the underperformance can be attributed to “flight to quality” buyers from overseas driving treasury yields to historically low levels. In addition, as we noted in the first quarter fixed income overview, the flow of funds into municipal bond funds had begun to ease dramatically as the first quarter came to a close. April saw inflows into municipal bond funds of only \$989 million... this compares to inflows into taxable bond funds of \$22.1 billion for the same period. Some recent negative municipal headlines as well as the continued daily coverage of the fiscal battles in states such as NJ, NY, CA, and IL may be causing investors to be cautious. Recently there have been several articles focused on the credit quality of essential revenue bonds (water and sewer bonds) versus other issues. The articles argue that essential revenue bonds are stronger quality credits as they are backed by a very defined stream of revenue (typically water or sewer bills that customer almost always pay.) We do agree that essential revenue bonds offer investors strong credit quality, and we have (and do) invest in such issues as opportunities present themselves.

Our Portfolios

I wanted to comment a bit on diversification. The situation with BP offers an excellent lesson on the need to have a well diversified portfolio. Once a marquis name, BP could (prior to April) issue debt at extremely attractive levels relative to treasuries, enjoyed a strong AA credit rating, and boasted a free cash flow that some small countries would envy. The company is now in a position where it has been forced to sell assets (recently to Apache Corporation) in order to fund potential liabilities. **The point is, no single issuer is immune from some form of disaster; therefore no single issuer should represent a significant portion of any portfolio.**

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Our Portfolios continued...

On the taxable side, our focus has been on high quality corporate and agency bonds (again, in small exposures.) We have begun to stretch portfolios that have good liquidity on the shorter end a bit farther out into the intermediate part of the curve as it does appear now that yields may stay lower longer than initially thought. While municipal yields have dropped, they have not dropped at the rate at which their taxable counterparts have. As a result, on a relative basis (versus treasuries) municipals are at compelling levels. The issue for investors at this point is the absolute levels at which bonds are trading. Since no one can really say for sure when we will start to see higher rates, investing at historically cheap levels relative to treasuries seems prudent. That said, our municipal purchases continue to focus on high quality general obligation, essential revenue, and pre-refunded debt. We have started to purchase non-MA bonds in credits where we feel comfortable – again, in an effort to increase diversification in the portfolios.

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