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Finding Value in a Gradually Normalizing World

By Jill King, Vice President, Senior Portfolio Manager

The U.S. Government's unprecedented efforts to restore financial stability have been well publicized in the press and have begun to show progress in arresting the financial crisis. Among the early signs of success: liquidity has improved in the short end of the curve, credit spreads have come off their wides, the new issue corporate bond market has been extremely active and mortgage markets have begun to normalize. The stimulus has also had an unexpected effect on local and state governments. The Federal government has been swift to provide all kinds of stimulus packages and ideas to reduce the income tax burden for the average American. But state and local governments have been hard hit by the economic downturn. Money in the state coffers has virtually dried up due to reductions in practically every form of revenue – income tax, property tax, sales tax. Additionally, it is the states that are responsible for an ever increasing liability for unemployment benefits, as unemployment rates approach 10%. Ten of the largest states –among them: California, New York and Illinois – are considering an increase in local and/or state taxes. These proposed actions contradict what the U.S. government is trying to accomplish and could be a crimp in the recovery process. While approximately 20% of the fiscal stimulus has been allocated to the states, it appears unlikely that this will lead to any additional impetus provided by state expenditures. If states are unable or unwilling to utilize their portion of the stimulus package to initiate projects that would provide a multiplier effect, the recovery process could significantly slow.

The activity in the Treasury market has been overshadowed by the attention paid to recent gyrations in the stock market. The Dow and S&P posted their best five-week gain since the Great Depression. But 1st Quarter earnings are expected to take some of the wind out of the equity market's sail. The Treasury market is taking most of its direction from changes in the equity market. The other major influence is the government's buyback schedule. This week the Fed is buying back March 2011 - April 2012 Treasuries and April 2010 - March 2011 Agencies. This action has given support to both the Treasury and Agency markets.

There also continues to be interest in FDIC insured paper. The deadline for lower government fees for issuing paper through the FDIC was April 1st. We saw a substantial amount issued prior to the deadline, but the new issue market has slowed considerably since April 1st. This has created an imbalance between supply and demand and has tightened spreads in this sector. For example, the first paper issued by JPMorgan and Morgan Stanley was issued from +150 to +180 basis points versus Treasuries. This paper now trades +25 basis points tighter than where equivalent Agency paper trades.

With increased attention on the "government equivalent" sector, we have seen renewed interest in two "quasi-government equivalents": Supra-Nationals and Sovereigns. Supra-Nationals such as International Bank for Reconstruction and Development (IBRD) – better known as the World Bank – and Inter-American Development Bank (IADB) have recently issued attractive short dated paper. IBRD and IADB are multi-national member organizations that promote economic development in moderate and low income countries. They carry a AAA rating and trade in tandem with U.S. Agencies and TLGP (Temporary Liquidity Guarantee Program) paper. Sovereigns, such as U.S. Agency for International Development (AID) also offer attractive returns. The AID administers a housing guaranty program that promotes basic shelter for low-income families in developing countries. The AID bonds are AAA rated and secured by the full faith and credit of the U.S. Government. There are over $1 Billion in AID issues outstanding, with Israel being the primary issuer. While Supra-Nationals and AID bonds have historically traded rich to U.S. Agency securities, each currently offers yield enhancement versus similar maturity Agency securities.

We continue to strive to find attractive and risk adverse investment alternatives for our clients. Supra-Nationals and Sovereigns (such as AID bonds) are but two examples that we're currently examining more closely. As the U.S. Government's efforts to stabilize the economy take hold, we expect other opportunities to present themselves. We'll monitor these developments closely and share all new findings with you.