

For the week of May 11, 2012

MARKET LEVELS

	Friday*	Last week	Dec. 31, 2011	One year ago
Dow Jones Industrial Avg	12,906	13,207	12,218	12,696
S&P 500	1,364	1,392	1,258	1,349
NASDAQ	2,955	3,024	2,605	2,863
Russell 2000	792	807	741	848
DJ STOXX Europe 600 (€)	252	258	245	282
Nikkei Index (¥)	8,953	9,380	8,455	9,717
MSCI EM Index	366	378	343	387
Fed Funds Target	0%-0.25%	0%-0.25%	0%-0.25%	0%-0.25%
2-Year Treasury Yield	0.26%	0.26%	0.24%	0.55%
10-Year Treasury Yield	1.85%	1.93%	1.88%	3.22%
U.S. \$ / Euro	1.29	1.32	1.30	1.42
U.S. \$ / British Pound	1.61	1.62	1.55	1.63
Yen / U.S. \$	79.89	80.18	76.91	80.94
Gold (\$/oz)	\$1,588.30	\$1,635.98	\$1,563.70	\$1,505.90
Oil	\$95.93	\$102.54	\$98.83	\$98.97

*Levels reported as of 8:30 a.m. Pacific Standard Time

MARKET RETURNS

Year-to-date (12/31/11-5/11/12)*

Year-to-date (12/31/11-5/10/12)

Dow Jones Indus Avg.	5.63%	90 Day T-Bill	0.02%
S&P 500	8.44%	2-Year Treasury	0.09%
NASDAQ	13.42%	10-Year Treasury	1.20%
Russell 2000	6.93%	ML High Yield Index	6.66%
MSCI World Index	5.28%	JPM EMBI Global Diversified	6.07%
DJ STOXX Europe 600	2.99%	JPM Global Hedged	1.50%
MSCI EM Index	6.84%		

*Returns reported as of 8:30 a.m. Pacific Standard Time

ECONOMIC OVERVIEW

The US economic data calendar this week featured second and third tier economic reports and did little to alter our view that the US economy is expanding at a moderate pace. On Thursday we learned that initial claims for unemployment fell last week to 367,000, bringing the 4-week moving

averaged back down to 379,000. This is good news as many market participants worried that the recent rise in initial claims was a repeat of events of spring 2011, when hiring slowed and growth almost stalled. The Bureau of Labor Statistics also released data on job openings and labor market turnover. Job openings in March rose to 3.7 million, the highest level since mid-2008. As job openings rise, the unemployment rate tends to fall. One final piece of labor market news arrived in the "quits" data. Quits rise (and fall) with the economy's prospects. In a weak economy, workers hold onto their jobs rather than quitting for new opportunities. Through March, quits also rose to their highest level since 2008. In short, labor market data continued to point to modest improvement in the US economy which will likely keep the Federal Reserve on hold as we approach mid-year.

US MARKETS:

TREASURIES

- US Treasuries rallied this week despite the \$72 billion of new coupon supply that cleared the market. The flight-to-quality trade underscored the strong bid for Treasuries, as concerns of EMU dissolution resurfaced. In typical fashion, the term structure bull flattened and swap spreads were pressured wider, noting that USD three-month Libor actually reset 0.1 basis points higher after 10 consecutive days of unchanged fixings.
- Next week the market will digest US inflation data, FOMC minutes, three long-end FED buyback operations and a \$13 billion 10-year Treasury inflation-protected securities auction.

LARGE-CAP EQUITIES

- The stock market fell for the second consecutive week as leadership changes in Europe added another level of uncertainty to global risk markets. The S&P 500 index ended the week down approximately 0.5%, while the NASDAQ Composite was unchanged. Small-cap stocks outperformed large-cap stocks. In terms of style, large-cap value stocks modestly outperformed large-cap growth stocks. The best performing sectors were telecoms and utilities, while the worst performing sectors were materials and financials.
- In earnings news, Cisco Systems topped street earnings and sales estimates. The company attributed the beat to corporate restructuring and the continued recovery in Japan. However, the company's forward estimates fell short of street expectations. Shares of CSCO fell over 10% on the news. In the headlines this week, JPMorgan Chase disclosed a failure in their risk controls which resulted in a \$2 billion trading loss. Shares of JPM fell over 7% on the negative news.

CORPORATE BONDS

- Investment grade primary activity picked up once again despite equities selling off most of the week. We saw nearly \$20 billion of issuance again this week as investors are searching for places to invest. Most deals have been brutally oversubscribed and printing considerably tighter than original price talk. Notable deals this week included Diageo (\$2.5 billion) and Devon Energy (\$2.5 billion).
- Investment grade corporate spreads widened most of the week as the credit market took its cues from the equity market. Renewed concerns regarding Greece leaving the Eurozone and the potential pull-back from austerity kept most investors sidelined away from new issuance. The sentiment concerning the Eurozone can shift quickly, so most investors are equipped to soak up cash that has been accumulating following a slow April calendar. The Barclays Credit

Index Option-Adjusted Spread (OAS) finished the week at +173, 4 basis points wider. Financials widened by 4 basis points (banks +5, insurance -0); industrials widened 4 basis points (basic materials +8, capital goods +4, telecom +6, consumer cyclical +3, consumer non-cyclical +3, energy +8); and utilities widened by 5 basis points.

MORTGAGE-BACKED SECURITIES

- Mortgages posted mixed performance as yields consolidated near the lows of the cycle. European political uncertainty helped lower coupons outperform with spreads tighter by 3 to 5 basis points versus comparable Treasuries. Sideline investors also joined the buying party as bets changed from bearish to neutral for risk-averse asset classes. In contrast, higher coupons struggled on profit taking from early gains after the release of this month's prepayment report. Although the prepayment was well-behaved, at record highs higher coupon mortgages (5-years thru 6.5-years) have little room for error. Any changes to existing programs (or new legislation) on the housing relief front would be destructive to premium mortgage valuations. Mortgage supply was a non-factor this week. In commercial mortgages, the market bifurcated with clean new issue transactions trumping older legacy deals. In fact, credit sensitive commercial MBS bonds failed to participate in the bond rally, posting lower dollar prices. The benchmark commercial mortgage transaction of the legacy days, GSMS 07-GG10 A4, widened 20 basis points or negative 1% versus Treasuries.
- For the week, the 30-year current coupon mortgage versus the 10-year Treasury spread closed flat at 91 basis points. According to Freddie Mac, the 30-year mortgage rate edged higher to 3.83%.

MUNICIPAL BONDS

- Sluggish new issuance continued to be a drag on trading in the tax-exempt market. A large week of inflows into municipal bond funds provided support for continued tightening of yields, especially for California-exempt bonds. With a substantial slate of cash looking to be invested, the market saw no lack of bids, especially from the retail sector. The few negotiated deals that did price were well oversubscribed in shorter maturities due to this demand.
- Yields declined across the yield curve, with the 10-year benchmark ending the week at 1.76%, down 6 basis points on the week, and the 30-year down 6 basis points to 3.09%

HIGH-YIELD BONDS

- The high yield market in May to-date has largely avoided the sell-off in the equity markets in May. Though many major equity indices are down 3-4% month-to-date, the high yield market is up with the Merrill Lynch high yield BB/B index up 0.5% month-to-date. This "de-coupling" of sorts is largely due to: (i) the liquidity in the high yield market, with another \$754 million flowing into high yield mutual funds and ETFs, and (ii) the high yield market is somewhat protected from the noise emanating from Europe, in particular Greece and Spain. Renewed concerns about peripheral European debt are once again weighing upon global equity markets post the recent elections in Greece and Spain. As a more US centric market, the high yield market has been spared some of the recent volatility. The high yield new issue market remains active and open for well-priced and well-structured deals. While the forward calendar has diminished somewhat, approximately \$4 billion of new deals priced this week including a \$850 million bond financing for Carlson Wagonlit, a global travel services company, and a \$300 million

bond financing for Louisiana Pacific Corporation, a manufacturer of building products. Carlson Wagonlit priced a \$465 million B+ rated bond deal with a coupon of 6.875% or a spread of 566 basis points over comparable duration US Treasuries. Louisiana Pacific priced a \$350 million, BB rated bond deal with a 7.5% coupon or a spread of 608 basis points. Both these deals and many of the other new deals were well-received and traded up in the secondary market.

INTERNATIONAL MARKETS:

EASTERN EUROPEAN EQUITIES -----

- Stocks in Eastern Europe were down -5% during the week. Hungary's Consumer Purchase Index (CPI) increased from 5.5% in March to 5.7% in April, more than expected, partly driven by fuel and tobacco prices. Core CPI was up from 5.0% in March to 5.1% in April reflecting the rising trend in non-durable goods on gradual pass through of FX weakening. New taxes recently announced by the government are also likely to boost 2013 CPI by several tenths, thus delaying a return to the 3% inflation target to 2014, assuming no additional external price shocks.

GLOBAL BONDS AND CURRENCIES -----

- Major non-US government bond markets benefited from safe haven flows again in the past week on political uncertainty and fresh concerns about the Euro-zone's fiscal woes. This week attention focused particularly on the so far unsuccessful efforts by Greece's political parties to form a government following last weekend's inconclusive elections and on the Spanish government's decision to bail-out one of the country's major banks. Ten-year German bund yields hit record lows while Spanish government spreads widened slightly on the week. However, the victory of the left-wing candidate in France's Presidential election last weekend did not unnerve French government bonds, which closed the week firmer. In the UK, the Bank of England (BoE) kept policy on hold as expected at the past week's Monetary Policy Committee meeting. Gilts found support from speculation that the coming week's quarterly Inflation Report from the BoE may open the way for an extension of the BoE's £325 billion quantitative easing program if the domestic economy remains weak. Japanese government bonds gained on the flight to quality as the Nikkei fell below 9000.
- In currency markets the USD was firmer against the euro, which came under pressure from events in Spain and Greece. Investors are fearful that Greece's political impasse may see it exit the single currency. The greenback was also up against Sterling, which was hit by speculation about the possibility of further asset purchases by the BoE. However the dollar traded sideways against the yen and rose against the commodity currencies following weaker than expected Chinese industrial output and retail sales data and an easing in commodity prices.

EMERGING-MARKET BONDS -----

- Emerging market dollar-pay debt spreads were wider this week.
- Poland's Monetary Policy Council (RPP) surprised markets by raising its headline interest rate for the first time in ten months by 0.25% to 4.75%, its highest level since January 2009. The rate hike came on the back of concerns over persistently high inflation. In a statement, the RPP declared that it is less concerned about an economic slowdown at this point. It noted that although growth has slowed down somewhat, it is expected to remain relatively high in the first

quarter. GDP grew by 4.3% last year and is expected to grow by 2.5% this year. Governor Belka further stated in press conference that the National Bank of Poland could not have normal policy with real rates below zero and that the decision to raise rates was a move to normalize rates rather than tighten policy.

- Indonesia kept its policy rate unchanged at 5.75% on the back of inflation risks due to the possibility of higher fuel prices and a declining currency. Though they left the benchmark rate unchanged, the central bank stated that, “Bank Indonesia (BI) will raise interest rates of monetary operation instruments and continue efforts to absorb excess rupiah liquidity to control short-term inflationary pressure and support the stabilization of the rupiah.” BI also stated that economic growth has remained strong. GDP expanded by 6.3% in the first quarter of 2012, above the trend rate of 6.1%

NEXT WEEK'S KEY ECONOMIC RELEASES

- 5/15/12** Consumer Price Index, Advance Retail Sales, NAHB Housing Market Index Housing Starts, Building Permits
- 5/16/12** Industrial Production, Capacity Utilization, FOMC minutes
- 5/17/12** Philadelphia Fed, Leading Indicators