

For the week ending June 10, 2011

## MARKET LEVELS

	Friday*	Last week	Dec. 31, 2010	One year ago
Dow Jones Industrial Avg	12,002	12,151	11,578	10,173
S&P 500	1,278	1,300	1,258	1,087
NASDAQ	2,661	2,733	2,653	2,219
Russell 2000	785	808	784	640
DJ STOXX Europe 600 (€)	268	274	276	248
Nikkei Index (¥)	9,514	9,492	10,229	9,543
MSCI EM Index	384	387	393	328
Fed Funds Target	0%-0.25%	0%-0.25%	0%-0.25%	0%-0.25%
2-Year Treasury Yield	0.40%	0.43%	0.60%	0.79%
10-Year Treasury Yield	2.97%	2.99%	3.30%	3.32%
U.S. \$ / Euro	1.44	1.46	1.34	1.21
U.S. \$ / British Pound	1.62	1.64	1.56	1.47
Yen / U.S. \$	80.35	80.34	81.19	91.34
Gold (\$/oz)	\$1,533.20	\$1,541.95	\$1,420.78	\$1,216.55
Oil	\$99.37	\$100.56	\$91.38	\$75.48

\*Levels reported as of 9:00 a.m. Pacific Standard Time

## MARKET RETURNS

Year-to-date (1/1/11-6/10/11)\*

Year-to-date (1/1/11-6/9/11)

Dow Jones Indus Avg.	3.66%	90 Day T-Bill	0.08%
S&P 500	1.62%	2-Year Treasury	0.89%
NASDAQ	0.29%	10-Year Treasury	4.44%
Russell 2000	0.19%	ML High Yield Index	5.19%
MSCI World Index	2.18%	JPM EMBI Global Diversified	4.48%
DJ STOXX Europe 600	-2.78%	JPM Global Hedged	1.46%
MSCI EM Index	-2.25%		

\*Returns reported as of 9:00 a.m. Pacific Standard Time

## RECAP OF THE WEEK'S ECONOMIC RELEASES

**June 7: JOLTS Job Openings** – Data from the Labor Department's Job Openings and Labor Turnover Survey (JOLTS) showed that there were 2.972 million job openings in April compared to 3.214 job openings in March. Further, total hires continue to outpace total separations (quits and layoffs). Although on net this

means the US labor market is adding to total employment, the level of “hires” and fires” are well below normal levels signaling a slow and stagnant recovery.

**June 9: International Trade** – In April, the trade balance (exports minus imports) shrunk to \$43.7 from \$48.2 previously, a larger decrease than the market had expected. This is a positive to April’s international trade contribution to Q2 GDP growth.

## ECONOMIC OVERVIEW

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Federal Reserve Chairman Ben Bernanke’s speech on the US economic outlook was the highlight of a week without any top-tier economic data releases. His remarks indicate that the Fed views the recent spate of weak economic data as evidence of a “soft patch” in growth, not a more severe slowdown. This is important because it signals that additional easing (e.g., QE3) is not forthcoming absent a more severe turn in the economic data. Further, Mr. Bernanke’s remarks can be viewed as a response to his critics, of which there are two major groups critical of Mr. Bernanke and the Federal Reserve. The first, and most vocal, group blames the Fed for many (if not all) economic ills. In their opinion, Bernanke is responsible for the decline in the international exchange value of the dollar, the rise in the price of oil, excess lending to domestic and foreign banks, excess liquidity in emerging markets and a bubble in segments of the financial markets. In response, Bernanke points out that the decline in the US dollar brings us back to levels that existed pre-crisis (before a dollar rally sparked by flight-to-quality concerns) and that global supply and demand considerations are at the heart of the price of oil, not US monetary policy. He also adds that emerging market policymakers have tools at their disposal to address domestic issues (e.g., inflation and excess liquidity).

The other critical group blames the Fed for *not doing enough!* This group clamors for additional stimulus (QE3?) from the Fed since the unemployment rate is lingering above 9% and the duration of unemployment for almost half of these workers has stretched on for more than six months. Mr. Bernanke’s apparent reluctance to do more (reiterated again in his speech this week) has this group of critics perplexed. Mr. Bernanke’s response is that the US economy is on better footing than a year ago and moving in the right direction. Private-sector payroll employment, he says, “increased at an average rate of about 180,000 per month over the first five months of this year, compared with less than 140,000 during the last four months of 2010 and less than 80,000 per month in the four months prior to that.”

Which group of critics has it right? The reality is probably somewhere in the middle – the Fed is not to blame for *everything* nor is it (or additional quantitative easing) the solution to all our economic woes. To see this, a great place to start is Perry Mehrling’s 2010 book, “The New Lombard Street: How The Fed Became Dealer of Last Resort.” Many of the initiatives that the Fed has unveiled since the onset of the crisis in 2007 were in its role as a “lender of last resort” to the financial system. Since the US financial system has evolved from a bank-based system (where the Fed uses discount window operations to act as lender of last resort) to a “market-based” system, the Fed became more like a dealer – absorbing Treasury, agency and other securities on to its balance sheet on one side and creating bank reserves on the other side. That’s because in order to fulfill its role as “lender of last resort” in a panic, the Fed needed to be more “dealer-like”. The financial system had evolved and with a lag, the Fed began to evolve with it. Meanwhile, the second group of critics must also realize that there is only so much the Fed can do beyond lender of last resort functions to steer the economy. Or, in Bernanke’s words, “the Federal Reserve’s actions in recent years have doubtless helped stabilize the financial system, ease credit and financial conditions, guard against deflation, and promote economic recovery” but “monetary policy cannot be a panacea”.

## US MARKETS:

### TREASURIES

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- Treasury yields oscillated but ended unchanged this week as a probe to new calendar year lows in yield was met with a sell-off exacerbated by modestly weak Treasury auctions. Ben Bernanke’s comments coupled with a continuation of elevated jobless claims did little to inspire those looking for meaningful

economic expansion. Rates investors are weighing the waning prospects of growth and inflation against concerns related to the debt ceiling and long-term funding requirements.

## **LARGE-CAP EQUITIES**

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- The stock market fell for the sixth consecutive week as Bernanke failed to lift investors' sentiments. Intra-day volatility continued to move higher on relatively light trading volume. The S&P 500 index ended the week approximately 2% lower, while the NASDAQ Composite was down 3%. Large-cap stocks outperformed small-cap stocks. In terms of style, large-cap value stocks modestly outperformed large-cap growth stocks. The best performing sector was utilities and the worst performing sector was financials. In the headlines this week, the US Senate rejected a plan to delay a cap on debit-card swipe fees. Shares of Visa and Mastercard fell 4% and 1.5% respectively, on the negative news.

## **CORPORATE BONDS**

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- Investment grade primary activity continued its torpid pace as ongoing geopolitical issues, weakness in sovereigns and comments from the Fed contributed to the malaise and ennui felt by most of the market. Trading volumes have dwindled which have intensified the spread widening the market has experienced over the past several weeks. Notable deals this week included Fiserv Inc. (\$1bln) and Spectra Energy (\$500mm).
- Investment grade corporate spreads have been trending wider over the past several weeks. The "risk-off" trade has been the latest preference for those uneasy about the market. Typically around this time of year, marked by the end of first quarter earnings and the beginning of summer, trading volumes diminish considerably, which might contribute to overall current market sentiment. The Barclays Credit Index Option-Adjusted Spread (OAS) finished the week 4 basis points wider at +139. Financials widened by 7 basis points (banks +8, insurance +7); industrials were 3 wider (basic materials +5, capital goods +3, telecom +3, consumer cyclical +2, consumer non-cyclical +3, energy +7); and utilities widened by 4 basis points.

## **MORTGAGE-BACKED SECURITIES**

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- Mortgages underperformed Treasuries from the weight of global economic malaise, weak equity markets, and lower interest rates. Early in the week, mortgage investors benefited from the 'risk off' trade with robust appetite with limited supply and a favorable benign prepayment report. Unfortunately, by the end of the week, sentiment shifted as a pronounced pickup in mortgage originations and money manager profit taking trumped demand from domestic and foreign financial institutions. Lower coupon mortgages held in better than higher coupons with spreads only wider by 3 to 5 basis points. After reaching nose-bleed cycle highs, higher coupons (super premiums) felt the weight of gravity as prices moved markedly lower on valuation concerns. Within the agency mortgage programs, Ginnie Mae mortgages bested conventionals on favorable supply/demand technicals. In mortgage credit, the non-agency and commercial mortgages underperformed trading directional with the equity and the broad credit markets.
- For the week, the 30-year current coupon mortgage versus 10-year spread widened by 4 basis points to 92 basis points. According to Freddie Mac, the 30-year mortgage rate fell below 4.5% for the first time this year to 4.49%.

## **MUNICIPAL BONDS**

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- Municipal bonds were somewhat cheaper relative to Treasuries as trading was stymied by low absolute yields. New issue, seeing its largest weekly supply of the year thus far with over \$5 billion coming to market, was well absorbed by investors. The weekly average is approximately \$3 billion. Also of note, muni funds posted a positive flow of \$274 million, breaking their negative outflow streak of 29 weeks.

- Two notable deals this week included \$440 million Washington State's Northwest Energy utility system (AAA/AA) and \$425 million Houston Utility (Aa2/AA) revenue bonds. Ten-year maturities came at a 3.72% and 3.13%, respectively. The market remained relatively unchanged for the week, with 5-year AAA munis cheaper by 1 basis point to a 1.18% and 30-year bonds unchanged at 4.25%.

## **HIGH-YIELD BONDS** \_\_\_\_\_

- The high yield market continued its turbulence into the second week of June as broad market spreads moved 15 basis points wider, and the absolute return is -0.70%. The more speculative issuers, CCC's, continue to underperform the rest of the market as risk aversion has set in over the last several weeks.
- The new issuance market was relatively quiet other than Arch Coal's \$2 billion, two-tranche deal, which they brought to fund the acquisition of International Coal Group. The deal was priced well and moved up a half point in the secondary market. The market will continue to closely monitor macroeconomic data as it becomes available as we are entering a quiet period as far as earnings reporting goes.

## **INTERNATIONAL MARKETS:**

### **EASTERN EUROPEAN EQUITIES** \_\_\_\_\_

- The CECE index of equities traded in Central Europe (Czech Republic, Hungary, and Poland) lost -2.4% over the past week, while the Russian stock market went up +3.7%.
- Kazakhstan plans on selling 5-10% of shares in major state-owned companies to its citizens through "people's IPOs" starting in October, according to the country's Economic Development and Trade Minister. The initial public offerings will stretch through 2013, followed by international share sales that will raise "billions of dollars." In February, Kazakhstan's president Nazarbayev ordered state companies to sell stock to citizens before elections that extended his rule into a third decade.

### **GLOBAL BONDS AND CURRENCIES** \_\_\_\_\_

- Major non-US sovereign bond markets were firmer in the past week, in line with developments in the US Treasury markets, as concerns about the momentum of the global recovery persisted. The ECB and the Bank of England both kept rates on hold at their monetary policy meetings over the past week, and although ECB President Trichet signalled another rise in Euro-zone rates in July, as expected, Bunds were nonetheless relieved that the ECB does not appear to be planning a series of rate hikes. Peripheral Euro-zone markets had yet another uncomfortable week as the ECB clashed with the German government over the details of the restructuring of Greece's debt. Portuguese government bond yields rose to fresh highs of around 10.5% on uncertainty about the new coalition government formed in the wake of last weekend's elections.
- In currency markets the US dollar was stronger against both the Euro and sterling. The Euro was adversely affected as investors scaled back their expectations of a series of near-term rate hikes by the ECB. A decline in German industrial orders, as well as speculation on the nature of the Greek debt restructuring, also weighed on the single currency. Sterling was hit by a warning from Moody's rating agency that its AAA rating was under threat if the pace of fiscal consolidation slowed. The yen benefited from some safe haven flows on concerns about the US recovery, while commodity currencies spent a relatively quiet week as commodity prices moved mainly sideways.

### **EMERGING-MARKET BONDS** \_\_\_\_\_

- Emerging market dollar-pay debt spreads were unchanged this week.

- Ollanta Humala narrowly defeated run-off opponent Keiko Fujimori to win Peru's presidential election. Humala, who is generally perceived as an advocate of greater state influence over politics and the economy, had to soften his initially harsh rhetoric to appeal to a broader electorate. Peruvian assets sold off immediately after the election results were announced, but have recovered slightly since.
- In Brazil, the Central Bank raised the SELIC overnight interest rate by 0.25% to 12.25%, as expected. In a statement accompanying the news of the rate hike, the Bank pointed to inflation risk, uncertainty of domestic economic activity, and the complex international environment as factors in its decision.

## NEXT WEEK'S ECONOMIC RELEASES

**June 14:** Producer Price Index, NFIB Small Business Optimism, Retail Sales

**June 15:** Consumer Price Index, Industrial Production

**June 16:** Housing Starts and Building Permits

**June 17:** Leading Indicators, Michigan Consumer Confidence