

For the week of May 18, 2012

## MARKET LEVELS

	Friday*	Last week	Dec. 31, 2011	One year ago
Dow Jones Industrial Avg	12,457	12,855	12,218	12,605
S&P 500	1,311	1,358	1,258	1,344
NASDAQ	2,815	2,934	2,605	2,823
Russell 2000	756	792	741	835
DJ STOXX Europe 600 (€)	239	251	245	280
Nikkei Index (¥)	8,611	9,010	8,455	9,621
MSCI EM Index	350	366	343	385
Fed Funds Target	0%-0.25%	0%-0.25%	0%-0.25%	0%-0.25%
2-Year Treasury Yield	0.30%	0.26%	0.24%	0.53%
10-Year Treasury Yield	1.73%	1.87%	1.88%	3.17%
U.S. \$ / Euro	1.27	1.29	1.30	1.43
U.S. \$ / British Pound	1.58	1.61	1.55	1.62
Yen / U.S. \$	79.12	79.93	76.91	81.61
Gold (\$/oz)	\$1,595.50	\$1,594.02	\$1,563.70	\$1,493.35
Oil	\$92.31	\$97.08	\$98.83	\$98.44

\*Levels reported as of 8:15 a.m. Pacific Standard Time

## MARKET RETURNS

Year-to-date (12/31/11-5/18/12)\*

Year-to-date (12/31/11-5/17/12)

Dow Jones Indus Avg.	1.96%	90 Day T-Bill	0.03%
S&P 500	4.23%	2-Year Treasury	0.03%
NASDAQ	8.07%	10-Year Treasury	2.83%
Russell 2000	2.00%	ML High Yield Index	4.93%
MSCI World Index	0.75%	JPM EMBI Global Diversified	4.16%
DJ STOXX Europe 600	-2.07%	JPM Global Hedged	1.82%
MSCI EM Index	2.18%		

\*Returns reported as of 8:15 a.m. Pacific Standard Time

## RECAP OF THE WEEK'S ECONOMIC RELEASES

**Tuesday, May 15: Consumer Price Index** – The headline consumer price index (CPI) was unchanged in April and 2.3% above year ago levels. The core CPI, which excludes food and energy prices, rose 0.2% on the month and also 2.3% over the last 12 months.

**Advance Retail Sales** – Retail sales rose 0.1% in April and 6.4% over the last 12 months. Retail sales are now almost 8% above pre-recession levels, defying gloomy predictions about a recession last year.

**Housing Starts, Building Permits** – Housing starts rose to an annual rate of 717,000 in April, up 2.6% from March. Building permits dropped 0.7% on the month, to a 715,000 annual rate. We may be seeing early hints of a recovery in housing construction.

**Wednesday, May 16: Industrial Production** – Industrial output rose 1.1% in April, after dropping 0.6% in March. Industrial production is 5.2% above year ago levels through April.

**Thursday, May 17: Leading Indicators** – The index of leading indicators ticked down 0.1% in May, led by deterioration in initial claims for unemployment insurance during the month. However, initial claims have fallen in May, so we are tempted to disregard this indicator for now.

## ECONOMIC OVERVIEW

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In April 2011, we argued: "Over time, the more volatile headline measure of inflation should converge with core measures of inflation...understanding the distinction between rising prices for a few goods and inflation is important, as it is this underlying inflation that guides central bank policy and should give us a gauge of the future path of overall consumer prices." The idea is that core inflation is the best predictor of actual trend inflation, to which volatile headline inflation returns over time.

This week's BLS report on April consumer prices drives this point home. The headline consumer price index (CPI) was unchanged on the month, while the core index rose 0.2%. But, more important, headline CPI fell to 2.3% year-over-year, converging with the year-over-year rate of change on the core CPI (also +2.3%). These numbers bode well for market participants who feared a repeat of spring 2011: aggressive Federal Reserve policies and global commodity prices last year meant that headline CPI had permanently diverged from core inflation and was only headed higher.

Does this mean the inflation threat is gone? For this, we turn to our favorite measure of core inflation, the Cleveland Fed's "Median CPI", which rose 2.4% over the last 12 months, compared to 2.3% on regular core CPI. This is the largest year-over-year increase since 2008. Statistical research suggests that the median CPI is 50% better at gauging actual underlying inflation than regular core CPI. None of this is to say core inflation is headed even higher. In fact, the three-month annualized rate of change on the core CPI is now 1.9%, suggesting core inflation pressures may have flattened out in recent months.

Indeed, as the release of the FOMC Minutes from the April meetings suggests, policymakers remain divided on inflation predictions: "most participants anticipated that inflation would fall back from recent elevated levels as the effects of higher energy prices waned, and... would run at or below the 2 percent rate that the Committee judges to be most consistent with its statutory mandate. However, other participants saw upside risks to the inflation outlook given the recent pickup in inflation and the highly accommodative stance of monetary policy."

The uncertainty of policymakers in regards to inflation reflects the larger trend: the FOMC is still very much in its "wait and see" mode. We saw this again with regards to QE3. The minutes reported, "Several members indicated that additional monetary policy accommodation could be necessary if the economic recovery lost momentum or the downside risks to the forecast became great enough." Until conditions seriously deteriorate, the Fed cannot justify another round of quantitative easing.

## US MARKETS:

### TREASURIES

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- A sharp bull-flattening rally developed in US Treasuries this week, led by outsized buying of the classic US bond futures contract. As of this morning, the US 30-year bond yield, now below 3%, has declined 22 basis points this week while the 10-year note is down 15 basis points. Concerns over the size of JPMorgan's hedging-related losses and new headlines regarding the deposit flight in European banks helped spur the rally.
- Next week the market is likely to continue focusing on political events in Europe. In passing, both durable goods and consumer confidence data await release and the Treasury will sell another \$99 billion of new coupon supply (2-years, 5-years and 7-years).

### LARGE-CAP EQUITIES

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- Equity markets sold off for the third consecutive week as concerns of a Greek exit from the euro and the solvency of Spanish banks weighed heavily on investor minds. The S&P 500 index was down over 3% for the week, while the Dow Jones Industrial Average lost about 2.7%. Small-cap stocks fared worse, with the Russell 2000 down over 4% this week. In terms of style, large-cap value stocks performed in line with large-cap growth stocks. The best performing sector was telecommunication services, while the worst performing sector was financials. This week saw the long awaited and much hyped IPO of social network company Facebook (ticker: FB). Shares of Facebook were priced at the high end of the range of \$38 on Thursday evening, valuing the company at \$104 billion.

### CORPORATE BONDS

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- Investment grade primary activity continued its energetic pace despite equities selling off the entire week. In the face of the current equity selloff, issuers are still taking advantage of overall low yield levels to issue paper. Nearly \$10 billion of paper came to the market this week, mostly 10- and 30-year paper from infrequent issuers. Notable deals this week included the Province of Ontario (\$3.5 billion) and Kellogg (\$1.45 billion).
- Investment grade corporate spreads leaked wider most of the week as once again the equity market took us wider. The newsworthy usual risks still remain in the marketplace: anti-austerity political parties in Greece and recent downgrades to growth estimates in China, Brazil and India. Spreads continue to test and trade through new recent wides. Market participants are trying to find out if this could be a rational re-entry point to start adding credit or if this is just another move wider. The Barclays Credit Index Option-Adjusted Spread (OAS) finished the week at +182, 9 basis points wider. Financials widened by 14 basis points (banks +16, insurance +7); industrials widened 7 basis points (basic materials +9, capital goods +5, telecom +9, consumer cyclical +3, consumer non-cyclical +6, energy +11); and utilities widened by 4 basis points.

### MORTGAGE-BACKED SECURITIES

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- Mortgages lagged Treasuries as macro market events fuel a flight-to-quality rally and drive mortgage rates into uncharted territory. The failure of Greece to form a coalition government increased the chance of their exit from the European Union. With market eyes abroad,

investors opted to avoid risk assets including commercial and non-agency mortgages. Agency mortgages fared better than credit assets but also suffered from price sticker shock (all coupons are trading at all-time highs) and historically low mortgage rates. Lenders have recently lowered their mortgage rates to levels that may entice more borrowers to refinance. With a prepayment spike on the horizon, pass-through spreads are vulnerable to a spread widening event. The one bright spot is that increased global chaos may lead to another round of quantitative easing by the Federal Reserve. If that happens, lower coupon agency mortgages may benefit from the incremental support. Higher coupons, however, are in trouble at current valuations with increased risk of new homeowner relief programs. It's an election year.

- For the week, the 30-year current coupon mortgage versus 10-year spread widened by three basis points to 95 basis points. According to Freddie Mac, mortgage rates fell to record lows of 3.79%. Offered mortgage rates, however, are not uniform with selected lenders posting more aggressive conforming 30-year fixed rates (i.e. Wells Fargo at 3.625%) to grow market share.

## **MUNICIPAL BONDS**

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- Municipal yields moved sideways in a volatile week, while Treasuries rallied on the continuing Euro-zone crisis. The California governor's office issued their "May revise" this week with a much larger-than-expected deficit to be addressed by the legislature in the next six weeks. Investors reacted by widening spreads on California GO bonds by only 6-10 basis points. S&P similarly kept their positive outlook on the state, citing efforts by lawmakers to address underlying structural deficits in the state, which have substantially improved since the nadir of state finances in 2009.

## **HIGH-YIELD BONDS**

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- The broad high yield market has held up relatively well in May 2012 post the negative macro-news of the Greek and French elections and the resulting instability in peripheral European sovereign debt and the news of the recent JP Morgan credit derivative trading imbroglio. Although major global equity indices are down 7-8% in May, the high yield market has fared much better with the Merrill Lynch high yield BB/B index down a modest 0.60% in May and the broad index, with CCC rated bonds included, down 0.71%. Year-to-date, the Merrill Lynch high yield BB/B index is up 4.9%. The macro "turmoil" notwithstanding, the US high yield market is functioning quite normally. A number of new deals have priced this week and another 10 are on the forward calendar. While the deals are not trading up materially, there is generally solid demand for these new deals. By week's end over \$5 billion of new deals will have priced this week in the high yield market. Importantly, no deals have been pulled from the market. Deals that have priced this week include a \$1.5 billion, B+ rated financing for Inmet Mining Corporation, a Canadian copper mining firm with global operations; these Inmet bonds were priced with a 8.75% coupon. Sally Beauty Holdings, a purveyor of beauty products and an existing high yield issuer, issued \$700 million of bonds rated BB+ with a 5.75% coupon to refinance existing indebtedness.
- Liquidity in the market is good though somewhat diminished from the end of April. While high yield mutual funds and ETFs did report outflows this week, the outflows at \$690 million were lower-than-expected. This relatively modest outflow was only the second outflow in the last 23 weeks, a period which has seen a record \$28.3 billion of inflows into high yield mutual funds.

## **INTERNATIONAL MARKETS:**

## **EASTERN EUROPEAN EQUITIES**

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- Stocks in Eastern Europe were down -8.4% during the week. Preliminary first-quarter GDP releases for Central and Eastern Europe surprised to the downside. Over the quarter, GDP contracted by 4% in Czech Republic due to a very weak domestic demand and by 5.1% in Hungary due to a decline in domestic demand, net exports and construction activity, while Romania's GDP contraction was a relatively mild -0.4%. Nevertheless, Romania entered technical recession, while the recession deepened in Czech Republic and Hungary's GDP contracted after more than two years of growth (except a downward revised 3Q11). Russia's GDP growth surprised with 4.9% in the first quarter, well above expectations, however the downshift in global growth momentum could cause a sharper-than-expected economic slowdown in Russia.

## **GLOBAL BONDS AND CURRENCIES**

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- Major non-US government bond markets continued to gain from safe haven flows in the past week as a number of factors combined to escalate the Eurozone financial crisis to near heights. Principally, Greece's major political parties failed to form a new government, precipitating fresh elections in June and increasing the chances that Greece will be forced to default on its debts and exit the euro. Fears of contagion to other Euro-zone countries were fuelled by Moody's ratings agency's downgrade of several Italian and Spanish banks, in the latter case citing Spain's economic deterioration and reduced creditworthiness. Some disappointing US economic data added to the risk-averse tone. Ten-year German Bund and UK Gilt yields fell around 10-13 basis points to record lows on the week in the flight to quality and news that the Bank of England would consider further monetary easing if the UK economy did not improve. Peripheral European sovereign bond spreads over German Bunds were wider on the week.
- In currency markets, US dollar was strong against most of the major crosses thanks to the safe haven bid. The euro continued to weaken against US dollar, as did sterling, which was undermined by talk of further quantitative easing. The Australian and New Zealand dollars also extended their recent depreciating trends against greenback on worries about global growth prospects, the mood of extreme uncertainty within the Euro-zone and its broader implications. The yen finished the week slightly higher versus US dollar on the flight to quality and the Japanese government's upgraded economic forecast.

## **EMERGING-MARKET BONDS**

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- Emerging market dollar-pay debt spreads were wider this week.
- Russia's first quarter GDP surprised to the upside, expanding by 4.9% year-over-year in contrast to consensus expectations of 4.1%. The higher growth is attributed to strong government consumption and a slowdown in import growth. Russia saw robust growth in consumption of 7% earlier this year due to higher real wages and government spending ahead of the presidential election this past March. Also, the first quarter GDP figure came in higher despite the recent slowdown in industrial output and investment readings.
- The People's Bank of China (PBoC) cut the reserve requirement ratio for all depository financial institutions by 50 basis points bringing the ratio to 20% for most banks in order to help

boost liquidity and support the economy. The PBoC last cut the reserve ratio in February and last November in response to tight liquidity conditions. The latest cut comes on the back of April's weak economic data as industrial production slowed to 9.3% year over year, down from 11.9% in March. Similarly, bank lending, fixed asset investment, and export and import figures all came in lower-than-expected in April.

## **NEXT WEEK'S KEY ECONOMIC RELEASES**

**Tuesday, May 22:** Existing Home Sales

**Wednesday, May 23:** New Home Sales

**Thursday, May 24:** Durable Goods

**Friday, May 25:** Michigan Confidence