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Fixed Income Commentary

European Pressures, Pending Bank Reform Hurt Corporates

Despite improving fundamentals in the U.S., concerns over European sovereign risk and slowing growth weighed on the corporate market in May. Additionally, the uncertainty regarding banking regulation remains an overhang on bank spreads as the market awaits a definitive outcome. May was the worst month for corporates since March 2009, with the index posting a 2.60% loss compared to Treasuries. The Barclays Capital U.S. Corporate Index is now down 99 basis points (bps) year-to-date vs. Treasuries, and corporate spreads are now back to early December 2009 levels. The option-adjusted spread (OAS) currently stands at 186 bps compared to the recent tights of 139 bps.

Of the three main sectors in the index, financials underperformed industrials and utilities while life insurers were the worst performing sector. The main contributor to the widening in life insurers was AIG, with 10-year Sr Holdco bonds down 10 points in May. The asset sale to Prudential PLC ultimately fell apart after AIG rejected the British company's attempt to renegotiate the purchase price from $35.5 billion to $30 billion. In general, global credit weakness does not benefit the value of AIG's assets and prospects for near-term repayment of the federal loan. Other underperforming sectors included energy (the Gulf of Mexico spill names in particular BP, Anadarko, Halliburton, Transocean), home builders, and metals and mining, as more cyclical sectors came under pressure.

Financials

Bank spreads were generally 30 to 70 bps wider in May. Morgan Stanley and Citigroup were the worst performers with spreads 65 to 70 bps wider while Goldman Sachs, JPMorgan Chase, and Bank of America widened 30 to 40 bps. Wells Fargo spreads have managed to skate through the volatility virtually unscathed with 10-years only 40 bps wider versus the recent tight spreads compared to the rest of the money center banks, which are 70 to 130 bps wider. The market is focused on regulatory reform and in particular potential restrictions on derivatives and proprietary trading, which are not meaningful parts of Wells Fargo's business.

Another overhang on bank spreads is potential rating agency downgrades following any financial reform passage. S&P came out last week with some clarification as to the timing of their review process. Specifically, S&P stated that it will take a measured approach to banks ratings and does not expect the passage to have an immediate impact on ratings. The market reacted positively to the news and spreads for Bank of America, Goldman Sachs, Morgan Stanley, Citigroup, and JPMorgan Chase tightened to end the month 20-40 tighter vs. their recent wides. At the end of the day, we believe that regulation of banks will be a net positive for bondholders but possibly negative for equity holders as banks de-lever and reduce risk.

As mentioned above, life insurers were the worst performing sector in the index with a 5.24% loss compared to Treasuries, primarily due to AIG which accounts for about 20% of the sector. Ex-AIG, other names appear to be 50 to 70 bps wider (MetLife, Prudential Financial, Lincoln National).

REITs ended 40 to 50 bps wider on average this month, which is roughly in line with the widening in corporates overall. They remain the top performing sector year-to-date after being the best in 2009. REIT spreads have held in relatively well, but spreads are drifting wider as market volatility continues. Given the REIT out performance, we haven't been adding much exposure other than a few attractive front end opportunities. One exception is HCP paper, which looks attractive at about 300 bps over Treasuries.

Utilities

Pipelines underperformed electric utilities after several months of convergence between the two. Pipelines widened significantly after Enterprise Products Partners and Kinder Morgan priced big new issue deals in a soft market. Both deals came 40 bps wide to their respective secondary issue levels and 70 bps wide on the month, and despite the price concessions, the deals still traded poorly. We have generally stayed away from MLPs (Master Limited Partnerships) and believe they should trade at a healthy discount as they tend to have higher leverage and use their free cash flow to pay dividends. Our exposure to pipelines is primarily in Southern Union, CenterPoint, and El Paso, which were roughly 30 to 60 bps wider in May compared to Enterprise and Kinder Morgan (MLPs), which were 70 to 90 bps wider. We did participate in the TransCanada new issue last week which came at 200 bps over 30-Year Treasuries with a 30 bps new issue concession and about 70 bps wider on the month. TransCanada is a high quality pipeline credit that operates mostly regulated long haul natural gas pipelines. It typically trades 70 to 100 bps tighter than its competitors, but due to poor technicals it came out wider than CenterPoint and only 40 bps tighter than Kinder Morgan.

Industrials

The focus was on all names related to the Deepwater Horizon oil spill in the Gulf of Mexico. Those names were 100 to 170 bps wider in May. Away from energy and cyclical credits, the rest of the industrial sector was generally 40 to 50 bps wider during the month, in line with the broader index.

EETC tranches were down about 2 points on average. The higher dollar deals (bonds trading above $105) underperformed and are down 3 to 5 points from their peak. We haven't seen many sellers of the high quality deals but as expected some investors were trying to lighten up on lower quality tranches. All in all, the sector has held in rather well, with Delta 7.111's still trading above par ($102.5/$103) and high quality tranches in the 6.5% yield area.

Municipals

California General Obligation (GO) bonds were about 50 to 60 bps wider in May. California is the biggest issuer in the municipal index, the widest in spread for GO debt and thus trades with the most beta. The rest of the space, especially revenue bonds, have held in very well on very little trading. The Bay Area Toll Authority 30-year traded at 160 bps over the 30-Year Treasury, only 20 bps wider in May, however, still 40 bps tighter than where they came in at the end of 2009.

	Monthly Excess Return	YTD Excess Return	YTD Total Return	OAS
Corporate Index	-2.60%	-0.99%	+3.59%	187
Industrials	-2.25%	-0.86%	+3.93%	153
Energy	-3.77%	-2.80%	+2.35%	163
Financials	-3.10%	-1.19%	+2.85%	244
Banks	-3.00%	-1.91%	+2.04%	246
Life Ins	-5.24%	-0.48%	+4.15%	316
REITs	-1.91%	+3.57%	+7.62%	259
Utilities	-2.64%	-0.97%	+4.29%	171
Pipelines	-4.36%	-1.78%	+3.43%	211

Source: Barclays Capital

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