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Fixed Income Weekly Recap: Week Ended February 3

By: SEI Fixed Income Portfolio Management

SEI Fixed Income Portfolio Management manages fixed-income strategies for SEI's Managed Account Program (MAP).

Economics

The week's busy economic calendar presented data from multiple sectors for analysis. Inflation data measured by the Personal Consumption Expenditures Core Price Index[1] fell in line with expectations, trending at 1.8% on a year-over-year basis. Manufacturing data continued to improve as the Dallas, Chicago and Institute for Supply Management (ISM) manufacturing indices all pointed toward expansion. The labor market also showed strength, with weekly initial jobless claims falling by 12,000 to 367,000. In addition, the ADP report showed a gain of 170,000 new jobs, while the nonfarm payrolls revealed the creation of 243,000 jobs. Despite progress on the labor front, Federal Reserve Chairman Ben Bernanke, in his *Economic Outlook and Federal Budget Situation* speech, reiterated frustrations with the pace of job growth. However, he noted that he expected stronger economic growth in 2012 than we saw in 2011.

Rates

Treasurys were little-changed on the week, with intra-day activity more volatile. The market rallied on Europe-related risk aversion and Bernanke's continued dovish comments to the House Budget Committee in which he reinforced the appropriatness of a highly accommodative monetary policy. The market re-traced on better-than-expected economic data that included strong ISM manufacturing and nonfarm payroll numbers in addition to a decline in risk-aversion due to headlines regarding an informal meeting of European heads of state.

The two- and 30-year yields climbed 1.5 and 5.0 basis points, respectively, while the five- and 10-year notes were flat. The Treasury released the refunding announcement[2] and is scheduled to auction $32 billion of three-year notes, $24 billion of 10-year notes and $16 billion of 30-year bonds. The Treasury also recognized that floating-rate notes may provide benefits for government finance, and plans to announce a decision as to whether or not it will introduce such a product at the May 2012 quarterly refunding statement.

Agencies outperformed across the curve, with the exception of the front-end and intermediate sector, which moved in line with nominals. Fannie Mae priced $5.5 billion of a new three-year Benchmark Note at a spread of 15.5 basis points to the on-the-run[3] three-year Treasury. Government-sponsored enterprise bellwether issuance has totaled $28 billion in just over a month, versus $14 billion in redemptions. This

[1] The Personal Consumption Expenditures Core Price Index, issued by the Bureau of Economic Analysis (an agency in the United States Department of Commerce), provides an overview of the average increase in prices for personal consumption in the United States, excluding food and energy.
[2] On a quarterly basis, the Office of Debt Management at the United States Department of the Treasury announces its funding needs for the next two quarter, detailing which securities will be offered and the dates of their announcement, auction and settlement.
[3] "On-the-run" refers to the most recently issued bond or note of a particular maturity.

compares to $20 billion issued in the same period last year. Federal Home Loan Banks has the next issuance window, which scheduled for February 8.

Credit

Investment-grade credit markets remained well-bid, as strong demand extended the rally for a sixth consecutive week. Supportive economic data and a muted tone from the European crisis front kept risk sentiment intact, with aggregate option-adjusted spreads,[4] as reflected in the Barclays Capital Credit Index,[5] tightening 3.0 basis points through Thursday. This move leaves the Index at 189.0 basis points, or 28.0 basis points tighter year-to-date. The banking sector has benefited from this improved risk sentiment, with the sector 79.0 basis points tighter year-to-date. The investment-grade derivatives space has also exhibited strong performance, with the CDX IG 17[6] tighter by 2.0 basis points on the week, and 21.0 basis point tighter on the year. Primary market activity began to pick up this week, with approximately $13 billion priced through Thursday.

Municipals

The municipal rally continued this week, driving yields down to mid-January levels. New issuance came in at an estimated $4.46 billion, but it could not keep pace with demand. The 10- and 30-year AAA yields rallied 8.0 and 29.0 basis points, respectively, to close the week at 1.67% and 3.08%. Based on preliminary reads, last month's performance came in just behind January 2009's in terms of achieving the best January performance in the last 10 years. Broad-based indices gained 2.50%. Fund flows remained heavy this week; according to Lipper, weekly municipal funds saw inflows of approximately $501.7 million.

Harrisburg's city council was denied Chapter 9 bankruptcy for the second time. U.S. District Court Judge Sylvia H. Rambo denied an appeal filed by City Council attorney Mark Schwartz. Judge Rambo ruled that the city council missed a deadline to challenge the November 23 decision that dismissed the bankruptcy filing.

U.K. Government Market

U.K. house prices declined for the second straight month in falling by 0.2%, according to the Nationwide House prices survey. The three purchasing manager index indices were mixed: Construction declined further in January, while both manufacturing and services jumped higher, exceeding market expectations. The manufacturing sector moved back into expansionary territory after three consecutive months of contraction. Finally, consumer confidence increased in January to its highest level since June, but still remains low overall.

The Gilt market was little changed on a weekly basis, as yields at the two-year point of the curve held at 0.38%. Prices at the 10-year point of the curve fell modestly, with yields increasing 3.0 basis points to 2.10% at the time of this writing.

View

We remain cautiously optimistic toward the fixed-income markets. We favor spread products, including the investment-grade credit sector. We are neutral toward the Treasury sector with a bias toward higher

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[4] Option-adjusted spreads (OAS) are the spreads over the Treasury spot yield curve that are required to equate market yield and market price when discounting expected future cash flows. OAS adjust for any embedded optionality including call provisions, put provisions and call or make-whole provisions. OAS equates the spread on bonds with such optionality to the spread that would be demanded if the bond was otherwise free of all embedded options.
[5] The Barclays Capital Credit Index is an unmanaged index composed of U.S. investment-grade corporate bonds.
[6] The CDX IG index is a benchmark high-grade derivatives index, which measures the cost of insuring a basket of U.S. investment-grade corporate debt against defaults.

rates, which we expect will unfold throughout the upcoming quarters. The portfolios are positioned with the view that economic growth will increase at a tepid pace, although continued headwinds from Europe will create uncertainty and choppy markets.

Next Week's Economic Calendar:

Monday: No Releases

Tuesday: Consumer Credit

Wednesday: Mortgage Applications

Thursday: Initial Jobless Claims, Wholesale Inventories

Friday: Trade Balance, University of Michigan Consumer Confidence