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Borrowing Costs Still Heading Lower

Chris Keith

Key Points

- *Interest rates continue to head lower*
- *It may not be so for bond investors, but there is a benefit to lower rates*
- *A non-essential purpose muni issuer gets into trouble*

Borrowing costs continue to decline as the summer progresses and that translates into lower bond yields pretty much across the board. As high-grade bond investors we see this more than many others do. But, as I have pointed out in the past and will again today, there are “bargains” out there. Before I get to that though, there is a positive side of the low rate environment as it does help the big-picture economy overall.

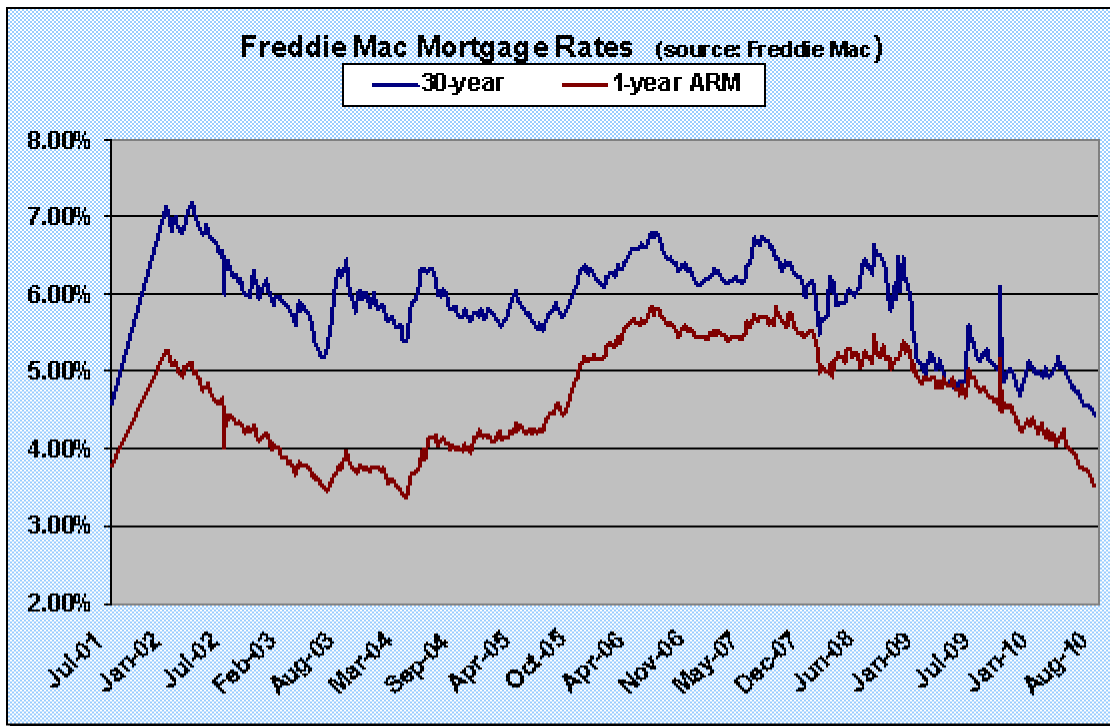
I read a report the other day that projects that the U. S. Government will sell (borrow) $399B in 3Q10. It made me think about how much the government, and that means us in the end, is benefiting big time from the drop in Treasury bond rates as it finances everything at or near record low yields. Those low yields translate into low borrowing costs at a time when we are running huge deficits. An economist we follow calculates that “with rates so low, the US Treasury is paying $230 billion less in interest per year than it would pay if rates were at levels that existed back in 2007.”

Thus far the deficit spending has not resulted in higher yields. In fact, bond yields continue to head in the other direction much to the surprise of many and to the dismay of bond investors who have cash to put to work today. It is a phenomenon that makes our job more difficult as we look for value. This is why I have written in the past about relative versus absolute yield levels. When compared to some of the alternatives, the relative levels on bonds are more attractive. It comes down to a matter of perspective. I don’t know if the market will re-test the panic lows of December 2008 (2.05% on 10-year Treasury), but when the month of July ended with a yield of only 2.90%, it marked a level that is far below the 5.50% average over the past twenty years. So, is there anyone other than the government who is benefiting from the low yields?

Our Chief Investment Officer, Rusty Vanneman, has a positive outlook for corporate earnings and part of that outlook is based on their low borrowing costs. The money they save on interest expenses helps the bottom line profitability of the corporation. Very recently, International Business Machine (IBM) borrowed $1.5B in a three year bond offering at a rate of 1.14%. That is only 30 basis points above the risk-free Treasury rate. IBM is rated A1/A+. Another issuer, McDonald’s (hamburgers) came to market with

a new issue 10-year offering. The bonds are rated A3/A, and were priced to yield 3.54% - just 55 basis points above similar maturity Treasuries.

The government and corporations are not the only ones to benefit from low borrowing costs, of course. Home buyers and homeowners are benefiting, too. Our graph below tracks Freddie-Mac's Primary Mortgage Market Survey. The most recent results from early August show an average 30-year mortgage rate of just 4.49%. With mortgage rates this low it makes perfect sense to look into refinancing your home mortgage.



It may be frustrating for some investors to see the low bond yields. Many investors who are more dependent upon their portfolio's income to supplement their living style will need to make adjustments, at least for a while. However, several of us have benefitted or may benefit in other ways and that is worth remembering or taking action (home refinance) when we consider the present environment.

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The "**Build America Bond**" program continues to roll right along. The program is part of the American Recovery and Reinvestment Act, a initiative of President Obama's that became law in February 2009. The program allows municipal issuers to receive a 35% subsidy on their interest expense from the Federal government. In return, they issue municipal bonds whose interest is taxable at the federal level. These bonds are trading at attractive levels relative to their traditional counterparts in the corporate bond market (recall the IBM and McDonald's issues above). I saw a secondary market BAB item with a 10-year maturity and rated A2/A. The bond was trading with a yield of 5.01%. We

have been selectively adding some BABs exposure into our taxable bond portfolios as yields on traditional taxable corporate bonds have dropped in proportion with those of Treasuries. We are taking advantage of any opportunity we can in this low rate environment, provided it fits our risk profile.

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In the past I have commented on the virtues of essential purpose revenue bonds that populate the muni market landscape. Examples include water and sewer authority bonds or electric utility bonds. I was recently asked for an example of a non-essential purpose issuer. As luck would have it, a very good example recently presented itself from an event that made bond market news. It seems a Colorado based issuer is having difficulty meeting the requirements of its debt service agreements when it failed to make a required payment to its trustee. This constitutes an “event of default”. The Colorado Educational and Cultural Facilities Authority served as the issuing conduit for the Rocky Mountain Roller Hockey League. The league was able to issue roughly $2M of non-rated bonds in order to “finance the cost of acquiring, constructing and equipping an indoor inline hockey facility.” I’m sure there are merits to the recreational nature of the facility, but this is an example of something I would have chosen to avoid, and not just because it was non-rated. In my mind this is not the type of essential purpose I think of when investing in muni debt for our clients. It makes me think of a quote about risk: Investing is not about avoiding risk, it is about the management of risk. I’m not looking to completely avoid risk in our muni portfolios, but I am trying to manage it prudently. Our bond program has always been presented to you, our clients, as a conservative program that errs on the side of caution. Investing in bonds to finance a roller-hockey rink violates the spirit of that intent.

Barclays Fixed Income Index Returns Through 7/31/10

	Duration	July	YTD '10	Return '09	Return '08	Return '07
US T-Bill Index	0.34	0.02%	0.13%	0.37%	2.44%	5.01%
US Treasury Index	5.33	0.68	6.58	-3.57	13.74	9.01
US TIPS Index	3.49	0.14	4.56	11.41	-2.35	11.63
US Aggregate Bond Index	4.13	1.07	6.46	5.93	5.24	6.97
US Govt / Credit Index	5.46	1.13	6.68	4.52	5.70	7.23
US Credit Index {A2}	6.44	1.92	7.65	16.04	-3.08	5.11
US High Yield Index {B1}	4.25	3.56	8.23	58.21	-26.16	1.87
Caa component	3.81	3.81	7.79	90.65	-44.24	-0.48
Emerging Market ($$) {BA1}	6.69	4.16	10.05	34.23	-14.75	5.16
Municipal Index	8.36	1.25	4.60	12.91	-2.47	3.36
Municipal Index - 5 Year	4.01	1.50	4.00	7.40	5.78	5.15

Source: Barclays Capital

Christopher Keith,
Fixed Income Manager.

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Sovereign debt securities are generally backed by the issuing government; portfolios that invest in such securities are not guaranteed and will fluctuate in value.

Treasury securities are guaranteed by the US government as to the timely payment of principal and interest and therefore considered risk-free, however they do contain market risk. If held to maturity, Treasuries offer a fixed rate of return and fixed principal value. The principal value of TIPS is adjusted according to the rate of inflation measured by the U.S. consumer price index.

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Yields are as of standard settlement and reflect the lower of the yield to maturity or the yield to call unless otherwise noted.

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