

A Tale of Two Cities

One of my office mates shares his books on tape with those of us having long commutes. My preference is the thriller, espionage themes. But my friend kept encouraging me to reacquaint myself with his classic tale of the French Revolution.

As I was listening, I noticed the theme is truly what's happening in the bond market. During 2009 we had a Tale of Two bond Markets. That is, the corporate and municipal bond markets had a splendid year but for different reasons.

Corporate bond spreads narrowed, prices went up, yields fell and balance sheets...oh those corporate balance sheets--had spectacular make-over's.

Corporate treasurers issued massive amounts of stock and paid down debt. High coupon, expensive debt was called or tendered and replaced with low coupon bonds. There were few wild-eyed worthless share repurchases. Debt distributions have been spread out and are now the most manageable we've seen in years. Corporate America is flush, flush, flush with cash on their fortress balance sheets and can withstand a second economic dip should one occur. In short, all these corporate actions are very bond and balance sheet friendly.

Municipal bonds, on the other hand, hit 42 year lows in yield while State, city and county finances continued to deteriorate. Fixing those bloated balance sheets is like turning around the Titanic in a bathtub...not easy.

The weakest seven sister states: California, New York, New Jersey, Florida, Arizona, Nevada, and Illinois are leading the nation in huge budget deficits, unfunded pension obligations and structural imbalances. Yet...demand for municipals is like your old Timex watch--it keeps on tickin'.

Certainly, municipal bond demand is driven by income taxes, baby boomers and the taxable Build America Bonds. Yet, we are concerned about the complacency the market has for these developments. We swapped many of your municipal bond positions for stronger credits whose metrics and financial where-withal were better. We'll see more of these portfolio changes in 2010. The public finance sector is not improving any time soon. The disconnect or Tale of Two Bond Markets will continue throughout the coming year.

What about interest rates? Treasury yields for bonds maturing ten to thirty years have moved up. The bond vigilantes are worried about inflation; the Government give-away programs that rely on the kindness of China to finance our increasing deficits; and the weakness of the US dollar. That is precisely why we are keeping your portfolios in relatively short duration and selling munis whose credit quality is deteriorating. We believe rates will continue to move higher. The Federal Reserve will follow the market; it clearly isn't leading the interest rates moves. So in the year ahead we are destined for a more normalized economy and rising yields.

The wonderful bond market ride we had last year has little chance of being repeated. Do not fear though; your short duration portfolios will be able to handle whatever changes the bond market has in store for 2010.

As always, we love to hear from you. I urge you to view our Website, www.envisioncap.com and watch the latest PBS Wealthtrack program in which I tell host, Consuelo Mack, what's in store for the bond market in 2010.

Wishing you a Happy New Year and good health.

All the best,

Marilyn Cohen