

Coping With Spread Compression

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A Minute in the Market

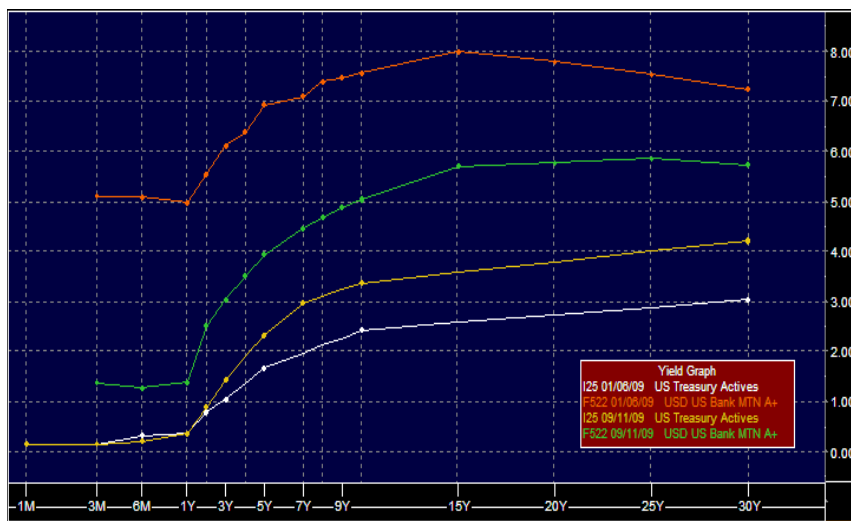
Ever since the stock market began to rally in March, fixed-income investors have had to deal with “spread compression” as the feeling has grown that the nation’s economic low point may be behind it. Spread compression refers to the shrinkage of yield spreads between ultra-safe U.S. Treasury securities and other comparably-maturing investments, such as corporate, municipal, and federal agency obligations. As investor optimism improves, the extra yield which investors demand to hold securities other than Treasuries begins to dwindle because they feel more comfortable with the investment risk they have taken. For the last six months, this process has been present in full force in the fixed-income markets.

Consider the chart that accompanies this comment. It shows yields of actively-traded U.S. Treasury securities as of January and September, 2009, versus yields of A1/A+ bank bonds. Note that Treasury yields out to one year’s maturity have remained consistently close to zero, one consequence of the Federal Reserve’s recession-fighting policy. However, beyond one year, yields on Treasuries have risen while yields on bank debt have fallen – by a lot. In January, comparably-maturing bank debt yielded roughly 4.625% more than the 2-year Treasury note, 5.25% more than the 5-year note, and 5.125% more than the 10-year note. By early this month, the corresponding numbers were roughly 1.75%, 1.625%, and 1.75%, respectively. This same pattern has befallen yields of municipal and other corporate securities as well. Simply put, bonds other than Treasuries yield a lot less versus Treasuries than they did just a few months ago – in three words, classic spread compression.

How should investors react to this? Step one is to stay focused on credit risk. Credit spreads remain wide by comparison with spread levels in recent years, but investors are still close enough to last year’s panic to be fully comfortable with them. However, we at SNW Asset Management think that good credits remain attractive relative to comparably-maturing Treasuries.

Step two is to look at the slopes of the yield curves in the chart. They remain strongly upward-sloping, meaning that longer-term yields continue to offer attractive differentials versus short-term yields. This may be largely a function of the Fed’s policy, which has effectively pinned short-term rates at zero. The Fed’s policy therefore incentivizes investors to move out the curve in search of reasonable yield. But, how far? Rates are still near decades-low levels, so it is dangerous to extend maturities too far, lest investors lock in current low yields for an unacceptably long period.

For SNW Asset Management, the right place on the yield curve seems to be longer than two years but not longer than four or five years. Depending upon the course of the economy, it may take the Fed a year or more to allow short rates to go higher, but, longer than that, any signs of economic recovery will surely push rates higher, towards more normal cyclical levels. For this reason, we think it is best to schedule investment maturities at recurring intervals between two and five years (or, in the muni market, between two and seven years). This is the strategy we think best combines reasonable current yield with protection from market-price deterioration if and when interest rates begin to rise. Investors do not want to go too long to adjust their portfolios at this point, because longer-maturing securities will suffer material loss of market value if rates rise substantially within the next 3-5 years.



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SNW Selected Municipal Underwritings

Amount (000's)	Issuer	Dated	Rating	2010	2011	2012	2013	2014	2015	2016	2017	2018
\$7,035	City of Yakima, GO Series 2009, WA	8/18/2009	AAA	1.070	1.330	1.750	2.050	2.430	2.700	2.970	3.240	3.480
\$1,165	Wahkiakum School District #200, GO Series 2009, WA	8/10/2009	Aa1	1.200	1.400	1.600	1.830	2.250	2.530	2.820	3.090	
\$11,085	Mt. Hood Community College District, OR	8/6/2009	Aa2		0.780	1.070	1.390	1.860	2.140	2.440	2.710	3.010
\$11,200	Dayton School District #8, GO Series 2009, OR	8/4/2009	AA	0.650	0.900	1.110	1.430	1.870	2.170	2.450	2.720	2.970
\$1,545	Marsing Joint School District #363, GO Ref Series 2009, ID	7/13/2009	Aaa	0.800	0.940	1.200	1.590	2.040				

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