

# Interest Rate Commentary

Monday, 11<sup>th</sup> May 2009

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## 2009 so far: Recovery approaching or will false hopes prove painful?

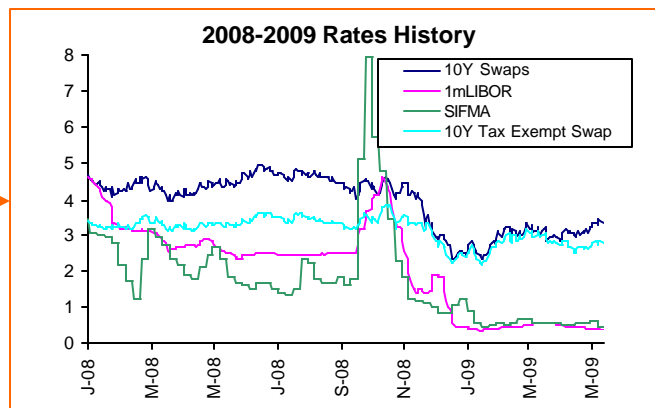
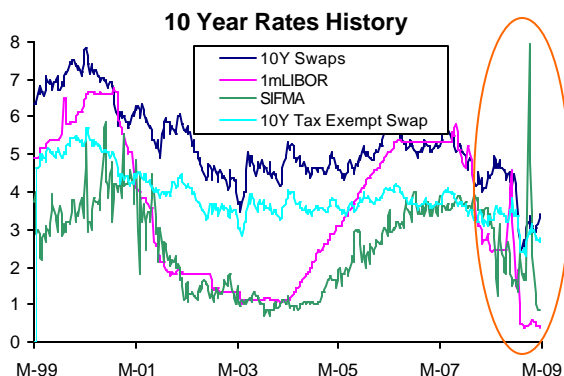
Now that the infamous stress tests are “over”, GM will follow Chrysler into bankruptcy, economic and housing data seemingly bottomed out, the stock markets rallying 30% since early March when all hope was abandoned, does anyone dare think that the worst is behind us?

The first two months of the year had the markets wondering how low could the US economy possibly go. The Dow hit 6,547 on March 9. While rates rose consistently and significantly across the board in January, since then the yield curve has widened significantly with 2 year swaps trading flat to down and 10 year swaps trading flat then up (both with a noteworthy drop coinciding with the early March stock implosion). Economic data which seemed so dire in March has stabilized (sales, confidence, general business activity). The main significant buck to this trend has been the unemployment rate which hit 8.9% in April. While the rate of job losses has slowed, there are many loud voices out there speculating how high the actual unemployment rate could go. Very few are confident of their own employment security and furloughs have spread from manufacturing jobs to the economy as a whole. As the underemployed are not counted as unemployed, the unemployment rate could be construed to be much higher.

The largely positive results of the much-discussed stress tests have provided a base to the financial sector ending speculation that a systemic meltdown won't occur. That doesn't mean, however, that banks are lending again. Both corporate and consumer lending are near-frozen. On the positive side, the non-government guaranteed corporate bond market has finally shown signs of life over the past two weeks with even high yield names dipping their toes into the water. LIBOR rates have fallen signaling that banks are comfortable to lend to each other finally. Government programs aside, these are all good developments.

Tax-exempt markets are still taking it on the chin however. Recent downgrades have left SIFMA pretty thin but still resetting at 130% of 1-month LIBOR. Many names are trading at multiples of that level. Weekly resets are all over the map based on perceptions of credit risk. Term swap ratios have headed back to historical and logical levels but are still in the 80-90% range. This probably says nothing about the market's expectations of future tax rates and everything about illiquidity and uncertainty. The Build America Bond program certainly has the opportunity to jumpstart at least the larger municipal bond/swap market.

Where do rates go from here? Like any other economic good, rates are subject to supply and demand. Right now there is a massive supply of US Treasuries and 10-year US bond yields have crept up to 3.21%. Government buybacks have provided a little relief from this march upwards however the question of whether the Fed is facing a losing battle of low-rates is definitely at hand. While deflation was the biggest fear in March, the nagging inflation question with so much cash in the market (once deflationary factors subside) is back on the table. Will the Fed be able to contain this monster in 2010 and beyond or will the government be able to generate enough revenue to buy back the hugely inflated debt load when the economy recovers? Lastly, the question of whether corporate (including financial) sector earnings can keep this bear stock market rally from flopping (and yields along with it) remains to be answered.



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