Payden&Rygel | Weekly Market Update

For the week ending September 2, 2011

MARKET LEVELS

	Friday*	Last week	Dec. 31, 2010	One year ago
Dow Jones Industrial Avg	11,286	11,285	11,578	10,320
S&P 500	1,179	1,177	1,258	1,090
NASDAQ	2,492	2,480	2,653	2,200
Russell 2000	690	692	784	632
DJ STOXX Europe 600 (€)	233	226	276	258
Nikkei Index (¥)	8,951	8,798	10,229	9,063
MSCI EM Index	355	336	393	351
Fed Funds Target	0%-0.25%	0%-0.25%	0%-0.25%	0%-0.25%
2-Year Treasury Yield	0.20%	0.19%	0.60%	0.50%
10-Year Treasury Yield	2.03%	2.19%	3.30%	2.63%
U.S. $ / Euro	1.42	1.45	1.34	1.28
U.S. $ / British Pound	1.62	1.64	1.56	1.54
Yen / U.S. $	76.78	76.64	81.19	84.28
Gold ($/oz)	$1,872.15	$1,827.95	$1,420.78	$1,250.95
Oil	$87.10	$85.37	$91.38	$75.02

Levels reported as of 10:30 a.m. Pacific Standard Time

MARKET RETURNS

Year-to-date (1/1/11-9/02/11)*

Dow Jones Indus Avg.	-2.52%
S&P 500	-6.23%
NASDAQ	-6.08%
Russell 2000	-11.96%
MSCI World Index	-6.01%
DJ STOXX Europe 600	-15.48%
MSCI EM Index	-9.59%

Year-to-date (1/1/11-9/01/11)

90 Day T-Bill	0.10%
2-Year Treasury	1.46%
10-Year Treasury	13.39%
ML High Yield Index	0.32%
JPM EMBI Global Diversified	7.36%
JPM Global Hedged	4.22%

Returns reported as of 10:30 a.m. Pacific Standard Time

RECAP OF THE WEEK'S ECONOMIC RELEASES

Monday, August 29 – Personal Income and Spending: Personal income increased 0.3% in July and personal spending rose 0.8% during the month. In real (inflation-adjusted) terms, consumer spending rose a healthy 0.5% during the month, allaying fears of a consumer-led downturn. However, August will be a critical month for this gauge.

Wednesday, August 31 – ADP Report: The ADP Employment report showed a gain of 91,000 private payroll jobs in the month of August, down from a 114,000 increase in July.

Thursday, September 1 – ISM Manufacturing Survey: The gauge of manufacturing sector business activity fell to 50.6 in August from 50.9 in July, clinging still to the +50 expansionary territory. Below 50 would denote a contraction.

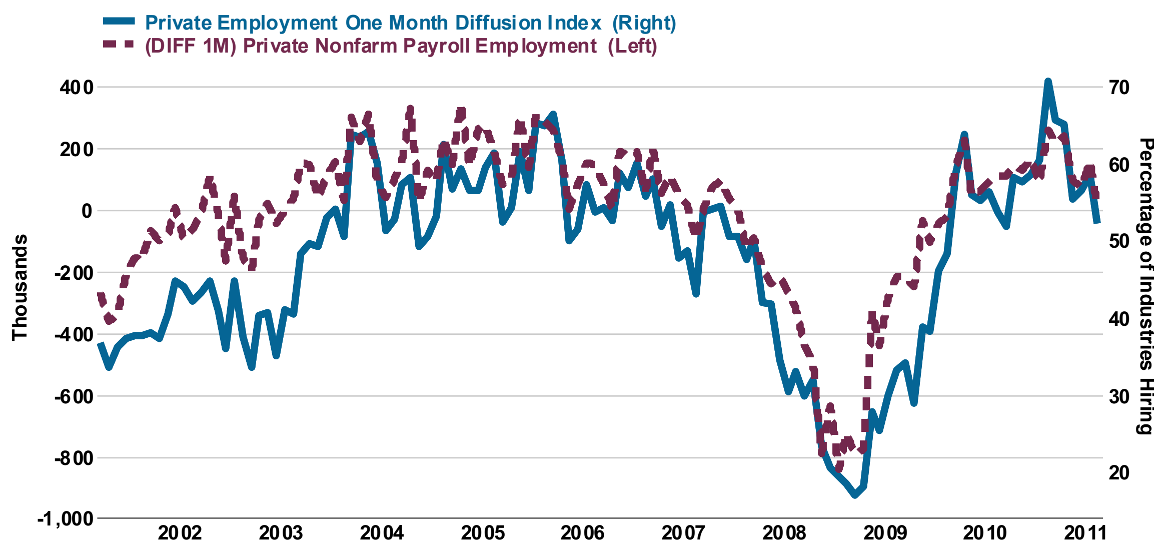
Friday, September 2 – Employment Situation: Nonfarm payroll employment was unchanged in August (0 net, new jobs were created) and the unemployment rate stayed at 9.1%.

ECONOMIC OVERVIEW

In August, the debt ceiling debate coupled with US and global economic worries (euro area crisis, global growth slowdown) buffeted the labor market. With the exception of telecommunication services (-47,000, most of which is attributed to the Verizon strike), local government (-20,000) and health care (+35,000), establishment survey firms were content to stand pat on the month. In fact, few sectors registered more than +/-10,000 jobs during the month. Further, the diffusion index for total private employment was at 52.2 in August (see chart below). A score of 50 means that 50% of the businesses were increasing employment while 50% where decreasing employment—a stalemate. As a result, net nonfarm payroll employment was unchanged in August (literally *0* in the BLS report) and the unemployment rate remained at 9.1%.

Once the labor market starts to tread water like this the question becomes, “What’s next?” Do we “dip” under or continue making progress this fall? While recession risk remains, to an extent that discussion misdiagnoses the problem. Keep in mind our gauge of the recovery, the employment-to-population ratio, ticked up to 58.2% in August from 58.1% in July but has been in the 58.1-58.4% range for an entire year. This is one sign that a “recovery” has yet to truly gain traction rather than the economy on the precipice of a renewed downturn.

What can provide the economy with a renewed burst of energy? I expect the market and policy discussion to turn again next week to the twin pillars of “stimulus”, monetary and fiscal policy. Both President Obama and Chairman Bernanke are slated to speak on September 8th and the details of any new stimulus plan will be important to digest (more on this next week). While short-term or one-time boosts may provide temporary relief to the economy and the markets, this is akin to a mid-afternoon caffeine boost when what you really need is a nap. The effect will soon fade and the underlying problem will resurface.



Source: Bureau of Labor Statistics

US MARKETS:

TREASURIES

- Treasury yields rallied meaningfully, led by the long end as investors continue to allocate to global sovereign paper. The 10-year ended the week just north of 2% while 30-year yields probed their recent low mark of 3.35%. The employment picture continues to disappoint, with non-farm payroll data reported at zero job growth versus expectations of 68,000. The Federal Reserve is closely watching the development of the macroeconomic picture as it prepares to debate the use of further monetary policy tools at its September 21st meeting.

LARGE-CAP EQUITIES

- The stock market rose modestly for the week despite mixed economic data and a disappointing jobs' report. Trading volume was on the lighter side as we approached the long weekend. The S&P 500 and NASDAQ Composite indexes both finished the week approximately 0.7% higher. Large-cap stocks performed in-line with small-cap stocks. In terms of style, large-cap growth stocks outperformed large-cap value stocks. The best performing sector was health care, while the worst performing sector was telecom services. In the headlines this week, the Department of Justice filed a suit to block AT&T from merging with T-Mobile USA, a subsidiary of Germany's Deutsche Telekom. The DOJ is seeking to prevent three firms from dominating 90% of the US mobile phone market. Shares of T fell approximately 4% on the news.

CORPORATE BONDS

- Investment grade primary activity came to a crawl this week as issuers and market participants alike sat on the sideline in anticipation of something to come out of the Jackson Hole conference on Friday. Those issuers that did decide to come to the market did so at a considerable concession, attracting investors and re-pricing existing paper simultaneously. Notable deals this week included PepsiCo ($1.25bln) and Illinois Tool Works ($1bln).

- Investment grade corporate spreads widened once again as thematically, nothing has really changed. Dealers are trying to reduce risk, widening their levels in order to attract buyers, which are pushing spreads wider across the board. Domestic and global financials spreads have gapped out over the course of August, so much so that Warren Buffett invested $5bln in preferred equity of BAC, which caused general spreads to ratchet tighter. The Barclays Credit Index Option-Adjusted Spread (OAS) finished the week at +195, 15 basis points wider. Financials widened by 28 basis points (banks +31, insurance +22); industrials widened by 14 (basic materials +26, capital goods +12, telecom +22, consumer cyclical +12, consumer non-cyclical+11, energy +18); and utilities widened by 12.

MORTGAGE-BACKED SECURITIES

- Agency mortgages underperformed Treasuries but outperformed other risk assets as the market priced in low long-term yields for an extended period. Weak economic data, declining equities, and lingering global sovereign debt woes weighed on the market and contributed to a flight-to-quality rally. Mortgages also suffered from a pickup in originations, waning demand from REITs, and a spike in volatility. Mortgage pass-through spreads were wider by 3 to 7 basis points across the coupon stack. Higher coupon mortgages lagged lower coupons and are at risk of new or modified plans by the Obama administration to help struggling homeowners refinance their mortgage loans. Ginnie Mae mortgages continue to outshine their Fannie Mae and Freddie Mac cousins as any perceived pickup in prepayment speeds will negatively skew to the conventional market. Another positive note, agency mortgages were at least up in value reaching all-time highs for lower coupons. The same can't be said for other products including mortgage credit that experienced falling prices with their close link to the macro view of the economy (i.e. credit and equities). With headline risk center stage, it's going to be an interesting September.

- For the week, the 30-year current coupon spread versus the 10-year Treasury widened seven basis points to 117 basis points. The 30-year mortgage rate offered to borrowers held steady at 4.22%.

MUNICIPAL BONDS

- This week, the summer doldrums effect finally kicked in for the municipal market after a hectic August. A mid-week month-end and an upcoming long weekend helped constrain buy side activity as well as curb new issuance. The largest deal was $242 million Florida State Board of Education Lottery Revenues (A1/AAA) with 10-year maturities issued at a 2.95%. As Treasuries fluctuated, municipal yields were little changed. As of Friday morning, the 10-year muni benchmark was lower by 2 basis points, while the 10-year Treasury was lower by 15 basis points.

- In separate California news, S&P upgraded California's $5.4 billion 2011-2012 revenue anticipation notes (RANs) slated for later this month from SP-1 to SP-1+, reflecting, among things, the state's smaller external cash flow borrowing amount in 2012, the capacity of the state's liquidity to absorb negative cash flows while retiring debt and paying interest, and the state controller's willingness and ability to implement aggressive cash management actions if necessary.

HIGH-YIELD BONDS

- The global high yield market tone is markedly improved over the course of the last week, with the recent equity rally and encouraging US economic data helping the market animal spirits. Since August 19th, major equity indices, such as the S&P 500, are up 8-9% and this has helped valuations and multiples in the high yield bond market. The Merrill Lynch high yield BB/B index is up over 1.2% in the period from August 25th through the end of the month. The cash that has been building up in the market over the course of the last few weeks due to lack of new issuance is certainly providing "dry powder" for this embryonic rally. Part of the rally also reflects short covering and buying by the major dealers, who had little in the way of high yield inventory entering late August. A portion of the "rally" also reflects window dressing that may have occurred at month end.

- All that said, the high yield market was over-sold and was certainly due for a rebound, even if the magnitude has lagged the rally in the equity markets. Many of the more liquid, bellwether high yield names such as Ally Financial (former GMAC), Chrysler Automotive, ILFC and many others are up 2-3% in price over the last few days. Encouragingly, the high yield market has experienced minimal outflow totaling less than $250 million from high yield mutual funds over the past 2 weeks. This apparent stabilization is a very positive step for the near term prospects of the global high yield market.

INTERNATIONAL MARKETS:

EASTERN EUROPEAN EQUITIES

- Stocks in Eastern Europe finished the week in slightly positive territory. This week's release of August manufacturing PMI in Emerging Europe pointed to continued moderation of economic activity in the region's key countries, though some countries' indices stayed in expansionary territory (above 50) and the region appeared little affected by expectation of significant slowdown in global growth. In Russia, PMI was roughly flat at 49.9 for the month; Hungary's PMI was lower at 50.1, while Poland's declined to 51.8. Also notable was Turkey's PMI 3.5 point decline to 48.8, signaling significant slowdown of growth expectations for the country's heretofore fast-growing economy.

GLOBAL BONDS AND CURRENCIES

- Volatility eased slightly from the previous week's highs early in the week, however, investors remained nervous and the market turmoil of recent weeks intensified again on Thursday. Most major sovereign bonds rallied, though lagged their US counterparts with yields on average 5 to 10 basis points lower compared to 15 basis points lower in the US. Credit spreads narrowed for the first time in three weeks

whilst liquidity in non-government bond markets improved considerably compared to the prior three weeks. Gold continued its advance in spite of the change in margin requirements from the previous week, whilst other commodities also maintained their upward motion from recent lows.

- Italian and Spanish sovereign bond spreads to German Bunds were on average 30 basis points wider despite the European Central Bank's continued bond purchase program. Despite easing slightly early in the week, the CDS on Europe's fiscally challenged countries ended the week higher, implying markets are becoming more concerned about the ability of European politicians to bring the debt crisis under control.

- In currency markets, The US dollar strengthened against most the major crosses. The Swiss franc, benefitted from safe haven flows and surged on Friday following poor US employment data. The Franc ended the week 2.5% stronger versus the greenback and 4.5% stronger versus the Euro. The single currency depreciated against most of its major peers due to the persisting fiscal problems of Europe. The Japanese Yen was unchanged versus the US dollar over uncertainty regarding incoming Japanese Prime Minister Yoshihiko Noda's stance on intervention in the foreign exchange markets however, the Yen remains close to its post World War 2 record. Both the Australian and New Zealand dollar finished the week higher against the greenback although, they fell from their mid-week highs on Thursday as worries over global growth pushed investors towards the liquidity of the US currency.

EMERGING-MARKET BONDS

- Emerging market dollar-pay debt spreads were tighter this week.

- In an unexpected decision, Brazil's central bank lowered the main SELIC interest rate by 0.5% to 12%, against market expectation of no change. In a statement accompanying news of the rate decision, the Bank emphasized the substantial deterioration of global economic conditions and the heightened risk for Brazil's economy though reduced trade/investment and weaker consumer confidence.

- Credit rating agency Standard & Poor's raised Peru's sovereign rating to BBB from BBB-, with a stable outlook. The upgrade was based on expectation that "broad fiscal and monetary policy continuity under Peruvian President Ollanta Humala's new government will support stronger economic policy flexibility and growth."

NEXT WEEK'S ECONOMIC RELEASES

Tuesday, September 6: ISM Non-Manufacturing Survey

Wednesday, September 7: JOLTs Job Openings

Thursday, September 8: Trade Balance