



# PORTFOLIO MANAGER'S REPORT



Tuesday August 17, 2010 8:37 AM

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## CURRENT OFFERING YIELDS - Tuesday: 08/17/2010 8:37 AM

## TODAY'S ECONOMIC DATA

Trsy (Last Price)	Change (From Yest)	Agcy NC (Bullets)	Muni - TEY (A1; GO; BQ)	CMO (Avg Life)	MBS (Avg Life)	17-Aug	17-Aug	17-Aug
3 mo	0.148%	-0.20 bp's	0.145%	0.480%			Producer Price Index (MoM)	Prior: -0.5% Actual: 0.2%
6 mo	0.182%	-0.10 bp's	0.179%	0.495%			PPI Ex Food & Energy (MoM)	Prior: 0.1% Actual: 0.3%
12 mo	0.233%	+0.0 32'ds	0.337%	0.586%			Housing Starts	Prior: 549K Actual: 546K
2 yr	0.504%	-1.5 32'ds	0.635%	0.889%	1.304%	1.324%		
3 yr	0.811%		0.942%	1.389%	1.611%	2.161%		
5 yr	1.425%	-2.5 32'ds	1.557%	2.389%	2.275%	3.005%	DJIA	10,356.89 54.88
10 yr	2.604%	-2.5 32'ds	2.757%	4.526%	3.404%	3.604%	NASDAQ	2,199.09 17.22
30 yr	3.719%	-11.5 32'ds	4.307%	6.920%			S & P 500	1,086.80 7.42

Source: Bloomberg Fair Value Curve or Last Price (Treasury only); ALL yields and spreads are "representative", not actual. Spreads change as the market changes, actual offerings may be higher or lower than

## TODAY'S NEWS

### Fed May Reemerge as Bigger Buyer With Resumption of Treasury Purchases

Aug. 17 (Bloomberg) -- The Federal Reserve will likely reemerge as the biggest buyer of Treasuries when it resumes purchasing U.S. government securities today to prevent money from draining out of the financial system. JPMorgan Chase & Co. strategists estimate the Fed will buy about \$284 billion in Treasuries over the next year, or more than the combined purchases of Japan and China during the year ended May. Analysts at Credit Suisse Group AG forecast purchases of \$307 billion, with \$47 billion coming from the proceeds of maturing agency debentures.

### Today's Topic- Bond Anomaly: Lower Treasury Yields = Lower Agency MBS/CMO Prices

Regular readers of this column understand that, for many months, we have advocated capturing market gains in premium priced, fast paying agency mortgage backed securities (MBS) and collateralized mortgage obligations (CMOs). In January, we expected the (then) impending cessation of the Fed's quantitative easing to be sufficient cause for taking gains while there was still an "800lb gorilla" in the room buying anything that moved. Many took action and reinvested into bullets or call protected agencies and/or municipal securities. Still, some waited...but for what? By mid-summer, cresting upon a tide of still higher bond prices, the answer was clear. Those who hesitated were actually not lost. To the contrary, they were (*illogically*?) rewarded for their inaction with stubbornly high post quantitative easing MBS/CMO pricing. So we issued the call once again - take profits before the tide turns. And many did...still, others inexplicably wait for an even better day. What are the chances that waiting may, again, prove to be as bountiful a course? Not so much - here's why:

"Fed says it will revive Treasury note purchases while keeping its benchmark interest rate at a range of zero to 0.25 percent" read the headline on the heels of last week's FOMC meeting. Welcome back quantitative easing. But this time, Treasury yields are significantly lower and the prominent fear/risk is that attendant prepayments are poised to begin anew and with vigor. Thus, the MBS/CMO market is experiencing a dramatic duration shift down the curve which cannot support the stratospheric pricing it has enjoyed most of this year. And further consider the fact that long end(10yr - 30yr)nominal Treasury yields are now higher than new production MBS and offer attractive price appreciation as rates tumble. To investment managers seeking return enhancements at every plate appearance, this completes their swing for the cycle:

- single: bought debentures in 2008 when rates were higher and spreads were historically wide
- double: took profits on debentures in 2009 and bought agency MBS/CMO at generous spreads
- triple: sold MBS/CMO at high prices and large profits in 2010
- home run: bought duration/yield with long Treasuries on the coattails of the Fed's buying program

Of course that home run is "betting on the come." Long duration Treasuries can be big winners, but it's a mercurial market in which today's profits become tomorrow's losses without warning. We don't recommend many investors swim in those waters. And if you do, be prepared for a vicious undertow. We do, however, enthusiastically recommend that you take yet another look at your MBS/CMO holdings to determine the wisdom of holding vs. selling. For income parched portfolio managers, the allure of capturing a gain on an asset melting like an ice cube on a summer sidewalk will be too refreshing to pass.

Please call your Country Club Bank Capital Markets rep for further discussion and trade specifics.