

The month of May showed a continuation of the uncertainty expressed after the events of April. The European debt crisis continued to weigh on investors' minds while there seems to be no end in sight for the oil disaster in the Gulf. While the topic du jour in the earlier part of the year surrounded the debate on inflation versus deflation, considerable global macroeconomic uncertainty has changed the tune. Of course the Fed watchers remain vocal, but the interpretation of the effect of the potential range of outcomes in Europe on both domestic and international economies has ruled the day.

In Henry Paulson's recent book *On the Brink*, he discussed his thought process as many of the financial catastrophes unfolded and his interaction with other policymakers. At one point he described a huge amount of trepidation in throwing out the "T-word" when referencing the potential size of the TARP program and other government initiatives. European officials could have used his advice. If you do happen to lead a discussion of a multi-nation led bailout in Europe with the "T-word" (1 trillion Euros), the number you throw out had better make a large dent in the problem. With the CDS markets still expressing significant concern over the PIGS, the market is saying that a trillion dollars will not be the solution. 5-year CDS on Greece continues to trade above 720 basis points. After a very temporary improvement earlier in the month, the cost of insuring Greek debt has continued to creep up. A potential debt restructuring in Greece looms, while unemployment of 20% continues to be the norm in Spain. To put Greek CDS levels in perspective, 5 year CDS on Greece traded around 35 basis points in mid-July of 2008, during the midst of the U.S. credit crisis. The problem was building but was not at all priced in. Ironically, despite increasingly poor debt/GDP ratios in the U.S., the market has responded with the traditional flight to quality and Treasury prices rallied. Throw in incredible 12-month returns across the high grade corporate sector and some current uncertainty is not unexpected.

April's Bond Market Watch talked about a three-ring circus, but a circus enables the viewer to leave the entertainment behind and move forward after its conclusion. The consequences of the potential weakness in Europe combined with the continuing effects of consumer deleveraging at home are leading to many skittish investors. The conclusion is far from predictable. On one hand, many of your garden-variety recovery signs are in place; earnings have largely surprised to the upside, the yield curve remains steep, ISM numbers shows supply side growth, and accommodative monetary conditions combined with rebounding GDP growth show signs of strength. However, the effects of financial reform, the outlook on the economic consequences of the Gulf, and the uncertain U.S. consumer—always reliable for 65-70% of GDP in the recent past—all raise more questions than answers. Gaining confidence in the recovery is difficult with such slack in aggregate demand, driven by stubbornly high unemployment (9.8% in May). As for the inflation question, the near-term threat of disinflation is more worrisome. The Fed's preferred indicator, the Core Personal Consumption Expenditure (PCE), came in at 0.1% month-over-month and 1.2% year-over-year as of the May 28th release date.

While the outstanding performance in credit was the big story in the bond markets for the first four months in 2010, May was all about the flight to quality. The yield on the Ryan Labs 10 year Treasury Index finished the month of May at 3.30%. When the 10-year approached 4% earlier this year, many investors felt that 5% was just around the corner. But with macro concerns come the flight to Treasuries, bolstering short term performance of Long Treasury indexes. The YTD return on the Ryan Labs 10 year Treasury index was 6.43% through May 31, 2010. YTD excess returns of credit versus Treasuries is now sharply negative, off over 500 bps in the Ryan Labs 30 year BBB index versus comparable Treasuries.

Last month, the story continued to be the performance of “BBB” rated credits versus higher grades, with a return of 2.0% in April versus 1.5% for the “AA” rated segment. Now, BBB’s in the 10 year sector are underperforming AA for the year, quite a turnaround in one month. The year-to-date return of the 10-year AA index is now 5.60% while 10-year BBB Corporate bonds returned 5.24%.

The U.S. core fixed income returned -0.87% in May, in aggregate. Equities had a much tougher month as the S&P returned -7.99% for the month of May. Within the investment grade universe, CMBS has been the best performing asset class for the year, up 10.00% year-to-date. But, CMBS returns suffered in May, losing -1.87% for the month. Meanwhile, ABS and MBS both had positive absolute returns for the month. Year-to-date the BC ABS index is up 3.32% while the BC MBS index is up 3.40%. Across the securitized landscape, fear over modification, default and extension continues to loom. But, with demand for high-quality collateral comes opportunity for senior tranches that may have got unfairly swept up in the beta of the last month. In credit, high grade corporate spreads widened substantially, going from 132 bps off Treasuries at the end of April to 182 bps at the end of May. The bond markets survived a volatile month but the future is looking uncertain. High-quality corporates continue to look attractive fundamentally but U.S. Treasuries remain the recipient of flows when macro uncertainty looms.

Yield and Total Returns									
Ryan Labs Indexes	YTW	QTD	YTD	12M ¹	Ryan Labs Indexes	YTW	QTD	YTD	12M ¹
RL 2 Year Indexes					RL 10 Year Indexes				
TIPS	0.12	-0.22	1.05	5.11	TIPS	1.45	4.05	4.32	10.73
Treasury	0.78	0.76	1.61	2.36	Treasury	3.30	5.00	6.43	5.19
FHLMC	1.09	0.19	0.46	1.65	FHLMC	3.56	4.76	5.10	7.47
FNMA	1.30	0.25	1.03	0.41	FNMA	3.14	3.54	5.02	8.01
AAA Corporate	1.48	0.55	1.97	4.06	AAA Corporate	3.97	4.41	6.76	12.27
AA Corporate	2.03	0.36	2.06	7.45	AA Corporate	4.53	2.60	5.60	19.10
A Corporate	2.58	0.19	1.98	8.68	A Corporate	5.05	1.88	4.58	17.39
BBB Corporate	2.88	0.75	3.15	11.49	BBB Corporate	5.47	1.61	5.24	22.66
RL 5 Year Indexes					RL 30 Year Indexes				
TIPS	0.61	1.28	2.54	7.95	TIPS	1.82	5.84	5.56	12.31
Treasury	2.10	3.05	5.13	5.76	Treasury	4.22	9.26	9.48	6.75
FHLMC	2.71	0.46	-3.70	-2.81	FHLMC	4.69	6.36	6.14	9.11
FNMA	2.52	0.42	1.06	2.17	FNMA	4.68	6.16	6.12	9.13
AAA Corporate	2.72	1.35	3.87	8.42	AAA Corporate	4.95	6.56	8.22	14.49
AA Corporate	3.14	1.63	3.75	11.96	AA Corporate	5.76	2.68	4.63	18.73
A Corporate	3.96	0.88	3.40	13.78	A Corporate	5.93	2.84	4.76	21.16
BBB Corporate	4.30	1.78	5.13	18.94	BBB Corporate	6.37	1.85	4.07	26.79
Barclays Indexes					Barclays Indexes				
BC Aggregate	3.19	1.91	3.73	9.05	BC ABS	2.45	1.06	3.32	12.14
BC CMBS	5.65	0.82	10.00	28.74	BC MBS	3.66	1.76	3.40	7.19

1) Last 12 Months Return

The material presented and calculated here is based on information considered reliable. Ryan Labs does not represent that it is accurate or complete.

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Ryan Labs TIPS				
	Yield To Worst (%)	MDuration (Years)	Year To Date Returns (%)	Last 12 Month Returns (%)
2 Year TIPS	0.12	2.35	1.05	5.11
5 Year TIPS	0.61	4.84	2.54	7.95
10 Year TIPS	1.45	10.51	4.32	10.73
30 Year TIPS	1.82	15.05	5.56	12.30
RL TIPS Index	1.00	7.99	3.28	8.83

Market Implied Breakeven Inflation Expectation				
	Yield To Worst (%)		Inflation (%)	
	Nominals ¹	TIPS	BEI ²	Current ³
CPI (1 Month Lag)				2.2
2 Year	0.78	0.12	0.66	
5 Year	2.10	0.61	1.49	
10 Year	3.30	1.45	1.85	
30 Year	4.22	1.82	2.40	

- 1) Nominals represent conventional U.S. Treasury Bonds and Notes.
- 2) BEI = Breakeven Inflation Rate (Nominal yields minus TIPS yields). Widening BEI indicates that TIPS are outperforming nominal bonds. When realized inflation is greater than implied inflation, TIPS also outperform.
- 3) Current Inflation = Bureau of Labor Statistics, Year over Year Consumer Price Index (non-seasonally adjusted, all items, 1 month lag)