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Weekly Review –October 4, 2002
From our Trading Desk

Treasury Market

Federal Reserve officials were out in force this week with a message meant to provide assurance to those that have little faith in the recovery potential of the U.S. economy. These officials continued to voice confidence that adequate monetary stimulus is in place to produce moderate, if uneven, growth over the foreseeable future. They urged patience and seemed to indicate that the funds rate was not likely to be reduced at the early November FOMC meeting. The Treasury market is currently priced to reflect a greater sense of urgency as the 2YR note traded below the funds rate while reaching 1.68% on Monday. All Treasury yields, except the bond, touched historically low levels on Monday as the September Chicago purchasing managers survey declined unexpectedly to a level of 48.1. The ISM manufacturing index on Tuesday corroborated this weakening trend as it fell to 49.5—the first contraction reading in 8 months. The ISM stated that it currently finds no momentum in the manufacturing sector.

September was a month of notable developments for the markets. The Treasury 10YR note produced its largest percentage yield decline in 22 years and the stock indices suffered their weakest performance in 4 years. The mid-month news of a dramatic widening of the FNMA duration gap probably led to some front-runner buying of Treasuries and likely contributed to the outsized performance of the 10YR note. FNMA subsequently announced on Tuesday that its duration gap has now narrowed to –10 months from –14 months. However this risk reduction was accomplished, it is unlikely that it involved the purchase of Treasuries. There was no evidence of direct FNMA involvement in the Treasury market during September.

In order for the Treasury market to rally conclusively from its current levels, it would seem that the economic environment will have to take a definitive turn toward stagnation. Shorter maturities are constrained until and unless the Fed eases the funds rate and longer maturities seem constrained until there is solid evidence that the consumer is spent or that the corporate earnings recession will last several more quarters. Conversely, while the September ISM services index showed resilience on Thursday, until the manufacturing sector clearly bottoms or business spending increases, the economy will have difficulty growing at a trend 2.5 to 3.0% rate.

The Friday release of the September employment data roiled the Treasury market. The market was biased to anticipate weaker data than the forecast and, therefore, was sent to sharply lower prices when the unemployment rate unexpectedly dropped to 5.6%. Yields jumped by 18 bps on the 2YR note and 8.5 bps on the bond as perceived economic strength took a toll. With equities not responding to the data, and instead slumping in response to several announced earnings shortfalls, Treasuries regrouped and began a steady climb back to unchanged levels. Participants chose to believe that the employment data was not fully realistic and, in the end, downplayed its significance. For the week the 2YR note rallied 4.5 bps and the bond yield rose 4.0 bps.

Breakeven rate traders along with the swap accounts have been the most active players in TIPS lately, while the real money accounts have been reluctant to add new positions as supply (6 to 8bln expected next week; reopening of 7/12's) approaches. When the Treasury market sold off mid-week, breakeven players were booking profits, buying back UST's versus selling TIPS. And in the long TIP sector, asset swap players have been buying bond TIPS versus libor over the past three weeks. As the 7/12 TIP reopening nears, traders feel the breakeven rate on the 7/12's will need to narrow to roughly 4bps to 145bps for the auction to clear successfully. Given the 3 month breakeven narrow for 7/12's is 144bps, the street should be comfortable buying 7/12 TIPS relative to nominals.

Agency Market

Issuance Calendar

ANNC. DATE	ISSUER	TKR	TYPE	AMT	PRICING	VERSUS
9/30/02	Freddie Mac	FHLMC	10nc3yr global note	2BB	117	10YR
9/30/02	Freddie Mac	FHLMC	2YR reference note re-opening	3BB	10/8/02	2YR
TBA	Freddie Mac	FHLMC	10YR reference note	TBA	10/10/02	10YR
10/7/02	Fannie Mae	FNMA	10YR callable benchmark	TBA	10/8/02	10YR
10/21/02	Fannie Mae	FNMA	2/3YR benchmark note	TBA	10/24/02	2YR
10/21/02	Fannie Mae	FNMA	30YR benchmark bond	TBA	10/24/02	30YR
10/31/02	Freddie Mac	FHLMC	3YR reference note	TBA	11/7/02	2YR
TBA	Freddie Mac	FHLMC	30YR reference bond	TBA	11/7/02	30YR

Agency Commentary

In a move that seemed to catch the agency market off-guard, FNMA announced its duration gap narrowed to –10 months early this week. The surprise announcement forced dealers to cover their shorts in the product and agencies snapped in 4-5 bps across the curve. However, continued equity market weakness, widening swap spreads, and talks of trouble at a German bank kept pressure on agencies throughout the week. With the exception of the 5YR sector, agencies finished mixed versus treasuries, and 2 bps tighter versus swaps. Since 5YR agencies widened the most during the duration gap concerns, they outperformed the rest of the curve when those fears subsided this week. FNMA 7/07's are also trading at 0% in the repo market which has kept surrounding spreads tight. 5YR agencies finished 4 bps tighter versus treasuries, and 6 bps tighter versus swaps.

In terms of relative value, 10YR agencies look attractive along the agency curve. 10YR agencies are now trading at their three-month wide spread levels versus treasuries and swaps. Part of the cheapening in this sector is attributed to the fact that 10YR treasuries are trading extremely special in repo, and the agency market gets 10YR supply from FHLMC next week. Since issuance, the range on the current 10YR FNMA has been 68-78; the issue closes the week at 76.5. As spreads begin to stabilize, these wider levels may be a prudent time to enter the market, given the limited supply going forward.

New agency supply has been a "non-event' over the last few weeks as the market continues to digest FNMA's duration gap needs. FHLMC priced $2BB of a new 10nc3yr global note at a spread of 117 over the 10YR note. However, FHLMC will bring 2YR and 10YR supply next week which should garner more market attention.

Active Swaps and Agencies

				3 MONTH	
ISSUE	**9/27/02**	**10/4/02**	**CHANGE**	**WIDE**	**NARROW**
2YR SWAP	41.0	43.0	+2.0	48.5	35.0
5YR SWAP	65.5	67.5	+2.0	69.0	44.5
10YR SWAP	64.5	**67.0**	+2.5	**67.0**	51.5
30YR SWAP	45.0	45.5	+0.5	57.5	42.0
2YR FNMA	27.0	27.0	Unch.	28.0	13.0
5YR FNMA	53.0	49.0	-4.0	58.5	34.5
10YR FNMA	75.5	**76.5**	+1.0	**76.5**	55.5
30YR FNMA	**73.5**	72.0	-1.5	**73.5**	63.5
2YR FNMA	**-14.0**	-16.0	-2.0	**-14.0**	-61.0
5YR FNMA	-12.5	**-18.5**	-6.0	-9.0	**-18.5**
10YR FNMA	**+11.0**	+9.5	-1.5	**+11.0**	+0.5
30YR FNMA	+28.5	+26.5	-2.0	+30.0	+18.5

Corporate Market

Benchmark Indices

TKR	09/27/02	10/04/02	CHANGE	% CHANGE	INSTRUMENT
USFICORP ($BB)	4.69	4.87	0.18	3.88%	CORPORATE SUPPLY
TYA ($PX)	115-09	115-12+	3+/32	0.09%	10YR FUTURES
GT10 (%YLD)	3.69	3.683	-0.007	0.19%	10 YR YIELD
LEH CORP (%YLD)	5.69	5.60	-0.09	1.58%	CORPORATE INDEX
JPSSPRD (BPS)	1092	1086	-6.00	0.55%	EMERGING MARKETS
SPX ($PX)	827	801	-26	-3.14%	S&P 500 INDEX
VIX (%VOL)	43.14	46.28	3.14	7.28%	VOLATILITY

Select Investment Grade New Issues

DATE	ISSUER	TKR	RATING	AMT	MAT	PRICING	CLOSE
10/3/02	Portland Gen. Electric	ENRNQ	Baa2/BBB+	150MM	8YR		
10/3/02	Duke Energy Corp	DUK	A1/A	350MM	30YR	175	
10/2/02	Conoco-Phillips	COP	A3/A-	600MM	30YR	125	
10/2/02	Conoco-Phillips	COP	A3/A-	1BB	10YR	105	
10/2/02	Conoco-Phillips	COP	A3/A-	400MM	5YR	95	
10/2/02	Southern Cal Gas	SRE	A1/A+	250MM	10YR	108	
10/2/02	Emerson Electric	EMR	A2/A	250MM	10YR	98	
10/1/02	Mid American Energy	BRK	Baa3/BBB-	500MM	10YR	218	
10/1/02	Mid American Energy	BRK	Baa3/BBB-	200MM	5YR	205	
10/1/02	Wells Fargo & Co	WFC	Aa2/A+	300MM	5yr-nc2yr	109	
9/30/02	Union Oil Co Calif.	UCL	Baa2/BBB+	400MM	10YR	150	

Credit Spreads

The corporate market saw very light flows this week as investors absorbed numerous economic reports and the earnings season began with a couple of disappointing announcements. Investors appear reluctant to add to corporate positions and many accounts continue to discuss the importance of a diversified portfolio going forward. The desire to avoid the next credit blow-up continues to lead to panic selling of troubled credits (TXU) and increased risk aversion. As we've discussed many times recently, the lack of retail buying interest has led to an illiquid market in which trading activity is being dictated by street players. Issuance was light again this week with the exception of a $2 billion Conocophilips (COP) deal. Spreads traded in a relatively tight range until Friday when spreads blew out in sympathy with the equity market weakness.

At day's end, Banks were 5 to 10 bps wider, Autos were softer with Ford leading the way, some 30 to 35 wider, while GM and DCX ended only 5 to 10 bps softer. Ford was under pressure from the At day's end, Banks were 5 to 10 bps wider, Autos were softer with Ford leading the way, some 30 to 35 wider, while GM and DCX ended only 5 to 10 bps softer. Ford was under pressure from the start of trading, midday a rumor about disruptions from the dockworkers strike would cause Ford to shut down 10-14 plants, which was denied by the company, added to the downside pressure on Ford debt. For the week Ford paper closed 36 to 40 bps wider across the curve. Finance companies came under big pressure as well on Friday as HI and CIT Group bonds were both significantly wider. HI bonds closed 20 to 40 wider for the day and 30 to 45 wider for the week.

Although earnings season is just beginning, bad news is already flowing. Dow Chemical (DOW) announced that it would miss its earnings target for the third quarter due to higher feedstock costs. DOW 6.00s of ’12 closed Friday bid at +200 (versus UST 10yr), 20 bp wider on the week. Credit Suisse paper widened throughout the week on concerns of mounting losses at the bank. Also, S&P indicated that it might further cut Credit Suisse’s credit rating despite a downgrade this past June. On the week, CRDSUI 6.50s of ’12 were 35 bp wider and CRDSUI 7.125s of ’32 were 30 bp wider. Friday, Texas Utilities (TXU) announced that profits fell more than expected. TXU 6.375s of ’06 closed bid at $81, a decline of more than 16 points. Finally, Boeing (BA) announced a $250 million pretax writedown on Friday. Boeing 10-year paper was 20-25 bp wider on light volume following the news.

Rating Changes

Disney	DIS	Downgraded by S&P 10/4/02 to BBB+ from A-
Alcoa Inc	AA	Downgraded by S&P 10/3/02 to A from A+
El Paso	EP	Downgraded by Moody’s 10/2/02 to Baa2 from Baa1
Penzoil-Quaker	PZL	Upgraded by Moody’s 10/2/02 to Aa2 from Ba3
West Penn Power	AYE	Downgraded by Moody’s 10/1/02 to A1 from Aa3
Comcast Cable	CMCSA	Downgraded by Moody’s 9/30/02 to Baa3 from Baa2
Sempra Energy	SRE	Downgraded by Moody’s 9/30/02 to Baa1 from A2
TCI Comm	T	Downgraded by Moody’s 9/30/02 to Baa3 from Baa2