Lookout Report
from S&P Valuation and Risk Strategies

Is The U.S. Economy Teetering On The Brink Of Recession Or Poised For Resumed Recovery?

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The Lookout Report provides cross-market and cross-asset views based upon the unique combined capabilities of S&P Valuation and Risk Strategies, S&P Index Services, Capital IQ, and S&P Leveraged Commentary and Data. Published by S&P's Valuation and Risk Strategies research group, the Lookout Report is a compendium of current data and forward looking insights from leading S&P market specialists. Key areas of focus and differentiation include aggregated corporate earnings, market and credit risk evaluation, capital market activity, index investing and proprietary data and analytics. Featuring interpretations of the investing horizon, the report previews the issues most likely to drive market expectations or cause a disturbance in the weeks ahead.

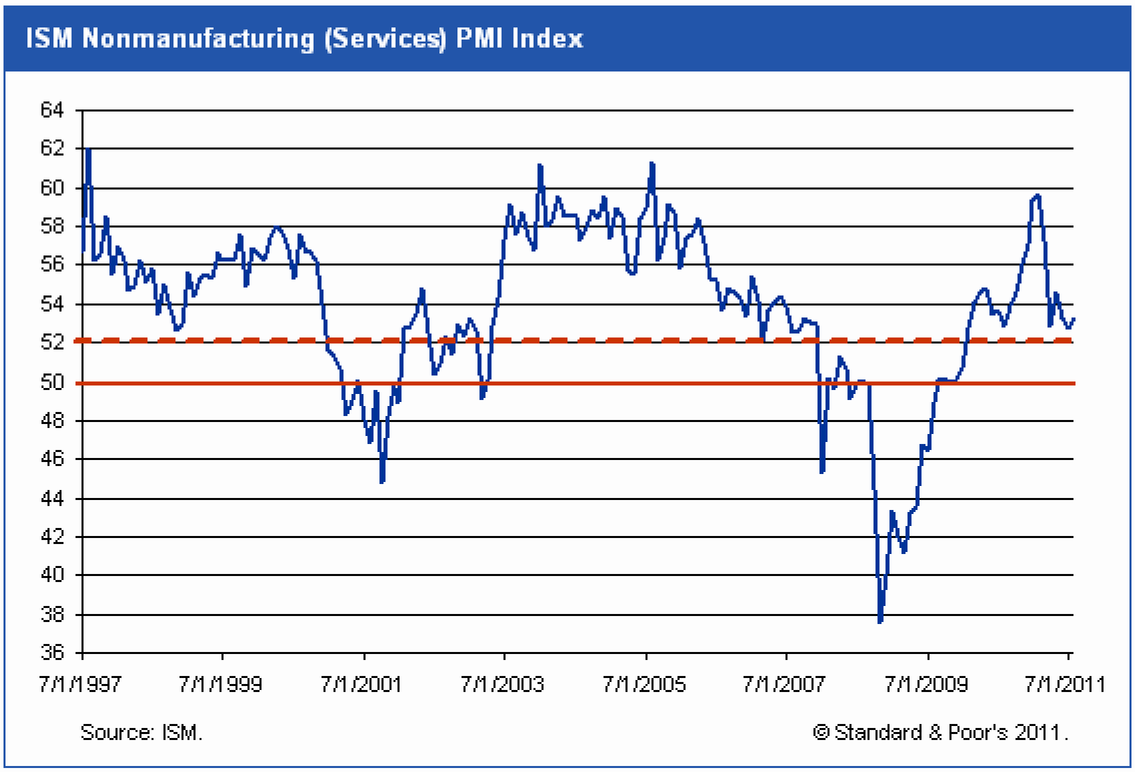
In our previous Lookout Report published two weeks ago, the research team said it was unclear to us whether the U.S. economy was heading toward recession or pulling out of a mid-year slump. We had hoped that the August Institute for Supply Management (ISM) Purchasing Managers Index (PMI) and employment reports would help clarify underlying economic conditions, but this has not been the case, in our view. The latest ISM manufacturing and services PMI indicators (50.6 and 53.3, respectively) both held above the neutral 50 level, suggesting that the U.S. economy--for the moment--continues to expand. However, the exceptionally soft August employment report reminded investors that the foundation for economic growth remains fragile at best.

Meanwhile, investors continue to treat the equity and Treasury markets as though the U.S. economy is teetering on the verge of recession. Financial markets remain extremely skittish and volatile, reinforcing the risk-aversion trade that pushed 10-year Treasury yields this week to record lows below 2.00%.

As far as the ongoing macroeconomic debate in the market is concerned, the burden of proof clearly lies with the bulls, who are fighting a two-front battle in the U.S. and Europe against soft economic fundamentals. We will continue to evaluate high-profile economic data such as the employment and PMI reports within the context of supporting--but still significant--indicators such as weekly initial jobless claims, durable goods orders, retail sales, and industrial production, which continue to send mixed and inconclusive signals about the economy. We are also paying very close attention to the ISM services PMI, which reversed its downward trend and reached 53.3 in August from 52.7 in July. This indicator has a history of receding to just above the 52.0 level during "soft patch" periods before recovering to levels normally associated with healthy GDP growth (see chart 1).

It has long been said that when the U.S. economy sneezes, the world catches a cold. We continue to believe that there is a reasonable chance that the U.S. could soon return to GDP growth in excess of 2%, which we believe would be a very positive and much-needed economic and sovereign fiscal development on both sides of the Atlantic. However, we must acknowledge that the three-month average rate of nonfarm payroll growth (35,000) has now fallen to the lowest level since October 2010, after having been very strong (215,000) as recently as April. We recognize that we might soon need to reconsider our sustained economic recovery view, and will have no choice but to adopt a more pessimistic view of the U.S. economy if the ISM service sector PMI decreases to lower than the 52 level in September after having just inflected higher in August. Alternatively, forthcoming improvement in the services PMI could suggest that the U.S. economy is belatedly pulling out of the second-quarter soft patch that was at least partially triggered by the events in Japan.

Chart 1



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Economic And Market Outlook: Earnings In North America And Europe

In North America, many investors remain concerned about the persistent drop in third-quarter S&P 500 earnings expectations. Although estimates typically decrease in the weeks leading up to earnings season, the recent declines seem to have come a bit earlier than normal for the third quarter. In Europe, analysts have significantly lowered aggregate expectations on economic growth concerns, leading to the lowered consensus.

Leveraged Commentary And Data: Leveraged Loans Lost 4.4% in August; The Year-to-Date Index Loss Is Now 1.77%

Managers attribute the widespread nature of the August correction to the sudden and severe change in the market's supply/demand equation. In fact, the market suffered its largest technical deficit since October, at $7.7 billion, as S&P/LSTA Index loans outstanding grew by $2.2 billion, even as net inflows into traditional accounts (prime-fund inflows and CLO issuance) slumped to negative $5.5 billion.

R2P Corporate Bond Monitor

As a result of sagging economic data in the U.S. and continued debt fears in the eurozone, investors' risk appetites remained low in August. Concurrently, corporate bonds' risk-reward profiles--as measured by average Risk-to-Price (R2P) scores--deteriorated sharply across the board, from July 29, 2011, to Sept. 2, 2011, continuing the July trend.

S&P Index Municipal Commentary: Are Municipal Bonds Still Cheap?

Demand for high-quality municipal bonds increased recently, as volatility in the equity markets, low default rates, and unique diversification characteristics have made the municipal bond asset class a flight-to-quality destination.

Market Derived Signal Commentary: CDS Spreads For Eurozone Banks Reflect Macro Challenges, But Risk Premiums Vary

We think credit protection for eurozone banking spreads should be maintained at this time, as sovereign debt default and ratings downgrade concerns continue to persist. But the wide differential between spreads makes it possible for investors with varying levels of risk tolerance to enter the market.

Capital Market Commentary: The Equity Market Forced Firms To Cancel IPOs In August

Equity market performance remained tumultuous in August, as the S&P 500 Index lost 5.7% in value. In the same period, many firms cancelled their planned initial public offerings (IPOs) due to market conditions. According to data retrieved from Capital IQ, companies withdrew 13 IPOs, marking the most for cancellations since December 2008, when firms pulled 22 IPOs off the market calendar.

S&P Index Commodity Commentary: Commodities Fare Well Amid Turmoil

Despite increasing global financial turmoil and volatility, commodities are generally expected to fare well, as emerging market demand remains intact, and the diversification benefits of real physical assets continue to gain support.

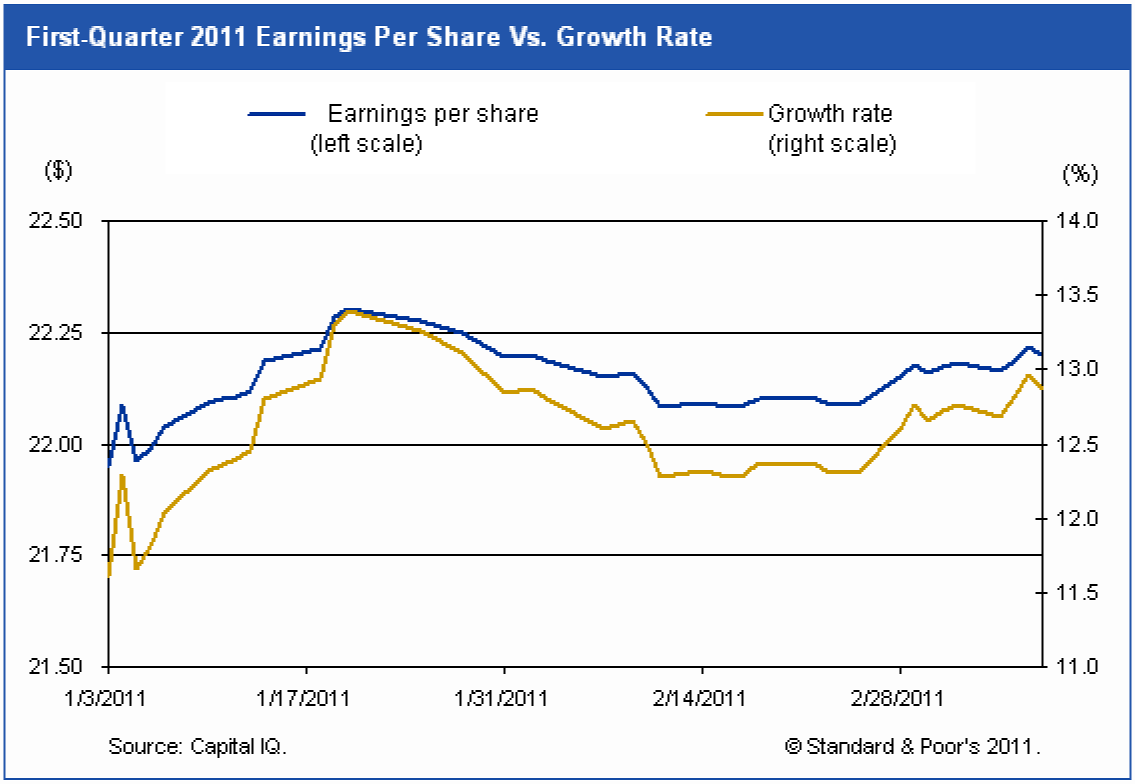
Economic And Market Outlook: Earnings In North America And Europe

North America: The Bar Has Been Lowered For Third-Quarter S&P 500 Earnings Season

Many investors remain concerned about the persistent drop in third-quarter S&P 500 earnings expectations. Although estimates typically decrease in the weeks leading up to earnings season, the recent declines seem to have come a bit earlier than normal for the third quarter. The research team reviewed the earnings for first-quarter 2011, second-quarter 2011, and third-quarter 2011, and compared the earnings expectations at the beginning of each calendar quarter (Jan. 1 for the first quarter, April 1 for the second quarter, and July 1 for the third quarter) with expectations from the month prior to each earnings season. Here's what we found:

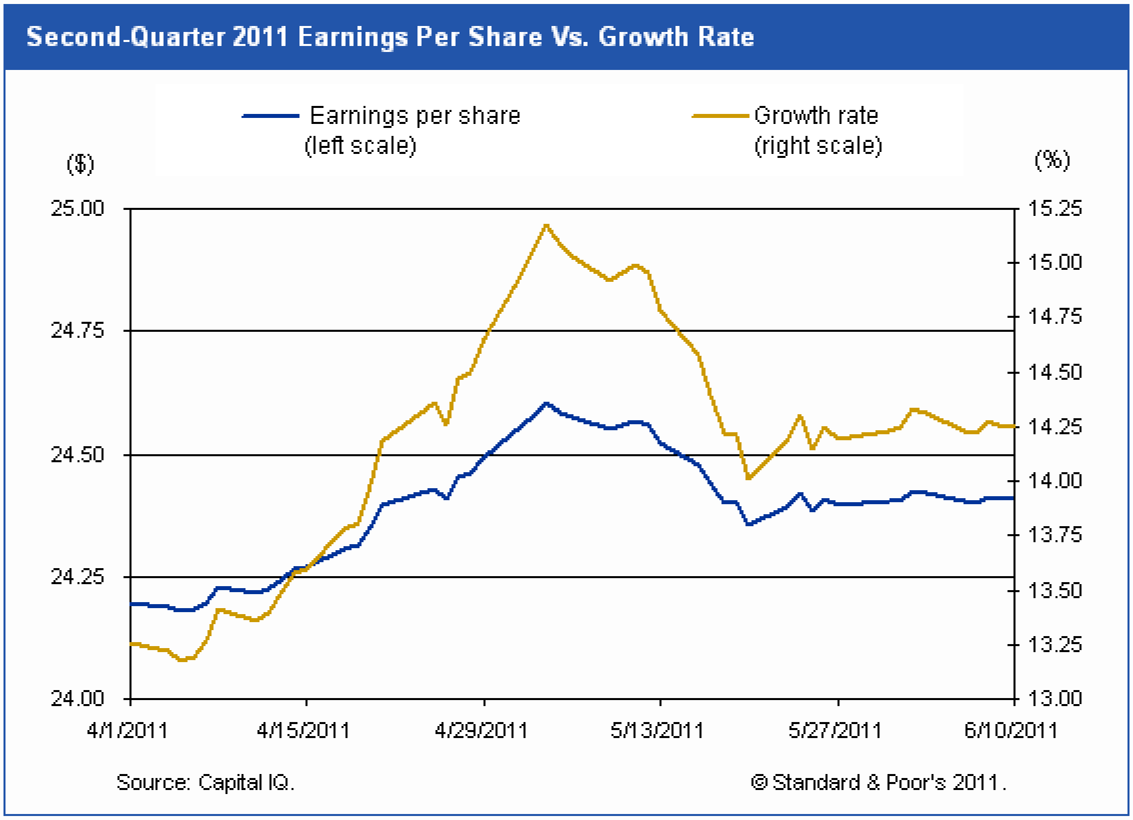
- On Jan. 1, according to the Capital IQ consensus, estimates for the first quarter stood at 11.6% ($21.95). By March 10, the consensus had increased to 12.9% ($22.20), a 1.3% increase in expected growth and a 25-cent increase in earnings per share (see chart 2).

Chart 2



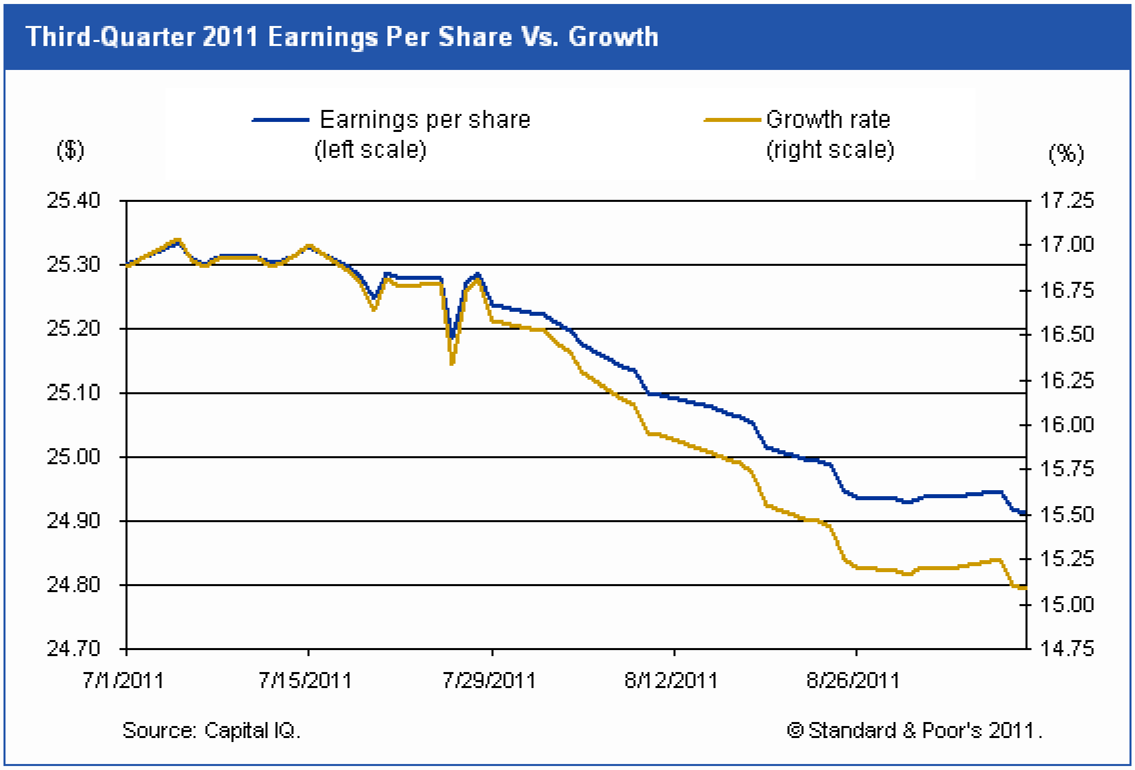
- On April 1, the second-quarter consensus estimated 13.3% growth ($24.20). By June 10, expectations increased to 14.3% ($24.41), nearly a 1% increase in growth and a 21-cent increase in earnings per share. In early July, however, we saw second-quarter expectations drop, at least partially in response to the much weaker-than-expected June employment report released on July 8. As earnings season began, 68% of companies exceeded expected earnings, and the growth rate rebounded, ending the quarter at a robust 19.1% (see chart 3).

Chart 3



- On July 1, estimates for the third quarter stood at 16.9% ($25.30) and on Sept. 8 dropped to 15.1% ($24.91), a 1.8% decrease in growth expectations and a 39-cent decrease in earnings per share. Following a string of largely mixed economic data this summer, the very disappointing July ISM PMI manufacturing report released on Aug. 1 triggered a steady and steep decline in Capital IQ S&P 500 consensus third-quarter earnings expectations. Since then, as additional disappointing economic data has come to light, including the August employment report, analysts' third-quarter estimates have continued to sink, but nonetheless remain at an overall respectable growth rate of 15.1% as of Sept. 8. The bar has now been lowered for third quarter S&P 500 earnings season, with about a month to go before companies once again shed light on how they are coping with the low growth and uncertainty-charged operating environment (see chart 4).

Chart 4



Europe: Analysts Revised Estimates Amid Continued Economic Growth Concerns

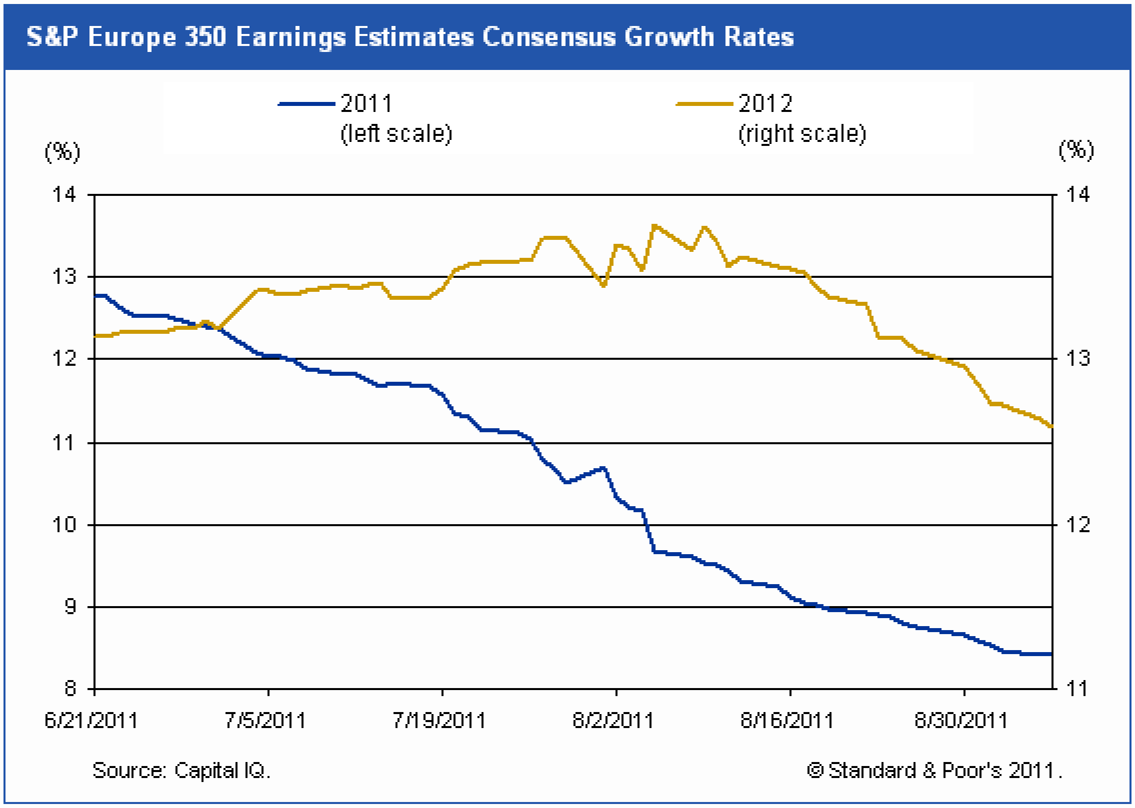
- Analysts' consensus expectations for S&P Europe 350 2011 and 2012 calendar earnings continued to decrease over the past month. On Sept. 6, calendar estimates for 2011 and 2012 stood at €101.21 and €113.95, respectively, the lowest levels since the start of the third quarter, according to Capital IQ data.

- Analysts have significantly lowered aggregate expectations for the cyclical consumer discretionary, energy, materials, industrials, and financials sectors. We believe that analysts revised estimates for many companies within these sectors on economic growth concerns, leading to the lowered consensus.

- In July, analysts lowered 2011 estimates more than 2012 estimates, possibly with a view that current economic uncertainty would be short-lived. In August, however, analysts started lowering longer-term 2012 estimates, probably with a view that the current sovereign debt problems could have wider consequences for the economy, and concluded that previous growth expectations beyond one year were too optimistic.

- Correspondingly, as chart 5 illustrates, 2012 earnings growth started fluctuating in August, when economic uncertainty concerns had again become widespread. By the middle of August, the earnings growth consensus began to trend downward. During the one month period ended Sept. 6., growth decelerated more than 1% to 12.6%.

Chart 5



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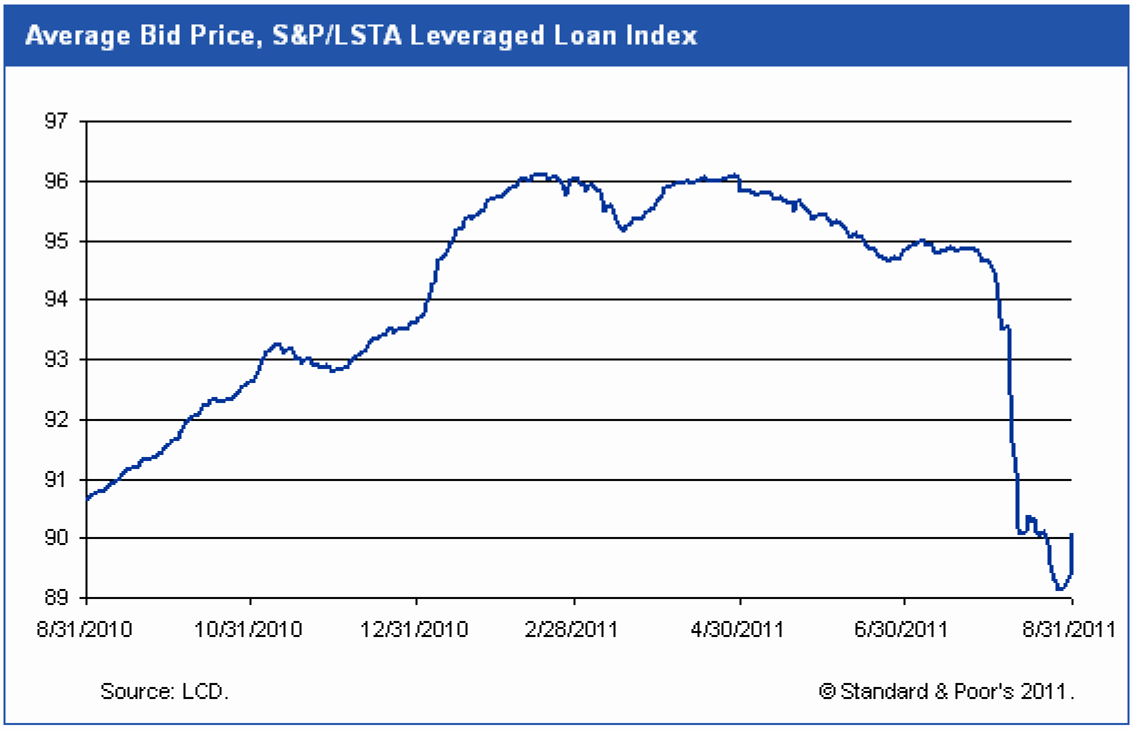
Leveraged Commentary And Data: Leveraged Loans Lost 4.4% in August; The Year-to-Date Index Loss Is Now 1.77%

For the loan market, the usually sleepy month of August was anything but, arriving like a grizzly bear and departing like a baby bull.

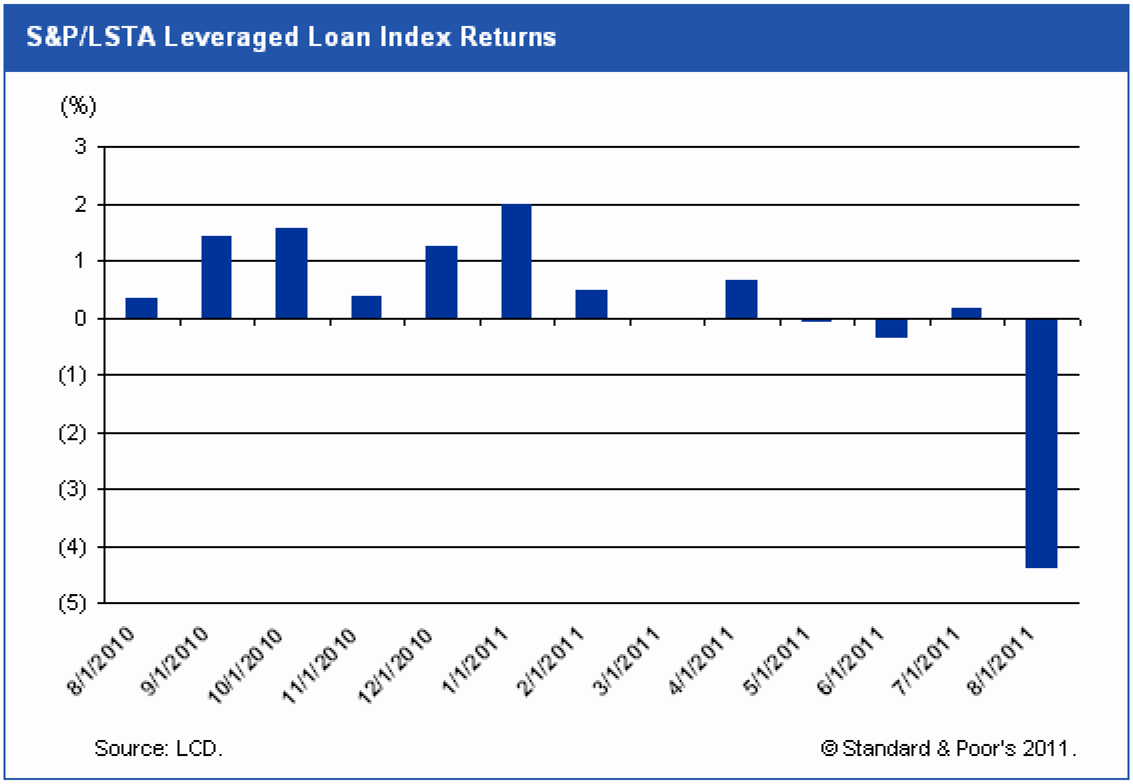
Between Aug. 1 and Aug. 26, the S&P/LSTA Leveraged Loan Index decreased by 5.4%. During that time, the average index price plunged to a 1.5-year low of 89.14% of par, from 94.65%, in response to crumbling technical conditions, a string of weaker-than-expected economic reports, and the fallout from Standard & Poor's Ratings Services' downgrade of the U.S. Then, between Aug. 27 and month-end, loan prices increased on the back of the rally in the stock market. The S&P/LSTA Index gained 1.08% during the final five days of the month, as the average index price recovered to 90.08 (see chart 6).

Chart 6



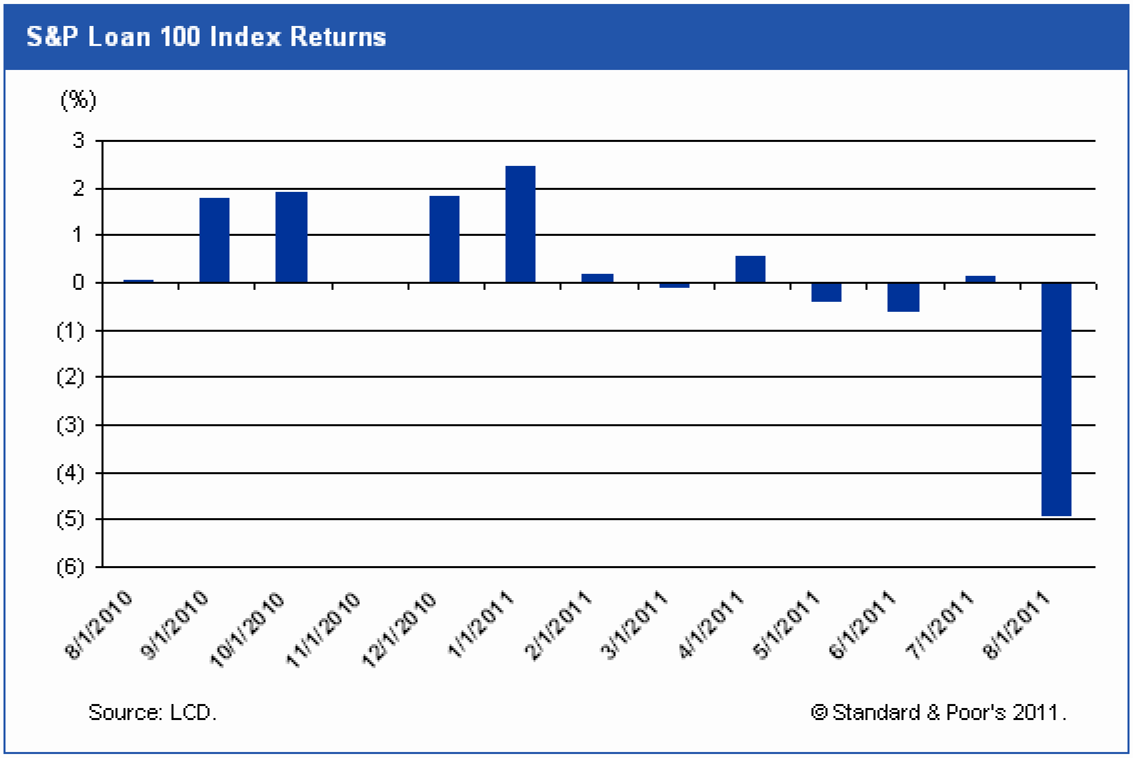
The late-August rally wasn't enough, however, to rescue the market from its worst drubbing since the dark days of late 2008. All told, the S&P/LSTA Index lost 4.4% in August (see chart 7). As a result, loan returns for the first eight months of the year dropped into the red, down 1.77% (by comparison, year-to-date returns were up by 2.76% a month earlier).

Chart 7



The damage was even more profound among the largest, most-liquid names in the S&P/LSTA Loan 100. This subset of the 100 largest loans in the overall universe fell 4.93% in August, leading to a year-to-date loss of 2.94% (see chart 8). As these figures suggest, high-beta names bore the brunt of the August sell-off, as loan mutual funds sold tradable names to free up cash to meet redemptions, which totaled a record $5.46 billion, according to Lipper FMI.

Chart 8



With the exception of defaulted loans, which were crushed by Tribune Co., there was no significant pattern by rating category or facility type, as table 1 shows.

Table 1

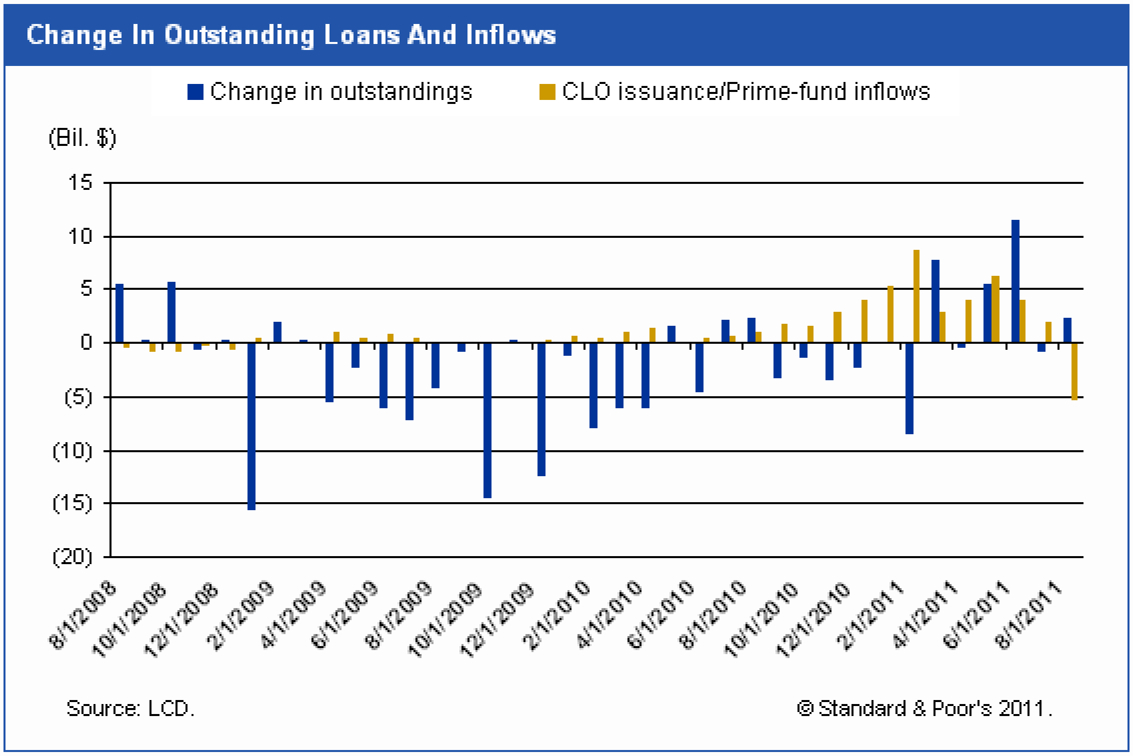
Returns By Type Of Debt

	Year to date (%)	8/31/2011 (%)
All loans	(4.40)	(1.77)
Performing loans	(4.46)	(1.80)
BB	(4.01)	(2.12)
B	(4.89)	(1.44)
CCC	(4.18)	(1.52)
D	(11.84)	(9.59)
Second-lien	(4.73)	2.89
First-lien	(4.40)	(1.92)
Middle market	(2.44)	3.14
Large corporate	(4.46)	(1.88)
Covenant-lite	(5.21)	(2.48)
S&P/LSTA 100	(4.93)	(2.94)

Source: LCD.

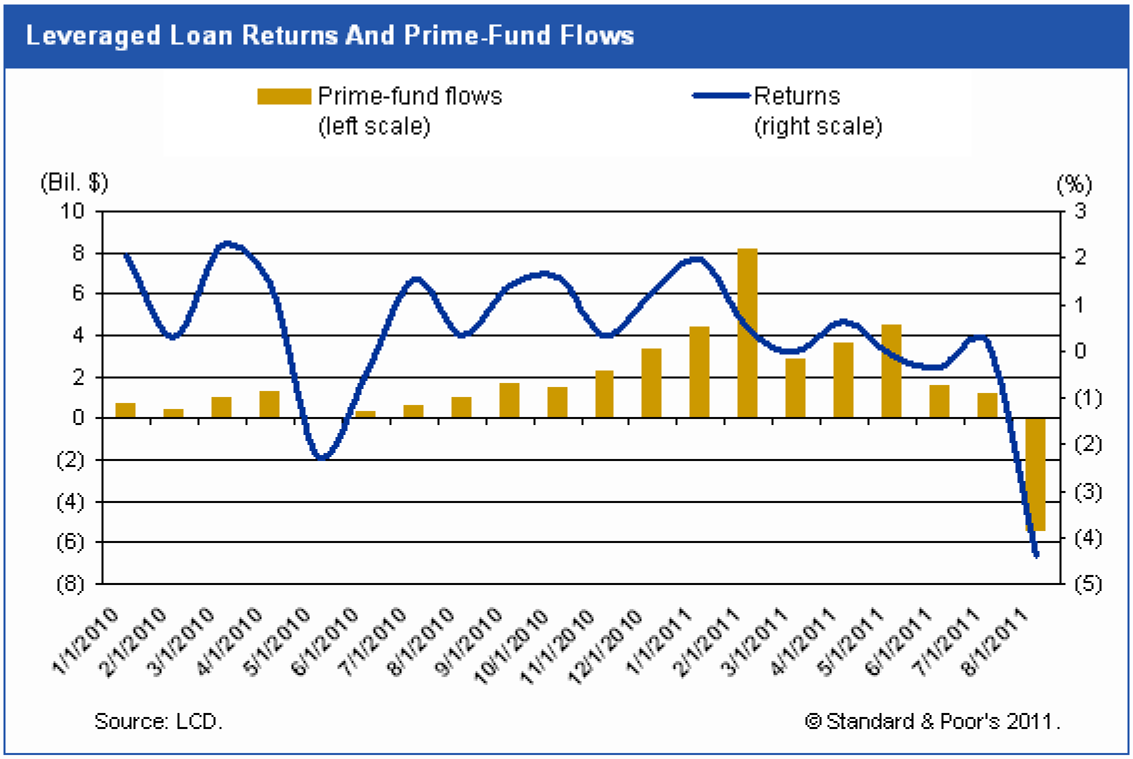
Managers attribute the widespread nature of the August correction to the sudden and severe change in the market's supply/demand equation. In fact, the market suffered its largest technical deficit since October, at $7.7 billion, as S&P/LSTA Index loans outstanding grew by $2.2 billion, even as net inflows into traditional accounts (prime-fund inflows and CLO issuance) slumped to negative $5.5 billion (see chart 9).

Chart 9



Drilling down further, it's no surprise that since 2010, the loan market's fortunes have been closely tied to its main engine of new capital: mutual fund inflows. And one of the factors that helped resuscitate the loan market in late August was the fact that outflows eased to $684 million during the week ended Aug. 31, from $945 million the prior week and a record $2.1 billion from Aug. 11 to Aug. 17 (see chart 10).

Chart 10



Looking out to early September, participants believe the primacy of loan mutual fund inflows will persist. After all, the other sources of new demand are on the disabled list. For example, the CLO window is again shut, and high-yield bond takeouts--a major source of loan demand earlier in the year--stalled completely in August, for obvious reasons. Finally, managers say allocations from institutional players have slowed to a crawl, as pension funds and endowments wait for the waters to calm.

On the supply side of the ledger, there is $13.7 billion of visible M&A activity on the calendar. But arrangers hope that this paper will prove easier to syndicate than advertised, with a nearly equal amount of repayments also in the queue and new underwriting at most dealers on a short leash until the current calendar clears.

That leaves the market tone for the final stretch of 2011 in the hands of investors in loan mutual funds. Of course, predicting what this crowd will do when the market gets back into gear after Labor Day is a fool's errand. The bull case is that investors will regain their appetite for two main reasons. First, the forward-LIBOR curve has rebounded after falling sharply following the Fed's announcement to keep short-term rates low through at least mid-2013. The three-year forward rate rose to 1.4% on Sept. 2, from 1.35% on Aug. 18, according to Bloomberg, and some participants speculate that this could help bring attention back to floating-rate loans.

The wide risk premium the market now offers could also drive loan demand. With loan prices down, the current yield of loan mutual funds stands in the 5% to 6% range, up from 4% to 5% earlier in the year and far above what is available for investors seeking low-rate duration. Indeed, on Sept. 2, the average yield on jumbo money-market accounts stood at 0.8%, with one-year jumbo CDs at 0.84%, according to Bankrate.com.

Whether investors seize today's wide loan risk premium as a buying opportunity clearly depends on whether they re-embrace the risk trade. Certainly the S&P 500's 8.5% rally in late August--to 1,219 at month-end, from a year-to-date low of 1,124 on Aug. 19--was an encouraging sign. However, fear reasserted itself during the first two days of September. On the first of the month, ADP signaled that the jobs report might be weaker than originally expected, and those fears were fulfilled the next day when the Commerce Department reported that the employment rolls stagnated in August, far short of economists' consensus forecast for an increase of 100,000 jobs. In response, the S&P 500 declined by 3.7% during the first two days of September, as investors fretted anew about a potential double-dip recession.

If the economy goes back into recession, the implications for the loan market are dour for three main reasons. First, a recession could result in higher default rates for leveraged issuers. Second, rates are likely to stay low, hurting the relative value of loans versus fixed-rate alternatives. Third, investors will remain fearful, hurting all credit and equity products.

The Recent Sell-Off In Context

The August loss was the fourth largest monthly decline on record since the S&P/LSTA Index commenced in 1997, and it was the largest outside of the three months following the bankruptcy of Lehman Brothers. Indeed, there are only 12 months during which the index has fallen more than 1% (see table 2).

Table 2

Declines Of Greater Than 1%, S&P/LSTA Index

Month	Price return (%)	Total return (%)	Context
Aug. 2008	(13.87)	(13.22)	Lehman aftermath, TRS MV CLO unwinds
Nov. 2008	(9.16)	(8.51)	Lehman aftermath, TRS MV CLO unwinds
Sept. 2008	(6.66)	(6.15)	Lehman aftermath, TRS MV CLO unwinds
Aug. 2011	(4.79)	(4.40)	Record mutual fund outflows/U.S. debt downgrade
July 2007	(3.99)	(3.35)	Stuctured-finance market collapses/Massive underwriting calendar
Jan. 2008	(3.80)	(3.23)	Defaults rise/technicals erode
Dec. 2008	(3.66)	(2.95)	Lehman aftermath, TRS MV CLO unwinds
Feb. 2008	(3.00)	(2.51)	Spike in BWIC activity/fear of TRS MV CLO unwinds
May 2010	(2.60)	(2.25)	European sovereign debt crisis flares
Sept. 2001	(2.10)	(1.66)	9/11 terror attacks
Nov. 2007	(2.01)	(1.39)	Supply-driven decline; Arrangers syndicated FDC
Oct. 2002	(1.57)	(1.18)	Default spike/Charter Communications teeters (but ultimately skirts bankruptcy)

Source: LCD.

Where things go from here is anyone's guess. But despite the last few days of brutal declines in equities, few think a repeat of the late-2008 market meltdown is underway.

Loans Versus Other Asset Classes

Even after the downgrade, investors famously rushed into Treasuries as a safe haven amid a sea of poor economic reports around the globe and Europe's ongoing sovereign debt crisis. As a result, loans lagged the three fixed-income categories LCD tracks monthly in this report--including high-yield--while beating equities.

Meanwhile, the S&P/LSTA Index and the S&P 500 are in a tie for last place year to date, with Treasuries lapping the field (see table 3).

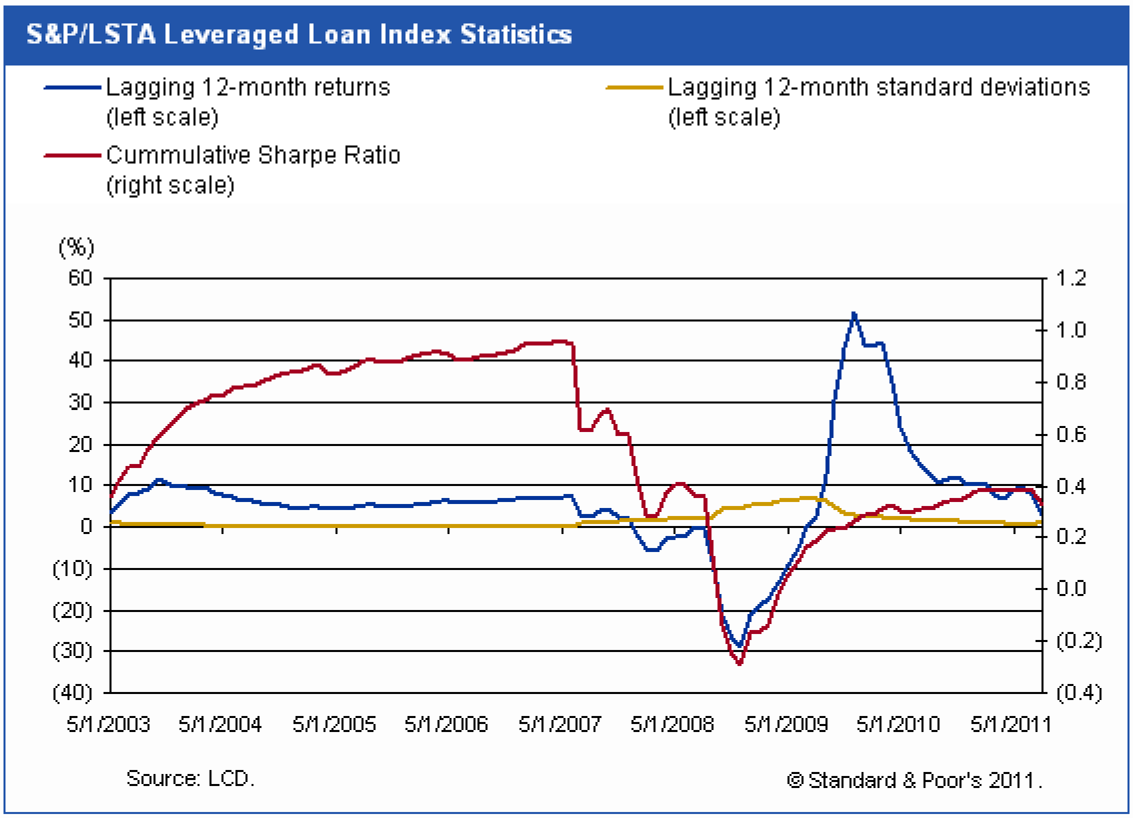
Table 3

Returns		
	Year to date (%)	**8/11/2011 (%)**
S&P/LSTA Index	(1.77)	(4.40)
BAML High-Yield Master	1.98	(4.01)
10-year Treasuries	12.26	5.70
S&P 500	(1.77)	(5.43)
BAML Corporate Bond Master	0.10	5.51

Source: LCD, Bloomberg, and Bank of America Merrill Lynch.

On a risk-adjusted-return basis, meanwhile, the August sell-off hit the S&P/LSTA Index hard. The Sharpe Ratio since the inception of the Index in 1997 fell to a 12-month low of 0.32, from 0.38 a month earlier (see chart 11).

Chart 11



That primarily reflects a decline in the historical average annual return to 5.13%, from 5.48%. The historical volatility of the asset class, meanwhile, inched up to 1.94, from 1.91.

The drop in the Sharpe Ratio in August didn't change the S&P/LSTA Index's relative standing on the leaderboard. It continues to lag the bond categories while leading equities (see table 4).

Table 4

January 1997 To August 2011			
	Annualized returns (%)	**Standard deviation of monthy returns (%)**	**Sharpe Ratio**
S&P/LSTA Index	5.13	1.94	0.32

Table 4

January 1997 To August 2011 (cont.)			
BAML High Yield (H0A0)	7.39	2.87	0.45
10-Year Treasury (GA10)	6.76	2.22	0.49
S&P 500 (SPX)	6.55	4.76	0.22
BAML Higrade Corp. (C0A0)	6.82	1.62	0.69

Source: LCD, Bloomberg, and Bank of America Merrill Lynch.

The outperformance of fixed-rate instruments here, too, mainly reflects the steady decline in interest rates. As of August, the 10-year Treasury yield was 2.04%, versus 6.3% at the end of 1996, according to the Federal Reserve.

Big Movers

Naturally, the list of big movers was tilted toward decliners in August. The two biggest detractors from Index returns--Tribune and Clear Channel--both sold off on news. High-beta names that accounts sold to free up liquidity dominated the rest of the list (see table 5).

On the positive side of the ledger, six of the 10 biggest contributors to index returns were courtesy of refinancings.

Table 5

Big Movers

Up	S&P loan rating	August index return contribution (%)	Comment
Dynegy Holdings	NR	0.011	Refinancing
La Paloma Generating	CCC+	0.004	Refinancing
DG FastChannel	BB-	0.003	
Royalty Pharma Finance Trust	BBB-	0.003	
Academy Sports & Outdoors	B	0.003	Refinancing
ISP Chemco	BB+	0.002	
CIT Group	BB	0.002	Refinancing
Autoparts Holdings Limited	B-	0.002	Refinancing
Lender Processing	BBB	0.001	Refinancing
Varsity Brands	NR	0.001	
Down			
Tribune Company	D	(0.154)	Exit date pushed back
Clear Channel Communications	CCC+	(0.132)	Disappointing earnings
First Data Corp	B+	(0.120)	
Univision Communications	B+	(0.116)	
Education Media & Publishing	NR	(0.080)	
Avaya	B	(0.059)	
HCA – The Healthcare Company	BB	(0.057)	
Sungard	BB	(0.051)	
Community Health Systems	BB	(0.049)	
Harrah's Entertainment	B	(0.044)	

Source: LCD.

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R2P Corporate Bond Monitor

Last Friday's hugely disappointing nonfarm payrolls report revealed zero net job creation in August, renewing worries that the economy may be heading toward recession. With the August PMI of 50.6 (0.3% lower than July) just barely holding above the expansion level, G-7 finance ministers will face the challenging task of restoring confidence in the global economy when they meet next week.

In Europe, concern that European leaders may fail to contain the region's sovereign debt crisis hurt the outlook for the global economy. Fears mounted Wednesday that Europe's debt crisis is reaching a critical tipping point, spreading from Greece, Ireland, and Portugal to the larger economies of Italy and Spain. Italy will once again be under scrutiny as the senate in Rome begins discussing the government's latest austerity measures.

As a result, investors' risk appetites remained low in August. Concurrently, corporate bonds' risk-reward profiles--as measured by average Risk-to-Price (R2P) scores--deteriorated sharply across the board, from July 29, 2011, to Sept. 2, 2011, continuing the July trend (see tables 6 and 7).

Despite the current soft economic climate, U.S. corporations managed to deliver second-quarter earnings that exceeded market expectations, according to the Capital IQ consensus. Among the 99% of S&P 500 Index companies that have reported earnings, 70% exceeded expectations. Unfortunately, the impressive earnings results have not been able to contain investor anxiety over the economy or the adverse market reactions in the equity and high-yield corporate bond markets.

European and North American securities' scores declined on average by 38% and 52%, respectively, due to increasing market and credit risks. Although average yields increased, with option-adjusted spreads (OAS) widening by 41 basis points (bps) in Europe and 4 (bps) in North America, average bond price volatility rose 84% to 0.66% in Europe and 116% to 1.09% in North America. According to our statistical models, the average probability of default (PD) increased by 136% to 0.13% in Europe and 133% to 0.70% in North America.

Although market and credit risks increased, European energy and health care securities tightened on average by 4 bps and 9 bps, respectively. Despite increasing risks, North American consumer staples, information technology, and utilities securities tightened in August by 37 bps, 11 bps, and 39 bps, respectively.

Table 6

European Risk-Reward Profiles By Sector--Average R2P Score And Components Changes

	Scores (%)	OAS (bps)	PD (%)	Bond price volatility (%)
Consumer discretionary	(40)	70	175	103
Consumer staples	(33)	9	26	52
Energy	(37)	(4)	81	38
Financials	(36)	38	31	101
Health care	(54)	(9)	11	122
Industrials	(37)	83	221	84
Information technology	(17)	88	91	66
Materials	(49)	83	274	234
Telecommunication services	(31)	44	185	(3)
Utilities	(44)	9	262	44

Change between July 29, 2011, and Sept. 2, 2011. OAS--Option-adjusted spread. PD--Probability of default.

Table 7

North American Risk-Reward Profiles By Sector--Average R2P Score And Components Changes

	Scores (%)	OAS (bps)	PD (%)	Bond price volatility (%)
Consumer discretionary	(56)	24	72	108
Consumer staples	(33)	(37)	10	112
Energy	(57)	3	123	128
Financials	(55)	22	68	118
Health care	(52)	14	187	108
Industrials	(61)	5	40	110
Information technology	(56)	(11)	128	115
Materials	(57)	28	140	128
Telecommunication services	(50)	29	424	135
Utilities	(46)	(39)	134	98

Change between July 29, 2011, and Sept. 2, 2011. OAS--Option-adjusted spread. PD--Probability of default.

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S&P Index Municipal Commentary: Are Municipal Bonds Still Cheap?

Demand for high-quality municipal bonds increased recently, as volatility in the equity markets, low default rates, and unique diversification characteristics have made the municipal bond asset class a flight-to-quality destination.

The S&P National AMT-Free Municipal Bond Index, which tracks investment-grade tax-free bonds, returned 3.5% this quarter, driving its year-to-date (through Sept. 7) total to 8.5%. The weighted-average yield of the index dropped 55 bps since year-end, which has led to higher bond prices.

The "belly of the curve" (the five- to 10-year range) rallied 110 bps since year-end, with the S&P AMT-Free Municipal Series 2016 Index (representing five-year bonds) returning just less than 2.5% for the quarter and 6.5% year to date. The Series 2020 Index (representing nine-year bonds) returned more than 5% for the quarter and 10.9% year to date.

Whether municipal bonds are expensive or cheap in the current environment depends on an investor's point of view. Low default rates, diversification, tax-exempt income, and lower volatility than other asset classes appear to have value to investors, keeping demand relatively high. The slower pace of the supply of new issues coming to market, compared with previous years, is helping to maintain a supply/demand imbalance.

One key indicator is the ratio of tax-exempt yields of municipal bonds relative to treasury yields. The S&P AMT-Free Municipal Series 2020 Index tracks actual high-quality noncallable tax-exempt bonds maturing in 2020: 2020 Index weighted-average yield: 2.59% (tax-exempt); Yield of 10-year U.S. Treasury Bonds: 2.05%.

The muni/Treasury ratio is the tax-exempt yield divided by the treasury yield (2.59%/2.05% = 126%). Prior to the end of the quarter, this ratio was historically about 85%. With the Federal Reserve maintaining low interest rates, this measure has been knocked out of whack.

However, tax-exempt yields tracking at 126% of Treasury bond yields indicate that high-quality municipal bonds remain an attractive option for risk-averse investors seeking diversification, tax-exempt income, and lower volatility (see table 8).

Table 8

Municipal Bond Indices

Index	Weighted-average coupon (%)	Weighted-average maturity	Weighted-average yield to maturity (%)	Yield change for month (bps)	Taxable equivalent yield (%)	--Change (%)-- Month-to-date	Quarter-to-date	Year-to-date
S&P National AMT-Free Municipal Bond	4.57	10/15/2025	3.45	(6)	5.31	0.73	3.50	8.46
S&P California AMT-Free Municipal Bond	4.49	10/1/2025	3.50	(7)	5.38	0.77	3.60	9.38
S&P New York AMT-Free Municipal Bond	5.01	2/15/2027	3.58	(5)	5.51	0.65	3.31	8.01
S&P Short Term AMT-Free Municipal Bond	5.04	12/15/2013	0.86	(1)	1.32	0.06	0.95	2.87
S&P National AMT-Free Municipal VRDO	N/A	7 Days	0.37	(6)	0.56	0.01	0.06	0.22
S&P AMT-Free Municipal Series 2012	4.61	7/30/2012	0.60	1	0.92	0.01	0.14	0.99
S&P AMT-Free Municipal Series 2013	4.67	7/25/2013	0.56	0	0.86	0.01	0.47	2.23
S&P AMT-Free Municipal Series 2014	4.66	7/25/2014	0.69	(2)	1.06	0.05	1.14	3.68
S&P AMT-Free Municipal Series 2015	4.64	7/25/2015	0.90	(2)	1.38	0.09	2.12	5.38
S&P AMT-Free Municipal Series 2016	4.63	7/25/2016	1.26	(3)	1.94	0.13	2.49	6.45
S&P AMT-Free Municipal Series 2017	4.62	7/25/2017	1.61	(6)	2.48	0.36	3.41	7.73
S&P AMT-Free Municipal Series 2018	4.60	7/25/2018	1.90	(9)	2.92	0.60	4.02	9.18

Table 8

Municipal Bond Indices (cont.)								
S&P AMT-Free Municipal Series 2019	4.58	7/25/2019	2.22	(10)	3.42	0.71	4.76	10.51
S&P AMT-Free Municipal Series 2020	4.11	7/25/2020	2.59	(10)	3.98	1.00	5.09	10.89
S&P Municipal Yield Index	4.47	6/30/2029	6.50	(6)	10.00	0.62	3.00	8.29
S&P Taxable Municipal Bond Index	5.37	4/15/2030	4.62	(15)	4.62	1.77	8.24	14.94
S&P L/T Intermediate Taxable Municipal	4.55	8/30/2021	4.02	(14)	4.02	1.28	7.46	13.25
S&P Municipal BAB Select	6.26	12/30/2038	5.16	(18)	5.16	2.61	10.67	20.03

Source: S&P Indices.

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Market Derived Signal Commentary: CDS Spreads For Eurozone Banks Reflect Macro Challenges, But Risk Premiums Vary

Standard & Poor's Ratings Services said Tuesday that weak growth prospects in the eurozone and risk intolerance in the wholesale funding market have stalled the rebound in the European banking industry (see "Industry Report Card: European Bank Rebound Falters Amid Slowing Economies And Market Turmoil," published Sept. 6, 2011, on RatingsDirect, on the Global Credit Portal). Standard & Poor's "believes that the further recovery of the industry will hinge on restoring order to the sovereign debt market, shoring up confidence in bank funding markets, and avoiding a double dip into recession in the large European economies."

Standard & Poor's outlooks on its ratings on more than half of the 50 largest European banking groups are negative. In addition, the difference between the most and least creditworthy European bank has widened. "European banks have built up their capital adequacy since the crisis, but need to improve it further to meet the demands of regulators and creditors and to restore market confidence," Standard & Poor's said.

Plans to support Greece, Ireland, and Portugal from widespread defaults eroded investor confidence, and the credit strengths of Italy and Spain are now in jeopardy. "The high risk premium on Italian and Spanish government bonds over German bunds, which has prevailed since the fourth quarter of 2010, reflects investor worries that these two large European countries could follow the path of their smaller brethren," Standard & Poor's said.

The research team wanted to learn to what extent these fears were reflected in the five-year credit default swap (CDS) spreads for the eurozone's largest banks. To keep our search focused, we concentrated on the five largest banking groups by total assets as of June 30, 2011 (see table 9). As there was no CDS data for the French bank Groupe BPCE, we added the sixth largest, ING Bank N.V.

Table 9

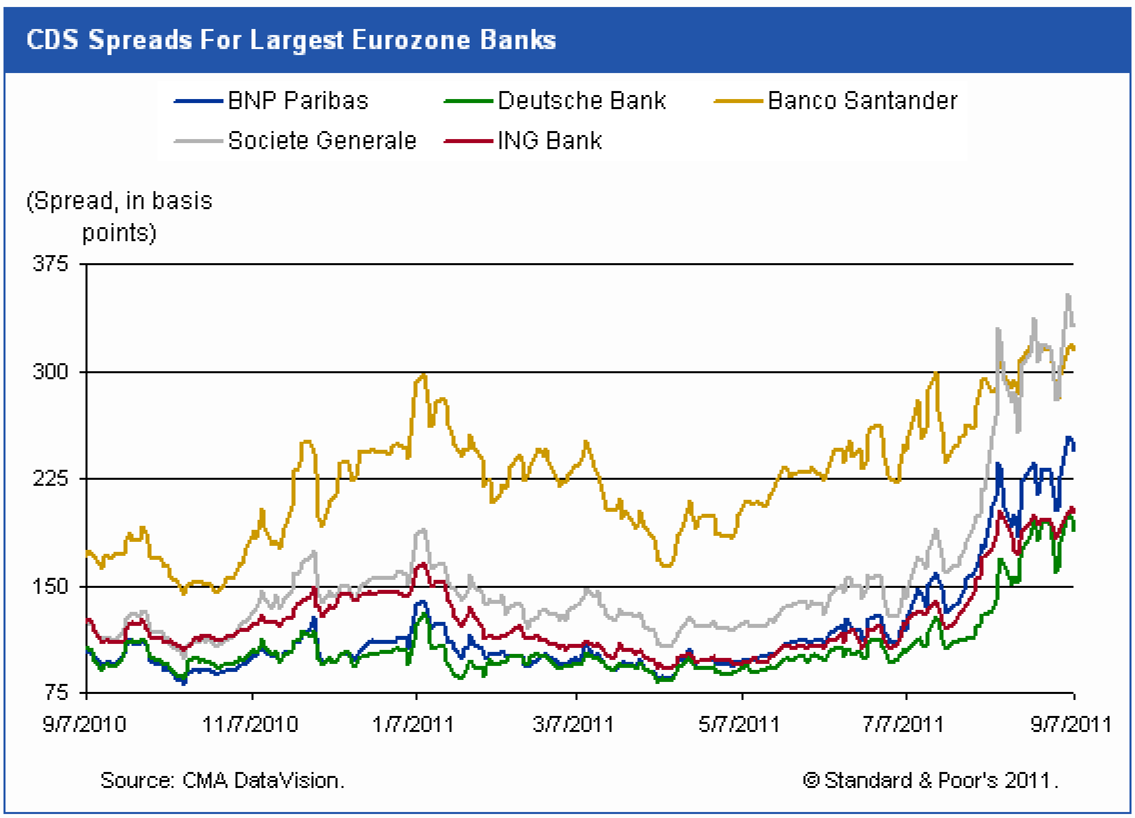
Five Largest Eurozone Banking Groups By Total Assets

Company	Location	Industry	Total C2Q2011 assets (mil. $)	S&P Ratings/Outlook
BNP Paribas	France	Banks	2.8	AA/Negative
Deutsche Bank AG	Germany	Capital markets	2.7	A+/Stable
Banco Santander	Spain	Banks	1.8	AA/Negative
Societe Generale	France	Banks	1.7	A+/Stable
*Groupe BPCE	France	Banks	1.5	A+/Stable
ING Bank N.V.	Netherlands	Banks	1.4	A+/Stable

*No CDS data. Data as of June 30, 2011. Source: CMA DataVision.

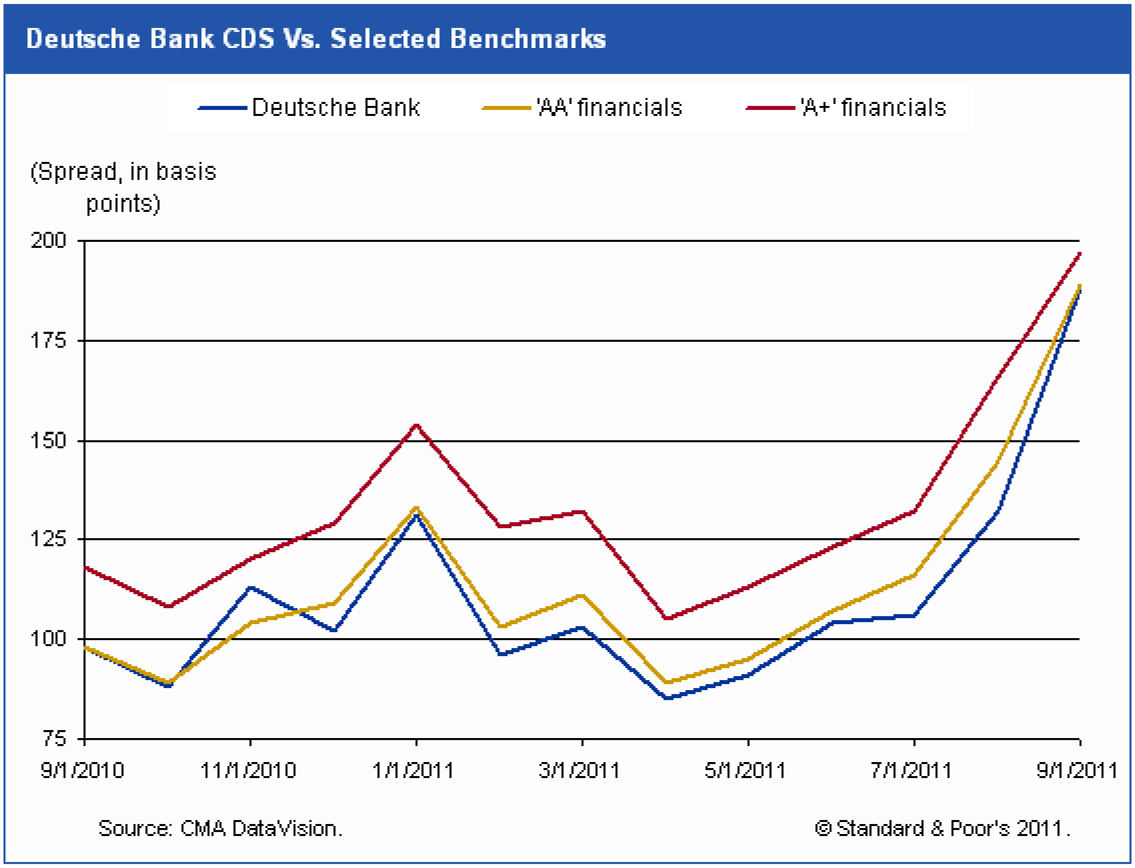
The CDS spreads for the five banks we analyzed reached record highs over the past year. The spreads widened by 138% to 245 basis points (bps) for BNP Paribas; by 77% to 188 bps for Deutsche Bank; by 84% to 314 bps for Banco Santander; by 162% to 331 bps for Societe Generale; and by 62% to 202 bps for ING Bank (see chart 12).

Chart 12



We then focused on the widest and tightest spreads in the group. Deutsche Bank, at 188 bps, is trading in line with its Market Derived Signal rating of 'aa' at 189 bps, and is 19 bps tight of its 'A+' credit rating benchmark (see chart 13). The spread has traded consistently tight of its credit rating benchmark all year.

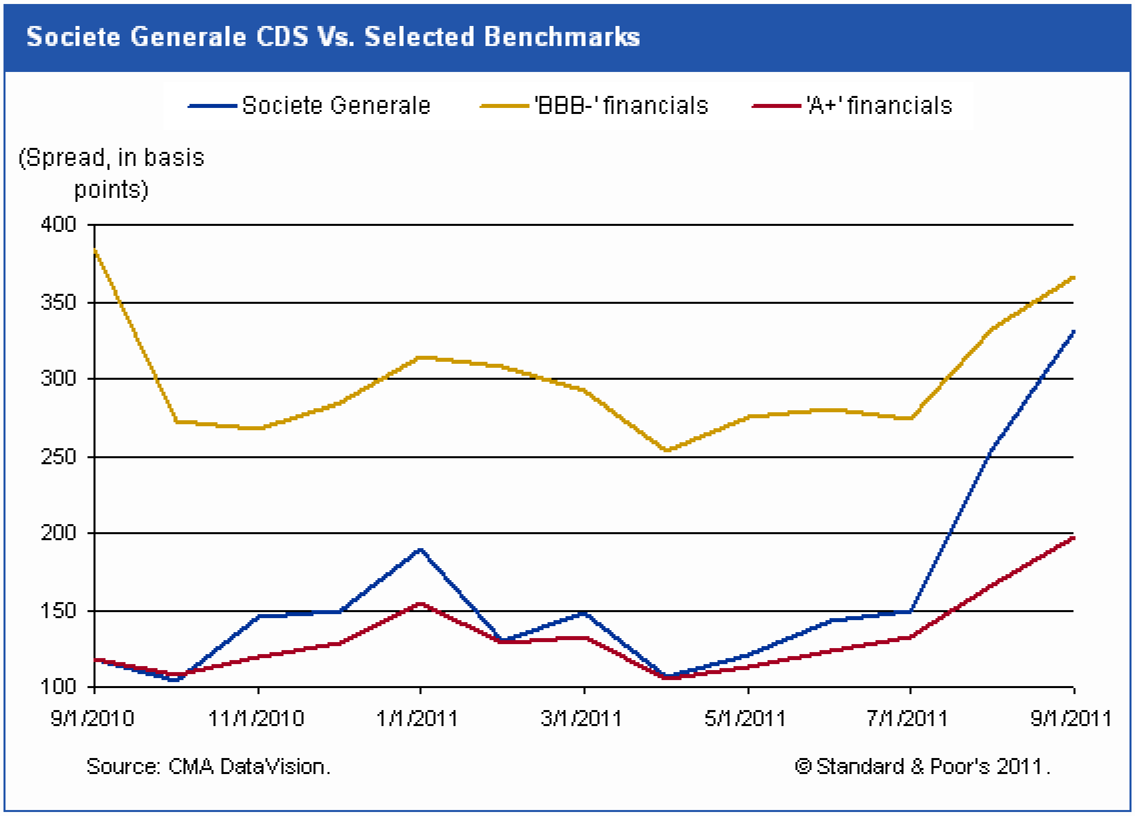
Chart 13



Standard & Poor's said its stable outlook on its rating on Deutsche Bank factors in its expectation that the bank's 2011 pre-tax earnings will likely surpass what was reported in 2010 on the strength of positive contributions from recent acquisitions. But the bank is not immune to macro challenges. "Nonetheless, stricter banking regulations (e.g. concerning liquidity) and low interest rates, which inhibit returns on low-cost funding, and the current challenging financial markets, may limit revenues and keep Deutsche Bank from reaching its target of €10 billion in pre-tax income in 2011 compared with €6.5 billion in 2010," Standard & Poor's said.

Societe Generale, at 331 bps, is trading 124 bps wide of its 'A+' credit rating but 35 bps tight of its Market Derived Signal rating of 'bbb-' (see chart 14). The bank is also trading 19 bps wide of the spread for Banco Santander and 86 bps wide of the spread for its larger French peer, BNP Paribas. Standard & Poor's has negative outlooks on its ratings on both of these companies.

Chart 14



"The stable outlook reflects our expectation that SocGen will post improving although still subdued core earnings in 2011," Standard & Poor's said in the industry report card. "We also expect SocGen to contain its risk profile, particularly in more volatile markets, and to continue to become more client-centric in corporate and investment banking." Negative rating factors include a large balance sheet with significant credit risk, a "complex book of illiquid assets and trading instruments, and large operations in emerging markets, notably Russia," Standard & Poor's said in an Aug. 11 research summary.

"Although expected to improve, SocGen's capitalization is only moderate and not supportive of its current ratings," Standard & Poor's said. In a financial crisis, however, the bank's considerable systemic importance would likely prompt government support if needed, likely limiting or obviating a deterioration in SocGen's creditworthiness.

We think credit protection for eurozone banking spreads should be maintained at this time, as sovereign debt default and ratings downgrade concerns continue to persist. But the wide differential between spreads makes it possible for investors with varying levels of risk tolerance to enter the market.

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Capital Market Commentary: The Equity Market Forced Firms To Cancel IPOs In August

IPOs

Equity market performance remained tumultuous in August, as the S&P 500 Index lost 5.7% in value. In the same period, many firms cancelled their planned initial public offerings (IPOs) due to market conditions. According to data retrieved from Capital IQ, companies withdrew 13 IPOs, the most cancellations since December 2008, when firms pulled 22 IPOs off the market calendar. Given that no IPOs were planned for the week ending Sept. 9, and that only three issues were completed last month, the research team considers these recent developments a significant stumbling block for the prospect of an uptick in capital markets activity.

As for the year's largest offerings (based on current market capitalization), the general trend has been negative. The price of the 10 largest IPOs priced this year in the U.S. marketplace has decreased by an average of 0.7% in the 30-day period ended Sept. 7, and by an average of 15.2% since their offering date (see table 10).

Table 10

Aftermarket Performance Of Highest Market Cap IPOs Priced In 2011

		--Price change (%)--		
Company	**Market cap. (mil. $)**	**One-week**	**30-day**	**Since offer**
Kinder Morgan Inc.	17,936.6	0.0	(2.1)	(18.3)
Nielsen Holdings N.V.	10,341.0	(2.0)	4.3	15.3
HCA Holdings Inc.	9,702.3	(5.5)	(14.7)	(39.5)
Yandex N.V.	9,437.8	(2.5)	(5.2)	(24.8)
LinkedIn Corp.	7,619.0	(9.5)	(13.4)	(16.0)
Arcos Dorados Holdings Inc.	5,594.4	(1.0)	10.2	25.9
Kosmos Energy Ltd.	4,935.1	(9.1)	(3.1)	(30.5)
Dunkin' Brands Group Inc.	3,248.2	2.0	0.6	(3.0)
HomeAway Inc.	3,225.3	(2.3)	24.2	(0.4)
Renren Inc.	2,755.9	(8.0)	(7.7)	(61.0)

Data as of Sept. 7, 2011. Source: Capital IQ.

M&A

Since Google announced its proposed $12 billion purchase of Motorola Mobility on Aug. 15, there have been just three announced U.S. M&A deals of more than $1 billion. Although U.S. M&A volume has slowed in light of recent market activity, 2011's volume to date is closing in on full-year 2010's results. According to Capital IQ data, several industries--industrials, consumer discretionary, and consumer staples--have already made more deals this year than for all of last year. Meanwhile, average deal value, which takes into account transactions of all value ranges, is up 42.8% this year compared with full-year 2010 results (see table 11). Given that there is more than $1.1 trillion in cash and short-term investments on the balance sheets of nonfinancial S&P 500 firms, along with current low interest rates, we believe companies have ample financial means to fund forthcoming deals.

Table 11

U.S. M&A

	1/1/2011-9/7/2011	**1/1/2010-12/31/2010**	**Change (%)**
Number of transactions by sector			
Energy	527	638	(17.4)
Materials	463	508	(8.9)
Industrials	1,321	1,305	1.2
Consumer discretionary	1,508	1,470	2.6
Consumer staples	288	281	2.5
Health care	855	947	(9.7)

Table 11

U.S. M&A (cont.)			
Financials	2,436	2,755	(11.6)
Information technology	1,317	1,415	(6.9)
Telecommunication services	70	82	(14.6)
Utilities	140	154	(9.1)
No primary industry assigned	553	445	24.3
Valuation summary			
Total deal value (mil. $)	784,469.94	796,743.70	(1.5)
Average deal value	211.11	147.85	42.8
Average TEV/Revenue	3.38	6.1	(44.6)
Average TEV/EBITDA	15.08	15.96	(5.5)
Average day prior premium (%)	38.14	39.16	(2.6)
Average week prior premium (%)	42.64	45.95	(7.2)

Source: Capital IQ.

Debt

CUSIP activity seemed to avoid the summer doldrums, based on reports that several asset classes significantly increased orders last month. According to information provided by CUSIP Global Services (CGS), the number of identifier requests for domestic corporate debt securities totaled 1,002 in August, the best monthly total this year for domestic corporate issues. Furthermore, domestic corporate debt CUSIP requests have jumped 9.47% in the past four months, compared with the first four months of 2011.

Similarly, CUSIP requests for municipal securities snapped back in August, following a nearly 30% decline the previous month. August marked the third time in the past four months that monthly requests exceeded 1,000. According to CGS data, CUSIPs sought for municipal securities totaled 1,101, excluding notes and other securities. It is worth mentioning that municipal CUSIP requests during the past four month have climbed by 43.8% from the volume recorded in the first four months of the year. Still, for the year-to-date period, total municipal CUSIP orders have slipped about 18% from a year ago.

On the other hand, international debt CUSIP request activity continues to be slow, reflecting the ongoing financial uncertainties permeating European markets. Recent data from CGS indicates that international debt CUSIP volume slumped to 60, marking the fifth consecutive monthly decline in requests and the lowest point since April 2009. Despite this recent trend, year-over-year CUSIPs request for international debt securities is up by more than 28%. In general, the recent trend suggests a possible increase in fixed-income offerings.

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S&P Index Commodity Commentary: Commodities Fare Well Amid Turmoil

Recession Indication

The S&P GSCI began September under pressure, with a 0.4% decline as of Sept. 7 on the back of weakness in the equity market-the S&P 500 Index fell 1.6%, while the U.S. Dollar Index rose 1.8%. Reflecting increasing recession fears, the economically sensitive industrial metals industry added to 2011 declines, as measured by the 2.5% loss in the S&P GSCI Industrial Metals Index for a year-to-date decline of 6.8%. Precious metals remained the best performing S&P GSCI sector in 2011 but were little changed on the month, consolidating previous gains, as measured by the third-quarter increase of 20.6% in the S&P GSCI Precious Metals Index. Providing little relief for consumers, supply disruption issues supported energy prices in early September led by strength in gasoline prices. Agriculture lost the most in early September, as wheat prices declined on additional supply prospects, notably from Canada. Despite increasing global financial turmoil and volatility, commodities are generally expected to fare well, as emerging market demand remains intact and the diversification benefits of real physical assets continue to gain support.

Metals--Negative Implications

The S&P GSCI Industrial Metals Index ended Sept. 7 as the worst performing sector in 2011, and the S&P GSCI Precious Metals Index ended as the best. The economic implications of such a divergence in metal prices is clearly negative, as the industrial metals reflect global demand and economic activity and the precious metals better represent the desire for store of value assets and safety. Despite increasing volatility in gold as it explores new historic highs, unless there is a substantial shift in the underlying foundation of extremely low-base interest rates and increasing financial market volatility, we expect the quintessential non-income producing store of value assets to remain well supported.

Agriculture--Wheat Vs. Corn

Wheat and sugar have pressured the S&P GSCI Agriculture Index in early September. Increased harvest estimates from Canada led to a 5% decline on the month in early September and a year-to-date loss of 21% in the S&P GSCI Wheat Index. In 2011, the agriculture story has been notably about weakness in wheat and strength in corn, as measured by the year-to-date increase of 18.81% in the S&P GSCI Corn Index as of Sept. 7. Corn supplies remain historically low and prices have increased accordingly as harvest estimates have deteriorated, while wheat is better supplied compared with corn--the S&P GSCI Wheat Index declined 19.1% over the past 12 months and the S&P GSCI Corn Index gained 56.5%. Year to date, the S&P GSCI Agriculture Index ended Sept. 7 with a slight increase of 0.4% after recovering from steeper losses earlier in the year.

Energy--Hurricane Support, No Consumer Relief

The S&P GSCI Unleaded Gas Index ended Sept. 7 as the best performing single commodity energy index on a year-to-date and 12-month basis, with gains of 26% and 61%, respectively. More recently, hurricanes hitting the U.S mainland have supported this trend. There are few commodities that directly affect U.S. consumers more than unleaded gasoline, and the implications of such rapid price increases are very negative. Indicating potential recessionary behavior for the fourth straight month in June, Americans drove less than they did a year earlier. As of Sept. 7, the year-to-date S&P GSCI Energy Index was up 3.9%, and 22.6% on a 12-month basis. Rapidly increasing emerging market demand and supply disruptions, notably in the Middle East and North Africa, have driven the strength in energy prices in 2011. Since 2008, the price of crude oil and the S&P GSCI Energy Index have had a high correlation with the S&P 500 Index, but that correlation showed signs of dissipating in September.

Table 12

Total Return

Index	September through Sept. 7	Year to date	12 months	Three years	Five years	Since 1999
S&P GSCI	(0.40)	2.85	22.38	(36.43)	(20.36)	83.56
S&P GSCI enhanced	(0.35)	4.70	23.09	(22.37)	5.33	337.32
S&P GSCI three-month forward	(0.49)	4.97	23.39	(22.80)	8.43	355.97
S&P GSCI dynamic roll	(0.24)	6.46	19.32	(12.34)	35.80	508.13
S&P GSCI light energy	(1.14)	1.83	22.18	(17.66)	(1.87)	69.84

Table 12

Total Return (cont.)						
S&P GSCI covered call select	(0.79)	6.16	23.86	21.03	51.19	N.A.
S&P WCI	(0.43)	16.93	40.01	(16.87)	16.26	319.10
S&P SGMI	(1.19)	8.86	24.87	58.71	84.07	N.A.
S&P 500	(1.62)	(3.37)	12.01	3.17	3.03	1.07
U.S. Dollar Index	1.82	(4.51)	(8.88)	(4.39)	(11.77)	(25.92)
S&P/BG Cantor seven- to 10-year bond	1.29	13.25	9.55	29.97	55.49	138.83
Baltic Dry Index	7.72	(1.64)	(40.23)	(69.20)	(55.14)	32.22
U.S. two-year note yield and change	20.00	(39.70)	(28.00)	(217.50)	(458.40)	(601.40)

N.A.--Not available. Source: S&P Indices.

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6. the Singapore government;
7. a statutory body established under any Singapore act;
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