Fixed Income Commentary
February 5, 2010

Fixed Income Weekly

Please refer to Appendix – Important Disclosures.

Fixed Income Market Comments

Treasuries in the 1-5 portion of the yield curve rose this week while the longer end of the curve was down as turmoil in Europe as some nations struggle to narrow their budget deficit was offset by an employment report that raised concerns among fixed income traders that economic improvement will continue. Greek Prime Minister George Papandreou pledged this week to freeze state workers' pay, boost fuel taxes and raise the retirement age to reduce a deficit that is more than four times the European Union's limit. The premium investors demand to hold Greek 10-year notes instead of benchmark German bunds widened 13 bps to 366 bps. The crisis in Greece appears to have spilled over to Portugal and Spain. In Portugal, there are reports that the Prime Minister will resign after failing to obtain backing for a more austere budget. Parliament Minister Jorge Lacao admitted that the credibility of the Portuguese state is at risk. Spain is in the spotlight after Paul Krugman issued a statement naming it and not Greece as the worst trouble spot. EU Economics Commissioner Joaquin Almunia has lumped all three countries together as being in the same mess. The CDS on Greece, Portugal and Spain are all at record highs.

In Friday morning trading, the benchmark 10-year note yield was 3.57% while the 2-year note yield was 0.76%, creating a 2s/10s spread of 281 bps. The yield on the 30-year bond was 4.53%. The investment grade corporate bond spread was +173 bps over (yield of 4.50%) while the high yield spread was +643 bps over (yield of 9.02%). The municipal bond yield was 3.53% while the Build America Bonds (BABs) spread was +196 bps over (yield of 6.37%). Futures contracts on the Chicago Board of Trade show traders see a 16% chance the Fed will lift the target rate by June, from 55% a month ago.

The Federal Reserve would consider reopening its program to support the mortgage market if interest rates spiked or the economy showed new weakness, Federal Reserve Bank of New York President William C. Dudley said in two new interviews. The Fed is buying $1.25 trillion in mortgage-backed securities in its effort to prop up the economy but has said it will end those purchases March 31. In interviews with the Nightly Business Report and the Associated Press, Dudley said the time is right to end the program because the economy is growing and because expanding the purchases would make it harder for the Fed to unwind its support down the road. But he said the Fed might reconsider if rates rose sharply. "Obviously, if mortgage rates were to back up a lot and if that had a big consequence for the economy, then we very well could rethink the issue about whether we wanted to buy more mortgages," Dudley told the Nightly Business Report. He made a similar comment in the AP interview. The Fed said after its policymaking meeting last week that it "will continue to evaluate its purchases of securities in light of the evolving economic outlook and conditions in financial markets."

January Employment Report

The unemployment rate in the U.S. unexpectedly declined in January to 9.7%, the lowest level since August, while payrolls dropped as company's boosted worker hours and overtime instead of taking on new hires. Payrolls fell 20,000 last month, reflecting a plunge in construction employment and a drop in state and local government hiring, figures from the Labor Department in Washington showed today. The factory workweek and overtime hours both increased. Payrolls were forecast to increase by 15,000, according to the median estimate of 85 economists surveyed by Bloomberg News. Estimates ranged from a decrease of 100,000 to a gain of 100,000. The jobless rate fell from 10% in December. It was projected to hold there. Forecasts ranged from 9.8% to 10.3%. Employment declined a revised 150,000 in December and increased 64,000 a month earlier. The revisions subtracted 5,000 from payroll figures previously reported for those two months. The underemployment rate -- which includes part- time workers who'd prefer a full-time position and people who want work but have given up looking -- fell to 16.5% from 17.3%.

B. Craig Elder
Senior Vice President
celder@rwbaird.com
414.765.3768

Ronald R. Freisleben, CPA
First Vice President
rfreisleben@rwbaird.com
414.298.7637

Government payrolls decreased by 8,000 in January. State and local governments reduced employment by 41,000 during the month, while the federal government added 33,000. The increase at the federal level reflected in part the hiring of temporary workers to conduct the 2010 census. The Labor Department today also issued the annual benchmark update showing the economy lost 930,000 more jobs than previously estimated in the 12 months ended March 2009.

With this report, the Labor Department for the first time issued data on earnings and hours for all workers. Before today, the figures reflected changes in earnings and hours for production staff. The average work week for all workers rose to 33.9 hours in January from 33.8 hours the prior month. The increase signals companies making more part-time workers full-time employees. The number of part-time workers for economic reasons dropped to 8.3 million in January from 9.2 million the previous month. Average weekly earnings increased to $761.06 from $757.46.

Factory payrolls increased 11,000 in January, the biggest gain since April 2006, after falling 23,000 in the prior month. The median forecast by economists called for a drop of 20,000. Payrolls at builders fell 75,000 last month after decreasing 32,000. Financial firms reduced payrolls by 16,000, after a 7,000 decline the prior month. Service industries, which include banks, insurance companies, restaurants and retailers, added 40,000 workers after subtracting 96,000 in December. The number of temporary workers increased 52,000 in January. Payrolls at temporary-help agencies often turn up before total employment because companies prefer to see a steady increase in demand before taking on permanent staff. Retail payrolls increased by 42,000 after an 18,000 decline.

U.S. Treasury Will Auction $81 Billion

The U.S. plans to sell $81 billion in its quarterly sales of long-term debt next week, saying there’s no need for more increases in auction sizes to finance the country’s budget deficit. The Treasury Department said it will auction $40 billion in three-year notes on Tuesday, $25 billion in 10-year notes the following day and$16 billion in 30-year bonds on Thursday. Next week’s auctions of bonds and notes will raise $32.7 billion in new cash, with the rest of the proceeds going to pay off maturing debt, according to the Treasury.

This quarter’s total long-term debt sales matched the record $81 billion in notes and bonds sold at the last refunding in November. “Treasury now believes that the current auction calendar provides debt managers with sufficient flexibility to address a range of expected borrowing needs,” said Matthew Rutherford, the Treasury’s deputy assistant secretary for federal finance, according to minutes of an advisory committee meeting yesterday.

The Treasury also said it is considering more frequent auctions of Treasury Inflation-Protected Securities (TIPS) to improve liquidity in this market. One possible addition is a second reopening of 10-year TIPS notes, which would start in July if implemented, the Treasury said. “Treasury will continue to consider other changes to the TIPS calendar in the coming year,” the department said. Any changes to the calendar would be announced in May as part of that quarter’s refunding discussions.

The Treasury said it expects to run up against the debt ceiling, which currently stands at $12.4 trillion, by late February. The Treasury said the department would keep Congress and the markets apprised of debt-limit developments because “the government’s cash flows are volatile.” The Treasury said it “retains the flexibility” to increase its Supplemental Financing Program, which borrows on behalf of the Federal Reserve, if needed. Since September, the department has reduced the program to $5 billion outstanding from $200 billion to make it easier to stay below the debt limit.

Earlier this week, the Treasury cut its estimate for government borrowing in the current quarter by 18% largely because of extra cash received from banks repaying government aid. Borrowing will total a net $392 billion from January through March, compared with a previous estimate of $478 billion, and it projects borrowing of $268 billion in the three months to June 30, the department said in a February 1 statement. Also, to help manage short-term borrowing needs, the Treasury said it plans to sell cash-management bills in the current quarter, possibly including “longer dated” securities.

The Treasury is financing a budget deficit that the White House this week said would reach a record $1.6 trillion this year. Bond dealers expect the government will run a deficit about $200 billion less than the White House projects, according to estimates provided to the Treasury and released this week.

Administration Will Recommend Making BABs Program Permanent

The Obama administration will recommend making permanent the Build America Bonds program in its fiscal 2011 budget proposal Monday, a Treasury spokesperson said Friday night. The plan would reduce the subsidy from 35% to 28% beginning January 1, 2011, but would greatly expand the program's reach to include refundings, working capital, as well as permitting nonprofit hospitals and universities to issue the debt. The lower subsidy is intended to make the program's cost equivalent to the cost to the federal government of traditional tax-exempt bonds. Under current law, the program is slated to expire at the end of the year.

Total BAB issuance from April 15, 2009, through January 28, is $70.983 billion, across 878 issues, according to data from Thomson Reuters. In January alone, issuers sold $6.862 billion of BABs across 87 issues.

The Joint Tax Committee, in a report on the stimulus law, last year estimated that BABs would result in lost revenue of $4.3 billion through 2019. On Tuesday, the Congressional Budget Office said that the popularity of the BAB program is expected to cost $26 billion more over the next 10 years than originally predicted.

High Yield Issuance Outlook from Moody's

High yield companies face "huge uncertainties" as they try to refinance more than $800 billion of borrowings in the next five years, according to Moody's. More than $700 billion of the debt that will need to be refunded in the speculative-grade market is maturing between 2012 and 2014.

The leveraged-loan market's ability to refinance high-risk, high-yield debt coming due was impaired after the collapse of Lehman Brothers, when banks started to restrict lending to improve their capital positions. About $171 billion in leveraged loans were arranged in 2009, down 42% from the previous year, according to data compiled by Bloomberg. Moody's indicated that while certain conditions have eased over the past year, refunding risk still faces huge uncertainties over the next five years. The sheer volume of debt due to mature in 2010-2014 will continue to raise concerns about the market's ability to absorb this wave.

Investors in collateralized loan obligations exited the leveraged loan market in 2008 and 2009, further restricting the issuance of new deals, the analysts said. Institutional investors, including CLO investors, made up 5% of the leveraged loan market in the fourth quarter of 2008, down from 67% in the first quarter of 2007. By the fourth quarter of 2009, 28% of the market was made up by institutional investors.

Companies plan to sell notes in the high-yield bond market to refinance outstanding loans. In 2009, a record $162.1 billion of high-yield bonds were issued, up from $64.3 billion in 2008, according to data compiled by Bloomberg. When comparing the 10-year average issuance rate of speculative-grade securities to 2014's peak refunding needs of $338 billion, it seems possible that the market can absorb the upcoming maturities -- as long as the U.S. economy as well as the high-yield bond and leveraged-loan markets continues to recover.

Fitch U.S. High Yield Default Rate 13.7% in 2009

The U.S. high yield default rate, according to data from Fitch, ended 2009 at 13.7%. In a report released by Fitch this week, the U.S. high yield default rate ended 2009 at 13.7% on $118.6 billion in defaults, and the year's weighted average recovery rate was 34.1% of par for a dollar loss on the year's bond defaults of $78 billion. Recovery rates fluctuated dramatically over the course of the year and showed substantial variability by credit and sector.

In the first half of 2009 the weighted average recovery rate was just 21.8% of par with a median of 17.4%. In the second half the weighted average recovery rate nearly tripled to 59% and the median rose to 42%. The distribution of recoveries overall was strongly skewed with 29% of the year's defaulted bonds experiencing recovery rates of 0% to 10% of par and another 28% experiencing recoveries of 11% to 30% of par.

Sectors facing systemic industry problems experienced grim recoveries. The weighted average recovery rate on broadcasting and media defaults was just 11.8% of par. Automotive defaults registered a similarly bleak weighted average recovery rate of 15.3% of par.

Issuers in Fitch's U.S. High Yield Default Index with outstanding loans at the time of default experienced an average loan recovery rate of 59.6% in 2009 with a median of 65.5%. The distribution of loan recovery rates in 2009 was worse than any other period since at least 2000 with just 43% of loans in Fitch's sample experiencing recoveries of 70% of par or higher. The weighted average recovery rate on the year's secured bonds was also low at just 36.8% of par, with a median of 25.4%. This is noteworthy given that a record 42% ($65 billion) of high yield bonds sold in 2009 consisted of secured bonds.

Recovery rates in 2009 were particularly weak on secured loans and bonds with levels across both categories dipping below prior recessions. This provides important insight into the consequences of changing underwriting standards and evolving capital structures on credit risk. Funding trends prevalent in the years leading up the credit crisis had an adverse effect on recovery outcomes in 2009.

On a mark-to-market basis, high yield bond defaults in 2009 did not cause significant incremental losses. The weighted average trading price of the year's defaulted bonds was already down to 35.9% at the start of the year before falling to 34.1% shortly after default. (Fitch's measure of recovery is the price of the defaulted instruments 30 days after default.)

The fear factor ran so deep in late 2008 that the market essentially priced in all of the year's defaults. However, the powerful high yield rally of 2009 may bring its own challenges as defaults going forward will occur from higher price points.

Fitch's forecast is for a high yield default rate of 6%-7% in 2010. The combination of easy monetary policy, a far improved economic outlook and a return to more normal funding conditions has had the desired effect of helping to stem corporate credit deterioration and the pace of the defaults. However, Fitch believes significant risks linger including: persistently high system-wide leverage, the potential for numerous economic pitfalls going forward including weak consumer spending and high energy costs, record volumes of leveraged loans and bonds coming due over the next few years, and the seasoning of weaker deals brought to market from 2005 through 2007.

In 2009 a total of 151 issuers defaulted on their high yield bond obligations, up from 63 in 2008 and just 15 in 2007. The default rate swung from an all time low of 0.5% in 2007, to 6.8% in 2008, to 13.7% in 2009. In dollar terms 2009 defaults were concentrated in the following sectors: banking and finance ($26.7 billion); broadcasting and media ($13.9 billion); automotive ($13.5 billion); cable ($12.6 billion); and gaming, lodging and restaurants ($10.2 billion).

Ratings Agency Credit Comments

S&P Raises Ratings on Midwestern School Districts

S&P yesterday said it has raised the ratings on 24 school districts in Illinois, Michigan, and Ohio, and also affirmed the ratings on two districts in Michigan and one in Ohio. At the same time, S&P revised the outlook on two of the 27 districts to stable from negative. The upgrades follow their review of school districts across the Midwest, particularly in light of criteria published in 2008 reflecting their view of smaller or more remote communities. In all cases, the outlook is stable. "The upgrade follows our view of the potential economic impact on the districts as a result of the local, state, and national economy," said Standard & Poor's credit analyst Jane Ridley.

We believe this is particularly important for school districts that receive a portion of their funding from per pupil revenues distributed by the state. Most states are struggling to maintain balanced operations in the face of an economic slowdown. However, regardless of each state's financial situation, S&P has communicated with each of the districts in this article regarding potential revenue fluctuations--both statewide and local—and S&P believes these districts should be able to maintain a stable financial position commensurate with their new rating level.

The upgraded issuers are Kankakee County Community Unit School District No. 1 (Momence) and Sangamon County Community Unit School District No. 5 (Ball Chatam) (Illinois); Comstock Park Public Schools, Coopersville Area Public Schools, Elkton-Pigeon-Bay Port Laker Public Schools, Fenton Area Public Schools, Fruitport Community Schools, Genesee School District, Gobles Public Schools, Holt Public Schools, Kent City Community Schools, Lakeview Public Schools, Linden Community School District, Melvindale-Northern Allen Park School District, Mount Pleasant Public Schools, Newaygo Public Schools, Reese Public Schools, Saline Area Schools, and Saranac Community Schools

(Michigan); Chillicothe City School District, Jackson-Milton Local School District, Ontario Local School District, Plain Local School District (Stark County), and Upper Arlington City School District (Ohio).

The affirmed issuers are Plymouth-Canton Community School and Whitmore Lake Public School District in Michigan, and Anthony Wayne Local School District in Ohio. The outlooks on two of these affirmed districts, Plymouth-Canton and Whitmore Lake, were also revised to stable from negative.

Berkshire Hathaway Lowered by S&P
On Thursday, S&P lowered its long-term counterparty credit rating on Berkshire Hathaway Inc. (BRK) to 'AA+' from 'AAA'. They also lowered their financial strength ratings on BRK's core insurance operations to 'AA+' from 'AAA'. At the same time, they removed the ratings from CreditWatch, where they were placed with negative implications on November 4, 2009. The outlook is stable.

S&P indicated that they took the actions in anticipation of BRK's acquisition of Burlington Northern Santa Fe Corp. (BNSF), which they expect to close no later than February 15. The transaction is BRK's largest acquisition to date. BRK already owned more than 22% of the stock of BNSF. BRK will finance the acquisition of the remaining shares for about $26 billion with a combination of 60% cash and 40% through the issuance of new BRK shares. The cash portion of about $16 billion will come from cash on hand and new debt issuance of approximately $8 billion. Standard & Poor's expects that a significant part of the internal cash will come from BRK's core insurance operations, as has been the case in other transactions.

The rating actions are based on S&P’s view that Berkshire's overall capital adequacy, as well as that of its insurance operations, has weakened to levels no longer consistent with a 'AAA' rating and is not expected to return to extremely strong levels in the near term. Furthermore, they expect that the consolidated liquidity position of BRK will be reduced from extremely strong historical levels as a result of the acquisition. As capital adequacy and liquidity levels have declined, investment risk remains very high in S&P’s view, compounding the need for extremely strong capital and liquidity given potential investment volatility. A key concern is that BRK's risk tolerances appear to have increased, yet we believe they remain ill defined while the organization increases in complexity. Generally, S&P believes Berkshire has a high risk tolerance for capital volatility and investment risk. They do not believe that the company's overall risk management framework has evolved at the same pace as the organization's complexity and that enterprise risk management practices remain in silos within each investment.

Fitch and S&P Ratings Action on MetLife
Fitch downgrades ratings of MetLife and Subs; Outlook Stable
Fitch Ratings downgraded by one notch the long-term ratings assigned to MetLife and its subsidiaries. The Rating Outlook is Stable. Yesterday’s rating action follows an updated, periodic review of MetLife, and reflects Fitch's concerns regarding the cumulative impact of adverse financial markets and the economic downturn over the past year on MetLife's capital, earnings, and liquidity. The rating action also reflects Fitch's macro concerns regarding the fragile nature of the economic recovery and continued deterioration in the commercial real estate market, which could result in higher-than-expected investment losses for MetLife. MetLife's operating earnings performance has materially weakened over the past two years due to market-related impacts, which have resulted in lower-than-expected investment income and increased reserving. Fitch projects GAAP EBIT to interest coverage ratio in the 5 times range for full year 2009, which is below rating expectations. While Fitch expects earnings to show improvement in 2010, results will be sensitive to future economic developments and financial market results.

S&P Places MetLife on CreditWatch with Negative Implications
S&P yesterday said that it placed its ratings on MetLife and subsidiaries, including the 'A-' long-term counterparty credit rating on MetLife, on CreditWatch with negative implications. "The CreditWatch placement reflects MetLife's announcement that it is in discussions with AIG about acquiring one of AIG's subsidiaries, American Life Insurance Co. (ALICO), an international life insurance company," according to S&P. No agreement has been reached, and there are no assurances that an agreement will be reached. S&P placed their ratings on MetLife on CreditWatch negative because of the sheer size of ALICO and to reflect their view that the potential acquisition could have a material adverse impact on MetLife's financial metrics, such as capitalization and fixed-charge coverage, as well integration risks.

Kraft Ratings Lowered by S&P

Earlier this week, S&P lowered its corporate credit rating on Kraft Foods Inc. to 'BBB' from 'A-'. They removed all ratings on the company from CreditWatch, where they were placed on Sept. 8, 2009, with negative implications, following Kraft's unsolicited proposal to acquire Cadbury. In addition, S&P affirmed its 'BBB' corporate credit rating and 'A-2' short-term and commercial paper (CP) ratings on U.K.-based branded confectionery manufacturer Cadbury PLC. The ratings were removed from CreditWatch with developing implications, where they were originally placed on Sept. 8, 2009, following Kraft's unsolicited proposal to acquire Cadbury. The outlook on Kraft and Cadbury is positive. They revised the CreditWatch listing on Cadbury's senior unsecured notes to CreditWatch with negative implications, from developing, meaning they could affirm or lower the ratings following their review. S&P presently does not have sufficient information to conduct their notching analysis related to structural subordination for Cadbury issue-level ratings. They will revisit our analysis based on where assets, liabilities, and cash flow reside within the final legal organizational structure.

Kraft's downgrade reflects S&P’s expectation for the likely completion of its acquisition of Cadbury for £11.9 billion (about $19.5 billion), with 60% cash and 40% equity components. They believe the substantial incremental debt that would be added to Kraft's balance sheet to fund the proposed transaction will weaken key credit metrics below their prior expectations at the current rating level. Under the current proposal, they estimate that Kraft's lease- and pension-adjusted total debt to EBITDA would be about 4.5x on a pro forma basis (including $675 million of expected synergies and excluding one-time implementation costs). This is compared with adjusted leverage of about 3.5x for the 12 months ended September 30, 2009, and their previous expectations that leverage would range between 3.0x and 3.5x in fiscal 2009. They expect Kraft to improve credit measures over the next few years through debt repayment and cash flow growth. Over the near to intermediate term, S&P also expects the company to forego share repurchases, maintain its current dividend, and restrict acquisitions to small, tuck-in opportunities financed with free cash flow.

Kraft has acquired control of Cadbury, and has received the approval of about 71.73% of Cadbury shareholders. Kraft has made its offer for Cadbury unconditional, and the offer will remain open until further notice and at least 14 days' notice will be given if Kraft decides to close the final offer. The ratings on Kraft reflect the company's position as one of the world's largest food and beverage companies, with a strong brand portfolio and international diversification. These strengths are partially offset by the company's past share repurchase and acquisition activity which has led to higher debt levels.

On a pro forma basis including Cadbury, S&P estimates Kraft will have about $50 billion in annual global net revenues. The company's leading position in packaged food products, with well-known brands (such as Kraft, Oscar Mayer meats, Philadelphia cream cheese, Maxwell House coffee, Nabisco cookies and crackers, Jacobs coffee, Milk chocolates, and LU biscuits) supports its excellent business profile. In addition, Cadbury significantly enhances Kraft's position in the confectionery market. The combined company would house over 40 confectionery brands each with revenue over $100 million following the Cadbury acquisition. Ratings benefit from the company's broad portfolio and geographic diversity, despite sizable commodity exposure in Kraft's product line. It is S&P’s opinion that the addition of Cadbury expands Kraft's access to higher-growth developing markets (such as India), which would account for about 25% of combined sales, compared with 20% currently. On January 5, 2010, Kraft announced that it will sell the assets of its North American pizza business to Nestle S.A. for $3.7 billion in cash. Kraft will use an amount equivalent to the full net proceeds from the sale to fund a partial cash alternative as part of its offer for Cadbury. The pizza business generated $1.6 billion of revenue, and about $300 million of EBITDA (based on Nestlé’s estimates) in 2009.

Kraft has been implementing a four-point strategy that was announced in February 2007 to restore consistent growth to operating performance. This three-year plan includes bolstering management effectiveness, enhancing portfolio relevance, exploiting sales capabilities to leverage scale, and reducing costs without compromising quality. Kraft's margins are currently below its peers, and more recently, the company has outlined a program to improve operating margins to the mid-teens in 2011. S&P believes margin expansion should occur through initiatives in procurement, manufacturing, customer service and logistics. Kraft also expects to realize $200 million of savings in 2009 from its 5-year restructuring that was completed in 2008, and continue with other smaller cost saving initiatives. S&P believes these efforts have helped improve the product portfolio and create a more focused company. In addition, Kraft expects to realize annual cost synergies of at least $675 million with Cadbury, by the end of the third year.

Kraft's next maturities include $500 million of notes due Aug. 11, 2010, and $2 billion of notes that mature in November 2011. As of September 30, 2009, Kraft had about $311 million of guarantees, of which $281 million related to its own performance. During the first nine months of 2009, Kraft contributed $225 million to its U.S. pension plans and $124 million to its non-U.S. pension plans. S&P expects fiscal 2009 capital expenditures to be consistent with the $1.4 billion spent in fiscal 2008, including restructuring and system investments.

The outlook is positive. S&P expects Kraft to continue generating strong cash flow despite a competitive operating environment and improve credit measures over the intermediate term. Although unlikely in the near term, they could consider an upgrade if Kraft can successfully integrate Cadbury, maintain a more prudent financial policy following the acquisition, and improve credit measures, including leverage sustained close to 3x. A downgrade could result if Kraft continues to implement a more aggressive financial policy, and/or operating performance declines, thereby significantly weakening credit measures.

Fixed Income Sector Allocation Comments

We have an Underweight allocation to the Treasury sector as we believe that yields are too low to place money in the sector. We would rather place money in the agency sector, Marketweight, as we believed these two sectors are joined at the hip as there is no credit risk or default risk in GSE debt at the present time.

MBS spreads remain exceptionally tight as the result of the Federal Reserve's Asset Purchase program instituted last year. However, we believe these spreads should soon begin to trend wider as the Fed's asset purchase program reaches an end on March 31, unless the Fed reopens the program as discussed above. We remain Underweight on MBS at this time.

We have an Overweight allocation to municipal bonds as they remain attractive on an after-tax basis when compared against the taxable sectors. While the financial situation of municipalities has deteriorated relative to corporations in the past year, we feel that risks remain relatively remote in either sector in 2010. The short-end of the municipal bond curve is unattractive relative to the long-end of the curve as the municipal-to-treasury ratio remains above 90% on the long-end of the curve. We believe that the BABs sector offers value as spreads on BABs are presently about 25 bps higher than investment grade corporate bond spreads.

We have a Marketweight allocation to investment grade corporate bonds and preferred securities as spreads at +171 over the comparable Treasury while in from the historically wide spreads during the credit crisis remain attractive. Financial issuers continue to offer the best value in the corporate bond market. We would favor the insurance and banking sectors, and senior debt of the systemically important banks, in particular.

While high yield credit spreads have been in our Marketweight target range of +500-+1,000 bps over, our concern about rising default rates resulted in our Underweight allocation to the sector. With the peak of the defaults likely reached for this cycle, we are raising our allocation to Marketweight. We believe that default rates will likely fall this year and recovery rates on defaulted issues will also slowly improve. Fitch projection is for the default rate to decline to the 6.0%-7.0% range while the BCA believes that it could fall to the 5.0% level. In addition, recovery rates could rise to the 50% area late this year. We will likely lower our allocation if indications are that the default rate isn't declining as expected or if high yield spreads contract to below the +500 bps level.

Fixed Income Commentary

February 5, 2010

Fixed Income Sector Allocation

Sector	Investment Stance	Remarks
Treasuries	Underweight	Demand/Supply issues still a concern
Cash/CDs	Marketweight	Safety for the risk averse investor
Spread Product		
Agencies	Marketweight	Spreads narrowing – still wide historically
MBS	Underweight	Spread gap from Treasury debt non-existent
Municipals	Overweight	Favor high-quality GO's & essential service
Corporates/Preferreds	Marketweight	Spreads and yields have tightened considerably
High Yield	**Marketweight**	**Default rates should fall**

Fixed Income Sector Spreads

Sector	1/3/01	1/2/02	1/2/03	1/2/04	1/3/05	1/6/06	1/2/07	1/2/08	1/2/09	1/4/10	1/28/10	2/4/10
Agencies	89*	n/a	36*	28*	41	36	25	47	103	34	35	36
Mortgages	94	71	37	31	26	52	37	87	147	17	16	14
Corporates	199	170	182	94	80	91	88	198	555	170	171	173
BABs****	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	201	196	196
High Yield	865	716	829	381	284	356	277	569	1,641	612	631	643

Fixed Income Sector Yields

Sector	1/3/01	1/2/02	1/2/03	1/2/04	1/3/05	1/6/06	1/2/07	1/2/08	1/2/09	1/4/10	1/28/10	2/4/10
Treasuries	5.13%	4.52%	3.19%	3.36%	3.75%	4.40%	4.77%	3.59%	1.72%	2.46%	2.22%	2.20%
Agencies	6.61%*	n/a	4.89%*	5.03%*	3.85%	4.77%	5.09%	4.15%	2.52%	2.27%	2.07%	2.06%
Mortgages	6.67%	6.41%	4.91%	5.02%	4.92%	5.46%	5.61%	5.36%	3.96%	4.14%	3.92%	3.83%
Municipals	4.71%	4.49%	3.73%	3.61%	3.63%	3.93%	3.94%	4.00%	4.52%	3.63%	3.60%	3.53%
Municipals*	7.25%	6.91%	5.74%	5.55%	5.59%	6.05%	6.06%	6.15%	6.95%	5.59%	5.54%	5.43%
Municipals***	7.80%	7.44%	6.18%	5.96%	6.01%	6.51%	6.52%	6.62%	7.48%	6.01%	5.96%	5.84%
BABs****	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	6.59%	6.41%	6.37%
Corporates	7.16%	6.49%	5.25%	6.01%	4.69%	5.33%	5.65%	5.79%	7.67%	4.73%	4.52%	4.50%
High Yield	14.40%	12.48%	12.08%	7.37%	6.74%	8.21%	7.70%	9.64%	19.40%	9.00%	8.96%	9.02%

*Fannie Mae Only
** Based on 35* Federal Income Tax Bracket
***Based on hypothetical 39.6% Federal Income Tax Bracket
****Build America Bonds (Taxable Municipal Bonds)

Sources:
Bank Credit Analyst: Portfolio Allocation Summary. February 3, 2010.
Barclays Capital Indices.
Bloomberg News.
The Bond Buyer: Obama Wants BABs Made Permanent. February 1, 2010.

Economic Calendar

DATE	TIME	INDICATOR	CONSENSUS	PREV. REPORT
02/09	10:00	Wholesale Inventories	0.5%	1.5%
02/10	08:30	Trade Balance	-$35.5B	-$36.4B
02/10	--	Monthly Budget Statement	-$70.0B	-$63.5B
02.11	08:30	Advance Retail Sales	0.3%	-0.3%
02/11	08:30	Retail Sales Less Autos	0.4%	-0.2%
02/11	08:30	Initial Jobless Claims	456K	480K
02/11	10:00	Business Inventories	0.4%	0.4%
02/12	09:55	U. of Michigan Confidence	74.8	74.4

Sources: Bloomberg

Fixed Income Commentary
February 5, 2010

Financing Calendar

DATE	TERM	APPROX. YIELD	AMOUNT
02/08	3-Month	0.10%	$23bln
02/08	6-Month	0.17%	$26bln

Sources: Bloomberg

Bond Rating Changes

Upgrades	Rating Type	Agency	Current Rating	Last Rating
BNSF Railway Co	LT Local Issuer Credit	S&P	BBB+	BBB *+
Burlington Northern Santa Fe Corp	LT Local Issuer Credit	S&P	BBB+	BBB *+
Encore Acquisition Co	LT Local Issuer Credit	S&P	BB	BB- *+
Hexion Specialty Chemicals Inc	LT Local Issuer Credit	S&P	B-	CCC+ *+
Avis Budget Car Rental LLC	LT Local Issuer Credit	S&P	B+	B-
Avis Budget Car Rental LLC/Avis Budgt Fin	LT Local Issuer Credit	S&P	B+	B-
Avis Budget Group Inc	LT Local Issuer Credit	S&P	B+	B-
Stallion Oilfield Services Ltd	LT Local Issuer Credit	S&P	CCC+	D
United Site Services Inc	LT Local Issuer Credit	S&P	NR	SD
ITC Deltacom Inc	LT Local Issuer Credit	S&P	B	B-
TTM Technologies Inc	LT Local Issuer Credit	S&P	BB-	BB- *-
Valassis Communications Inc	LT Local Issuer Credit	S&P	B+ *+	B+
Dex Media East LLC	LT Local Issuer Credit	S&P	B	D
Dex Media Inc	LT Local Issuer Credit	S&P	B	D
Dex Media Inc/Old	LT Local Issuer Credit	S&P	B	D
Dex Media West LLC	LT Local Issuer Credit	S&P	B	D
Lubrizol Corp	LT Local Issuer Credit	S&P	BBB+	BBB *+
Media General Inc	LT Local Issuer Credit	S&P	B	NR
Quality Home Brands Holdings LLC	LT Local Issuer Credit	S&P	CCC+	NR
RH Donnelley Corp	LT Local Issuer Credit	S&P	B	D
RH Donnelley Inc	LT Local Issuer Credit	S&P	B	D
Sonic Automotive Inc	LT Local Issuer Credit	S&P	B+	CCC+ *+
Sun Microsystems Inc	LT Local Issuer Credit	S&P	A	BB+ *+

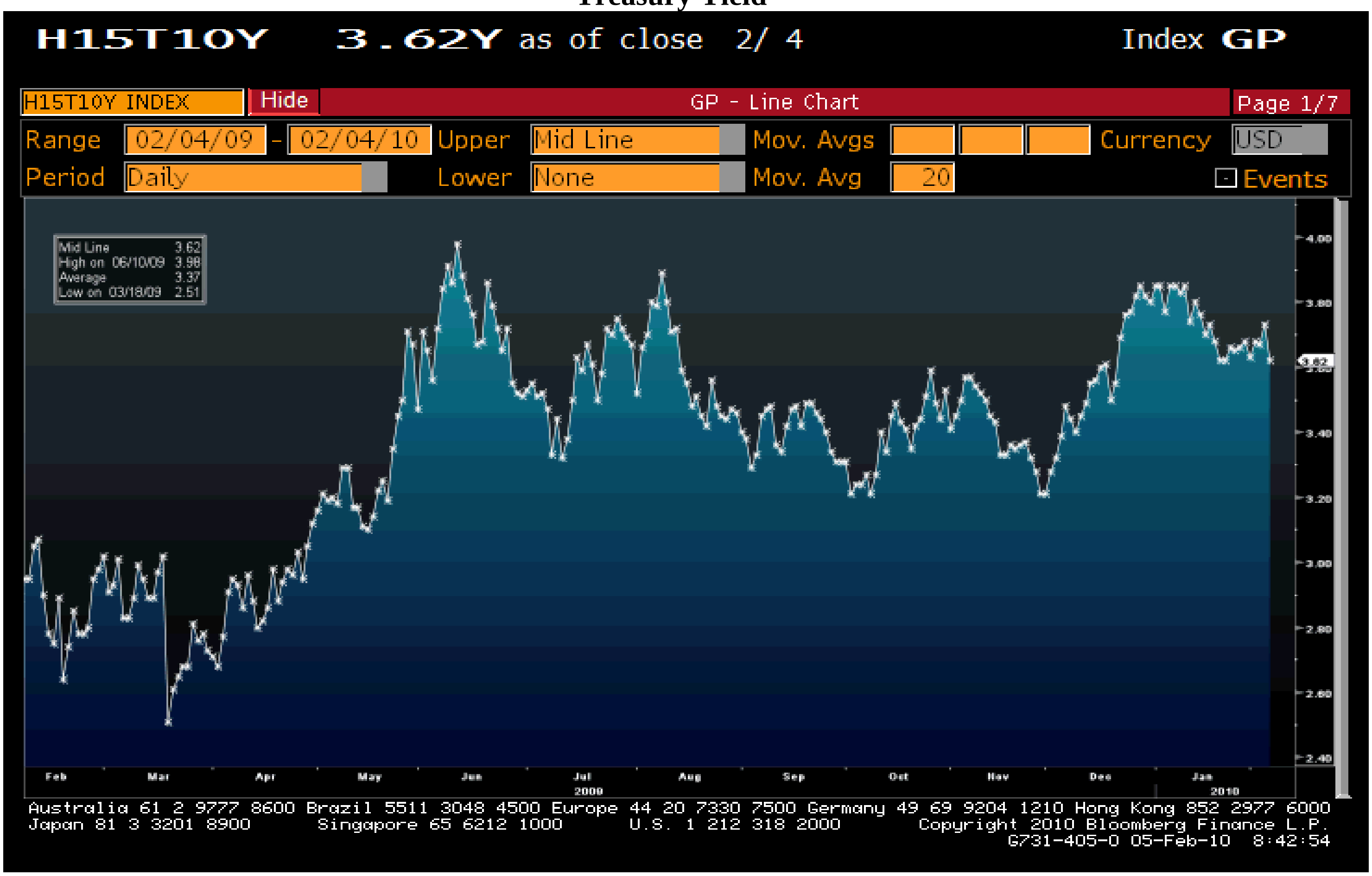
Downgrades	Rating Type	Agency	Current Rating	Last Rating
Berkshire Hathaway Inc	LT Local Issuer Credit	S&P	AA+	AAA *-
Berkshire Hathaway Life Ins Co of NE	LT Local Issuer Credit	S&P	AA+	AAA *-
Central States Indemnity Co of Omaha	LT Local Issuer Credit	S&P	AA+	AAA *-
Columbia Insurance Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Cornhusker Casualty Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Fairfield Insurance Co	LT Local Issuer Credit	S&P	AA+	AAA *-
GEICO Casualty Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Geico Corp	LT Local Issuer Credit	S&P	AA+	AAA *-
Geico General Insurance Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Geico Indemnity Co	LT Local Issuer Credit	S&P	AA+	AAA *-
General RE Corp	LT Local Issuer Credit	S&P	AA+	AAA *-
General Reinsurance Corp	LT Local Issuer Credit	S&P	AA+	AAA *-

General Star Indemnity Co	LT Local Issuer Credit	S&P	AA+	AAA *-
General Star National Insurance Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Genesis Indemnity Insurance Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Genesis Insurance Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Government Employees Insurance Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Kansas Bankers Surety Co/The	LT Local Issuer Credit	S&P	AA+	AAA *-
Lehman Brothers Derivative Products Inc	LT Local Issuer Credit	S&P	NR	CC *-
Lehman Brothers Financial Products Inc	LT Local Issuer Credit	S&P	NR	CC *-
Medical Protective Co/The	LT Local Issuer Credit	S&P	AA+	AAA *-
National Indemnity Co	LT Local Issuer Credit	S&P	AA+	AAA *-
National Indemnity Co of Mid-America	LT Local Issuer Credit	S&P	AA+	AAA *-
National Indemnity Co of the South	LT Local Issuer Credit	S&P	AA+	AAA *-
National RE Corp	LT Local Issuer Credit	S&P	AA+	AAA *-
Wesco-Financial Insurance Co	LT Local Issuer Credit	S&P	AA+	AAA *-
Windstream Corp	LT Local Issuer Credit	S&P	BB-	BB *-
Windstream Georgia Communications Corp	LT Local Issuer Credit	S&P	BB-	BB *-
Windstream Holding of the Midwest Inc	LT Local Issuer Credit	S&P	BB-	BB *-
American Central Insurance Co	LT Local Issuer Credit	S&P	A *-	A
American Employers' Insurance Co	LT Local Issuer Credit	S&P	A *-	A
Atlantic Specialty Insurance Co	LT Local Issuer Credit	S&P	A *-	A
AutoOne Select Insurance Co	LT Local Issuer Credit	S&P	A *-	A
Camden Fire Insurance Association/The	LT Local Issuer Credit	S&P	A *-	A
Employers Fire Insurance Co	LT Local Issuer Credit	S&P	A *-	A
Farmers and Merchants Insurance Co	LT Local Issuer Credit	S&P	A *-	A
First Metlife Investors Insurance Co	LT Local Issuer Credit	S&P	AA- *-	AA-
General American Life Insurance Co	LT Local Issuer Credit	S&P	AA- *-	AA-
Massachusetts Homeland Insurance Co	LT Local Issuer Credit	S&P	A *-	A
MetLife Inc	LT Local Issuer Credit	S&P	A- *-	A-
Metlife Insurance Co of Connecticut	LT Local Issuer Credit	S&P	AA- *-	AA-
Metlife Investors Insurance Co	LT Local Issuer Credit	S&P	AA- *-	AA-
Metlife Investors USA Insurance Co	LT Local Issuer Credit	S&P	AA- *-	AA-
Metropolitan Life Insurance Co	LT Local Issuer Credit	S&P	AA- *-	AA-
Midwestern Insurance Co	LT Local Issuer Credit	S&P	A *-	A
New England Life Insurance Co	LT Local Issuer Credit	S&P	AA- *-	AA-
Northern Assurance Co of America	LT Local Issuer Credit	S&P	A *-	A
OneBeacon America Insurance Co	LT Local Issuer Credit	S&P	A *-	A
OneBeacon Insurance Co	LT Local Issuer Credit	S&P	A *-	A
OneBeacon Insurance Group Ltd	LT Local Issuer Credit	S&P	BBB *-	BBB
OneBeacon Lloyd's of Texas	LT Local Issuer Credit	S&P	A *-	A
OneBeacon Midwest Insurance Co	LT Local Issuer Credit	S&P	A *-	A
OneBeacon US Holdings Inc	LT Local Issuer Credit	S&P	BBB *-	BBB
Pennsylvania General Insurance Co	LT Local Issuer Credit	S&P	A *-	A
Traders & General Insurance	LT Local Issuer Credit	S&P	A *-	A
United Security Insurance Co	LT Local Issuer Credit	S&P	A *-	A
White Mountains Insurance Group Ltd	LT Local Issuer Credit	S&P	BBB *-	BBB
York Insurance Co of Maine	LT Local Issuer Credit	S&P	A *-	A

Kraft Foods Inc	LT Local Issuer Credit	S&P	BBB	A- *-
Altegrity Inc	LT Local Issuer Credit	S&P	B *-	B
Duke Realty Corp	LT Local Issuer Credit	S&P	BBB-	BBB
Duke Realty LP	LT Local Issuer Credit	S&P	BBB-	BBB
Simmons Co	LT Local Issuer Credit	S&P	NR	D
SunTrust Bank Holding Co	LT Local Issuer Credit	S&P	BBB	BBB+
SunTrust Bank/Atlanta GA	LT Local Issuer Credit	S&P	BBB+	A-
SunTrust Banks Inc	LT Local Issuer Credit	S&P	BBB	BBB+
Wilmington Trust Co	LT Local Issuer Credit	S&P	BBB-	BBB
Wilmington Trust Corp	LT Local Issuer Credit	S&P	BB+	BBB-
Banco Bilbao Vizcaya Argentaria Puerto Rico	LT Local Issuer Credit	S&P	BBB	BBB+
Citizens Bank/Flint MI	LT Local Issuer Credit	S&P	B+	BB+
Citizens Republic Bancorp Inc	LT Local Issuer Credit	S&P	B-	BB-
F&M Bank-Iowa	LT Local Issuer Credit	S&P	B+	BB+
Overseas Shipholding Group Inc	LT Local Issuer Credit	S&P	BB-	BB
Portland General Electric Co	LT Local Issuer Credit	S&P	BBB	BBB+
Sun Microsystems Inc	LT Local Issuer Credit	S&P	NR	A

Sources: Bloomberg

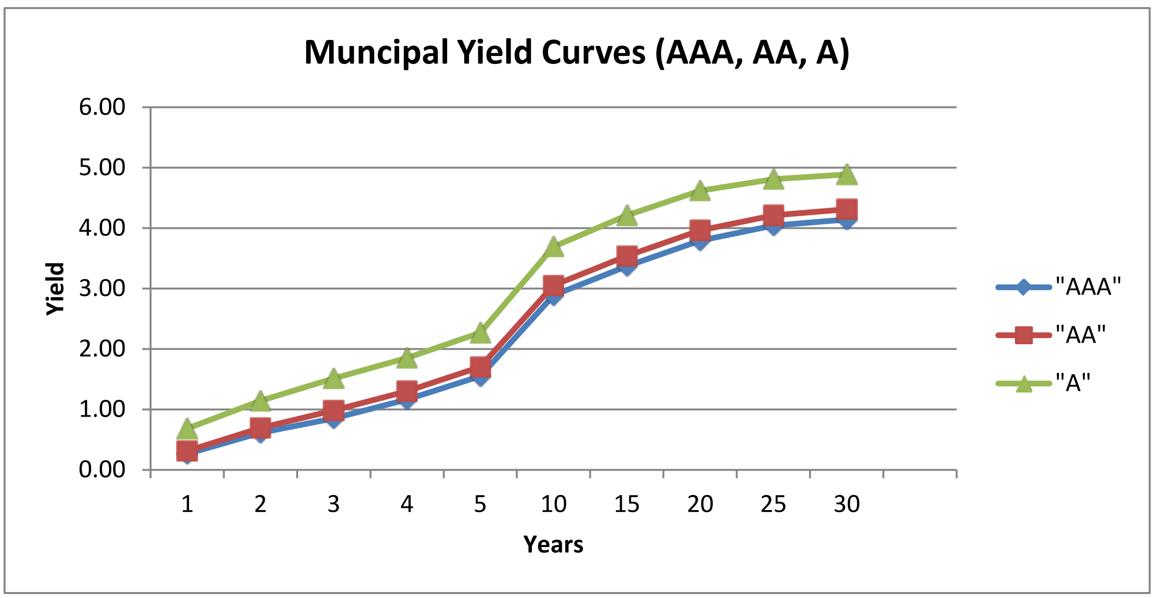
Treasury Yield



Sources: Bloomberg

Municipal Yield Curve

General Obligations - Yields as of 02/04/10							
Time (Yrs)	Year	"AAA"	Pre-re	Insured	"AA"	"A"	"BAA"
1	**2011**	0.26	0.26	0.50	0.31	0.68	1.94
2	**2012**	0.61	0.61	0.95	0.69	1.14	2.56
3	**2013**	0.85	0.85	1.32	0.98	1.51	2.87
4	**2014**	1.16	1.16	1.69	1.30	1.85	3.19
5	**2015**	1.55	1.55	2.13	1.70	2.27	3.59
10	**2020**	2.89		3.55	3.05	3.69	4.92
15	**2025**	3.37		4.01	3.54	4.21	5.27
20	**2030**	3.79		4.37	3.96	4.62	5.57
25	**2035**	4.04		4.60	4.21	4.81	5.74
30	**2040**	4.14		4.68	4.31	4.89	5.81



Please note that these levels are representative of institutional net levels, and do not reflect retail sales credit.
These yields should be used as general market indicators only.

Source: **Municipal Market Data**

SUMMARY OF KEY FIXED INCOME MARKET INFORMATION

WEEK ENDING : 2/5/2010

		TODAY	WEEK AGO	MONTH AGO	YEAR AGO
BOND BUYER REVENUE INDEX		4.96%	4.99%	4.96%	5.74%
BOND BUYER 20-BOND INDEX		4.36%	4.39%	4.31%	4.96%
BOND BUYER 11-BOND INDEX		4.08%	4.10%	4.03%	4.74%
REPRESENTATIVE MUNICIPAL BOND YIELDS					
(Source: Bloomberg)					
'AAA' RATED G.O.s	2 Year	0.58%	0.59%	0.61%	0.99%
	5 Year	1.62%	1.66%	1.68%	1.91%
	10 Year	3.21%	3.25%	3.29%	2.93%
	15 Year	3.84%	3.85%	3.86%	3.81%
	30 Year	4.46%	4.46%	4.47%	3.65%
PRIME RATE (Source: Bloomberg)		3.25%	3.25%	3.25%	3.25%
DISCOUNT RATE (Source: Bloomberg)		0.50%	0.50%	0.50%	0.50%
FEDERAL FDS AVG (Source: Bloomberg)		0.25%	0.25%	0.25%	0.25%
COMMERCIAL PAPER	30 Day	0.13%	0.12%	0.11%	0.35%
{PRIME ISSUERS}	60 Day	0.15%	0.13%	0.12%	0.55%
Bond Equivalent Yield	90 Day	0.17%	0.18%	0.16%	0.55%
(Source: Bloomberg)					
AGENCY DISCOUNT NOTES *	30 Day	0.09%	0.05%	0.03%	0.35%
Bond Equivalent Yield	60 Day	0.10%	0.09%	0.05%	0.32%
	90 Day	0.12%	0.11%	0.07%	0.37%
TAXABLE 7-DAY FLOATER		1.21%	1.16%	1.16%	2.15%
(Source: Robert W. Baird & Co.)					
TAX FREE 7-DAY FLOATER	Non-AMT	0.22%	0.27%	0.22%	0.48%
(Source: Robert W. Baird & Co.)	AMT	0.63%	0.68%	0.63%	1.06%
U.S. TREASURY BILLS	3 Month	0.08%	0.08%	0.04%	0.27%
Bond Equivalent Yield	6 Month	0.15%	0.15%	0.15%	0.41%
(Source: Bloomberg)					
GOVERNMENTS	2 Year	0.81%	0.92%	0.95%	0.96%
(Source: Bloomberg)	5 Year	2.31%	2.44%	2.55%	1.91%
	10 Year	3.63%	3.68%	3.81%	2.94%
	30 Year	4.57%	4.58%	4.70%	3.68%
CORPORATE 'A' FINANCE YIELDS					
(Source: Bloomberg)	2 Year	2.39%	2.53%	2.48%	6.97%
	5 Year	4.20%	4.36%	4.38%	7.62%
	10 Year	5.42%	5.51%	5.53%	8.37%
	30 Year	6.18%	6.23%	6.26%	8.96%
CORPORATE 'A' UTILITY YIELDS					
(Source: Bloomberg)	2 Year	1.68%	1.83%	1.91%	3.39%
	5 Year	3.30%	3.47%	3.60%	4.34%
	10 Year	4.94%	5.03%	5.16%	5.35%
	30 Year	5.74%	5.73%	5.86%	5.90%
CORPORATE 'A' INDUSTRIAL YIELDS					
(Source: Bloomberg)	2 Year	1.22%	1.34%	1.41%	2.88%
	5 Year	3.00%	3.15%	3.30%	3.99%
	10 Year	4.59%	4.63%	4.77%	5.02%
	30 Year	5.61%	5.62%	5.71%	5.98%
CDs	1 Year	0.35%	0.45%	0.50%	1.55%
(Source: Robert W. Baird & Co.)	2 Year	1.25%	1.35%	1.40%	2.30%
	5 Year	2.80%	2.80%	2.95%	3.50%
	10 Year	3.65%	3.75%	3.75%	4.00%

* Yields presented represent the prevailing market price as of 2/4/2010 and are not representative of a specific issue.

Analyst Certification

The senior research analyst(s) certifies that the views expressed in this research report and/or financial model accurately reflect such senior analyst's personal views about the subject securities or issuers and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

A complete listing of all companies covered by Baird U.S. Research and applicable research disclosures can be accessed at http://www.rwbaird.com/research-insights/research/coverage/research-disclosure.aspx. You can also call 1-800-792-2473 or write: Robert W. Baird & Co., Fixed Income Capital Markets, 25th Floor, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.

Disclaimers

This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. ADDITIONAL INFORMATION ON COMPANIES MENTIONED HEREIN IS AVAILABLE UPON REQUEST .

The Dow Jones Industrial Average, S&P 500, S&P 400 and Russell 2000 are unmanaged common stock indices used to measure and report performance of various sectors of the stock market; direct investment in indices is not available.

Baird is exempt from the requirement to hold an Australian financial services license. Baird is regulated by the United States Securities and Exchange Commission, FINRA, and various other self-regulatory organizations and those laws and regulations may differ from Australian laws. This report has been prepared in accordance with the laws and regulations governing United States broker-dealers and not Australian laws.

Other Disclosures

UK disclosure requirements for the purpose of distributing this research into the UK and other countries for which Robert W Baird Limited holds an ISD passport.

This report is for distribution into the United Kingdom only to persons who fall within Article 19 or Article 49(2) of the Financial Services and Markets Act 2000 (financial promotion) order 2001 being persons who are investment professionals and may not be distributed to private clients. Issued in the United Kingdom by Robert W Baird Limited, which has offices at Mint House 77 Mansell Street, London, E1 8AF, and is a company authorized and regulated by the Financial Services Authority. For the purposes of the Financial Services Authority requirements, this investment research report is classified as objective.

Robert W Baird Limited ("RWBL") is exempt from the requirement to hold an Australian financial services license. RWBL is regulated by the Financial Services Authority ("FSA") under UK laws and those laws may differ from Australian laws. This document has been prepared in accordance with FSA requirements and not Australian laws.