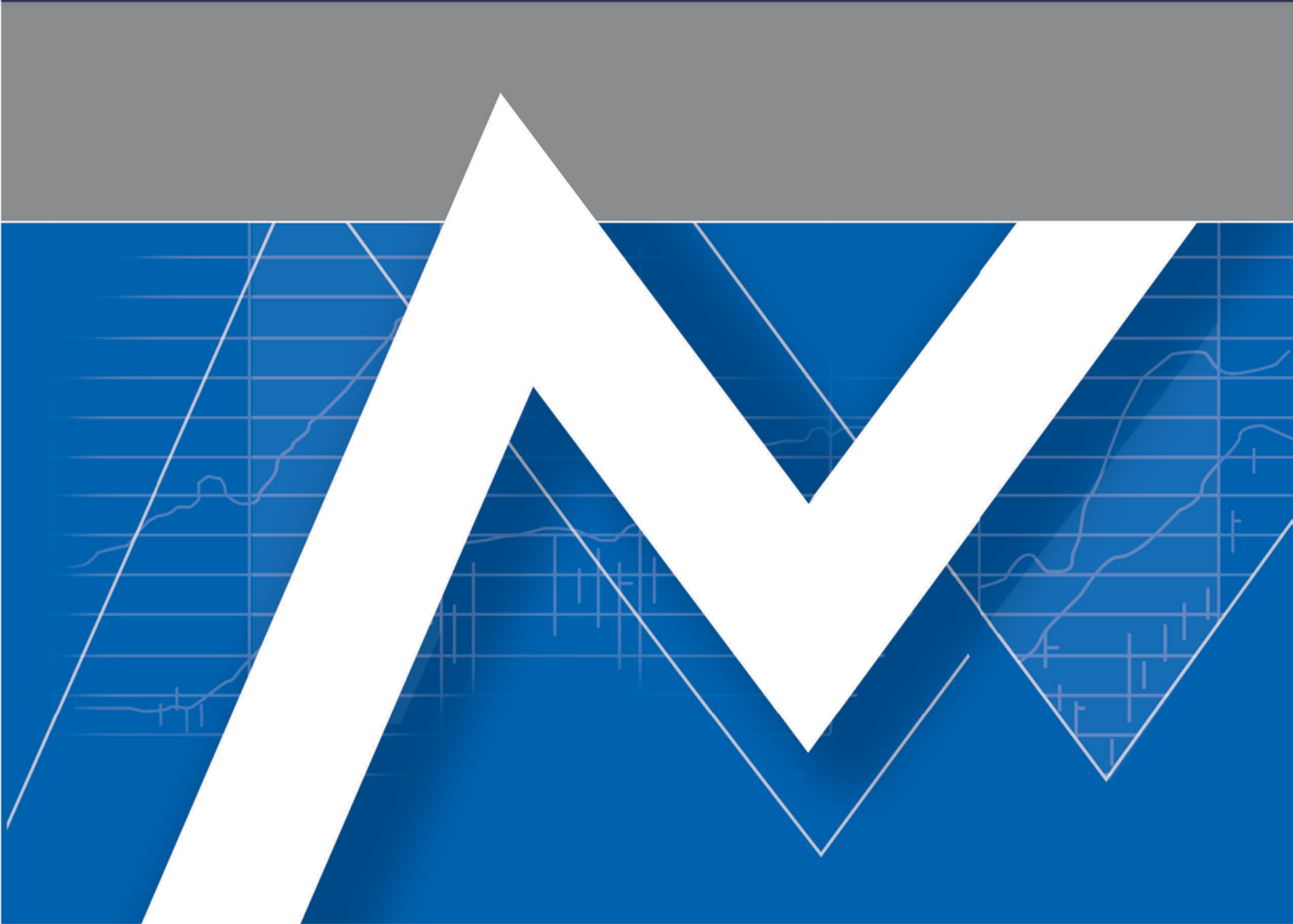
SIFMA®
Securities Industry and Financial Markets Association

RESEARCH REPORT

MAY 2008



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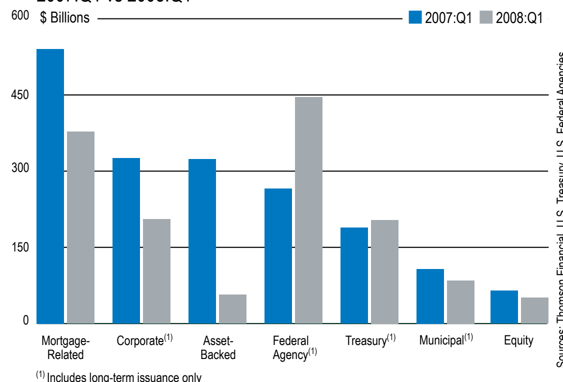
May 2008

Capital Market Issuance Reaches $1.43 Trillion, Tops Fourth Quarter But Short of a Year Ago

Securities issuance in the first quarter of 2008 reached $1.43 trillion, an increase from the $1.36 trillion issued in the fourth quarter of 2007, but substantially lower than the $1.81 trillion issued in the first quarter of 2007. The sharpest volume declines were in the most credit-risk-sensitive sectors. The turmoil in the private-label securitization markets virtually stalled non-agency MBS issuance and reduced other consumer ABS issuance as well. High-yield corporate bond issuance dropped to a historically low level, but investment-grade volume declined only modestly. The municipal market volume also declined in the first quarter as the market turmoil extended to tax-exempts. Equity underwriting activity also slipped as the indices fell to below year-end levels during the quarter. Treasury issuance increased in the quarter on a higher projected budget deficit. The shift toward government sponsored enterprise (GSE) or agency mortgage financing led to higher agency debt and mortgage-backed securities (MBS) issuance in the quarter.

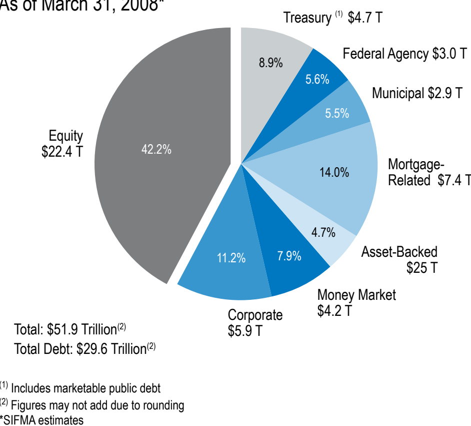
The credit market uncertainty continues to affect the outlook for all asset classes, and the credit market stresses have had implications globally. However, the effect of increased liquidity through the series of Federal Reserve and other central bank actions should help to moderate the resulting housing and credit crunch pressures in the second half of the year. Nevertheless, the prospect of an economic recovery must still be considered tenuous, as the outlook remains sensitive to consumer spending, which has been buffeted by the housing downturn, rising commodity prices and the employment situation. Although corporate bond credit spreads and default projections have risen, a rebound in corporate credit and indeed the equity markets should be quicker than in the consumer and housing sectors. Financial institution progress in the loss recognition and capital replenishment cycle is helping to drive increased stability in the market environment. As we entered the second quarter, the environment looked more promising based on lower volatility and a financial asset price rebound.

Issuance in the U.S. Capital Markets
2007:Q1 vs 2008:Q1



(1) Includes long-term issuance only

U.S. Capital Markets Outstanding
As of March 31, 2008*



(1) Includes marketable public debt
(2) Figures may not add due to rounding
*SIFMA estimates

Issuance Highlights

$ Billions	2007	2007:Q1	2008:Q1	% Change
Municipal	429.0	107.5	84.6	-21.1%
Treasury	752.3	188.5	203.8	8.1%
Federal Agency	941.8	265.4	445.5	67.9%
Mortgage-Related	2,050.1	540.4	377.5	-30.1%
Asset-Backed	901.2	323.2	56.3	-82.4%
Global CDO	503.0	186.5	11.7	-93.7%
Corporate	1,204.7	325.3	205.0	-37.0%
Equity	246.0	64.4	51.0	-20.8%

* Percent change between 2008:Q1 and 2007:Q1

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Municipal Volume Declines Amid Market Stress; Issuance Picks Up at Quarter-End

Short- and long-term municipal issuance totaled $89.2 billion in the first quarter of 2008, from the $114.0 billion issued in the same period of last year. Total first-quarter issuance declined 29.0 percent on a linked-quarter basis from the record-setting $125.7 billion issued in the fourth quarter of the record-setting 2007. The first-quarter decline was the result of rising municipal yields relative to yields on Treasury securities and credit market stress that extended to the tax-exempt market, among other factors. Market dislocations in the auction-rate securities (ARS) market and the turmoil in the bond insurance industry curtailed new deals as issuers looked to restructure debt in response to the turbulence and focused on converting existing ARS programs to other structures. Issuance picked up as issuers returned to the market during the quarter, with March recording the third highest monthly volume on record.

Long-term municipal issuance volume was $84.6 billion in the first quarter, below the record $107.5 billion issued in the same period last year, and the $104.7 billion issued in the fourth quarter of 2007. New short-term issuance was $4.6 billion, down from $6.5 billion in the first quarter of last year. The ratio of the 10-year AAA-rated general obligation municipal yield to that of Treasury securities of similar maturity increased steadily throughout the quarter, ending March at a historically high 111 percent, compared to 93 percent at the end of December. The increase reflects investor "flight to safety" amid the volatile credit market conditions. As of early May, the yields on 10-year municipal securities have risen to 3.86 percent, with the ratio to comparable maturity Treasuries standing at 98.6 percent. There are signs of improved price movements as investors are beginning to see the municipal sector as "cheap."

Issuers, Investors and Rating Agencies Adjust to Changing Market

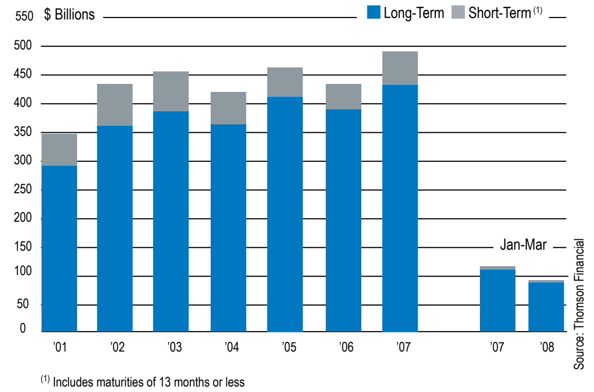
The use of third-party credit enhancement has slowed in recent months as monoline bond insurers' ratings have come under closer scrutiny with their falling capital levels. The ARS crisis has attracted the attention of investors, regulators and rating agencies. There has been increased interest in unified rating scales to harmonize municipal and corporate ratings. Underlying municipal credits have remained strong and the rate of default in the municipal market has been below one percent for the last 37 years, well below the rate seen in the corporate bond market. Credit default swaps provide municipal investors an additional risk management tool. In late April, Markit announced the formation of an index to track the growing municipal credit default swap market.

New Money Volume Maintains Pace; Drop in Refundings

New capital issuance totaled $52.1 billion, just 2.8 percent behind the $53.6 billion issued in the first quarter of last year. New capital volume nearly kept up with the record 2007 pace as many issuers sidelined by the monoline insurer situation early in the quarter finally brought their deals to market. Several use-of-proceeds sectors saw a modest decline from the first quarter of 2007, with education-related issuance totaling $11.9 billion, compared to $16.1 billion, and general government sector issuing $13.0 billion, compared to $15.2 billion in the same period last year.

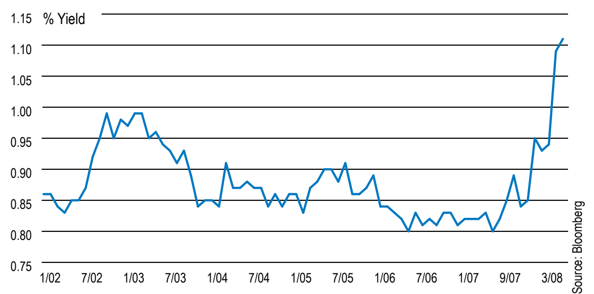
Refunding activity totaled $32.7 billion in the quarter, less than the $53.8 billion issued in the first quarter a year ago, when the volume exceeded expectations. Volume was down across most of the larger sectors. A notable exception was transportation, the largest issuing sector, which reached a $8.2 billion volume in the quarter, ahead of the $5.7 billion issued in the first quarter of 2007. Funding will remain constrained until municipal-to-Treasury yield ratios return to their long-term average of below 100 percent.

Short- and Long-Term Municipal Issuance
2001–2008:Q1

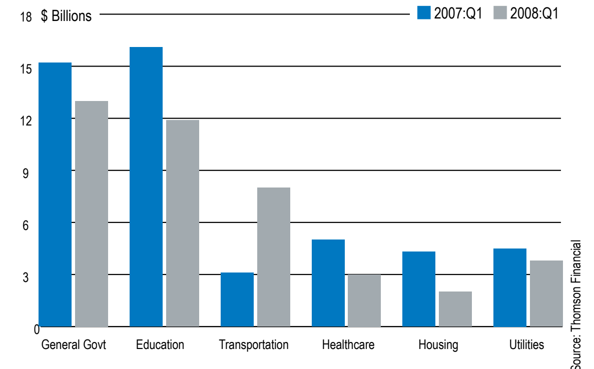


(1) Includes maturities of 13 months or less

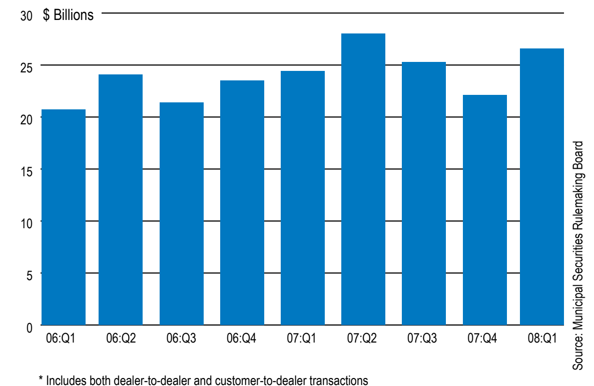
Municipal GO AAA and 10-Yr Treasury Ratio
Jan. 2002–Mar. 2008



Municipal New Capital: Use of Proceeds
2007:Q1 vs. 2008:Q1



Average Daily Trading Volume of Municipal Securities*
2006:Q1–2008:Q1



* Includes both dealer-to-dealer and customer-to-dealer transactions

Net Treasury Issuance Higher, Yield Curve Steepens as Fed Cuts Rates

Total net issuance of U.S. Treasury securities, including bills and coupons, was $190.9 billion in the first quarter of 2008, 51.7 percent higher than the $125.8 billion issued in the first quarter of 2007, a result of a rising budget deficit projection. Net coupon issuance was $36.4 billion in the first quarter, virtually unchanged from the $36.9 billion issued in the first quarter a year ago, but net bill issuance rose sharply to $154.5 billion in the first quarter, compared to $88.9 billion in the first quarter of 2007. Consistent with the results of SIFMA's recent Government Forecast, Treasury announced that total net pay down will be lower in the second quarter of 2008 compared to the second quarter a year ago. Treasury expects to paydown $35 billion of marketable debt in the second quarter of calendar year 2008, compared to $138.6 billion a year ago. Treasury generally pays down bills in the second quarter. The Congressional Budget Office projects a federal budget deficit of $219 billion for fiscal year (FY) 2008, compared to the $163 billion budget deficit in FY 2007. The higher deficit projection reflects a below-trend economic growth forecast as the economy works through the effects of the extended housing sector weakness and credit market displacement. Through the first half of the current fiscal year, the deficit was approximately $310 billion, compared to $264 billion through the first half of FY 2007. The U.S. Treasury introduced a 52-week bill in the second quarter to help reduce reliance on large cash management bills and provide for sufficient financing to absorb the government's additional borrowing requirements.

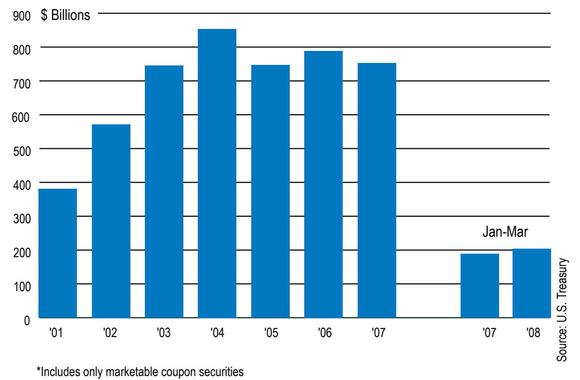
Gross coupon issuance volume increased 8.1 percent during the first quarter to $203.8 billion, up from $188.5 billion in the first quarter of last year. Gross bill issuance was $941.9 billion, modestly higher than the $863.5 billion issued in the first quarter of 2007. Gross issuance is affected by expected refunding of maturing and callable debt as well as Treasury's new cash needs. Total marketable Treasury debt outstanding reached $4.71 trillion as of March 31, 2008, a 4.3 percent increase from the end of the previous quarter. Daily trading volume of Treasury securities by primary dealers averaged $688.7 billion in the first quarter, compared to $546.0 billion during the same period a year ago.

In addition to the series of rate cuts, the Federal Reserve has acted to add liquidity to the credit markets through the formation of the Term Auction Facility (TAF), to channel funds to qualified banks needing assistance in meeting funding requirements, as well as the Treasury Security Lending Facility (TSLF) and Primary Dealer Credit Facility (PDCF), to provide funding to primary dealers in exchange for a specified range of collateral.

Treasury securities prices continued their rally as credit market dislocations and anticipated rate cuts drove the yield curve steeper. Yields across the maturity spectrum returned to historic lows as investors continue to seek the safety and quality of the Treasury market. The 2-year Treasury yield was 1.58 percent at quarter-end, compared to 3.05 percent at the end of 2007 and 4.57 percent at the end of March 2007. The 10-year Treasury yield followed a similar pattern, falling to 3.41 percent at the end of March 2008, down from 4.02 percent at the end of 2007 and 4.64 percent at the end of March 2007. The 2-year to 10-year yield spread widened from 98 basis points at the end of the year to 183 basis points at the end of March 2008. The Federal Market Open Market Committee (FOMC) cut the fed funds target benchmark to 2.00 percent on April 28. The accompanying FOMC statement that "the substantial easing of monetary policy to date should help to promote moderate growth," suggested that the FOMC may be ready for a pause after having reduced the target fed funds rate by 225 basis points since the beginning of 2008.

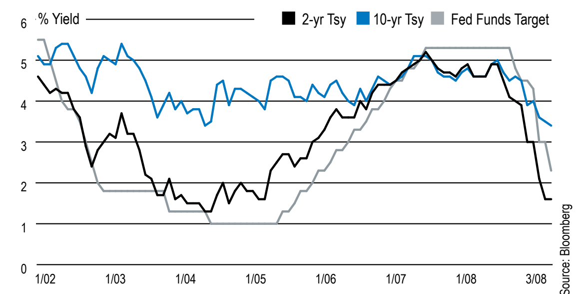
[1]The most recent SIFMA Government Forecast can be found at: http://www.sifma.org/research/pdf/GovForecast0408.pdf

Issuance of the U.S. Treasury Securities*
2001–2008:Q1

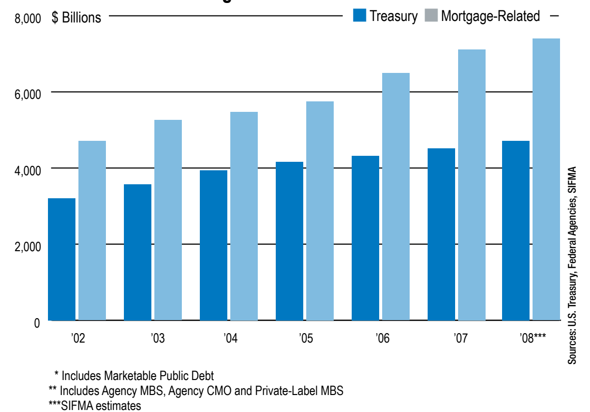


*Includes only marketable coupon securities

Treasury Yields and Fed Fund Rate
Jan. 2002–Mar. 2008

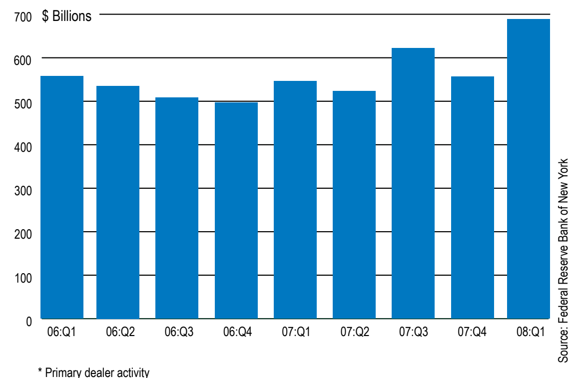


U.S. Treasury Securities Outstanding* vs. Mortgage-Related Securities Outstanding** 2002–2008:Q1



* Includes Marketable Public Debt
** Includes Agency MBS, Agency CMO and Private-Label MBS
***SIFMA estimates

Average Daily Trading Volume of Treasury Securities*
2006:Q1–2008:Q1



* Primary dealer activity

Agency Issuance Rises in Tight Credit Market Environment

Issuance surged at each of the five federal agencies in the first quarter of 2008, with long-term debt issuance totaling $445.5 billion, 67.9 percent higher than the $265.4 billion issued in the same period last year and nearly double the $257.5 billion issued in the fourth quarter. The linked-quarter and year-over-year volume growth is the result of increased conforming mortgage financing as the private-label market for mortgage-backed securities has stalled. Also influencing the GSE expansion is the increase of the mortgage interest rate spread between agency and non-agency mortgages and increased flexibility for Fannie Mae and Freddie Mac, such as the temporary increase through the end of year of the conforming loan size limits to $729,000.

The Federal Home Loan Bank System (FHLB) continues to be an important and lower-cost source of liquidity during the credit crisis for depository institutions. With increased demand for funding from member banks, FHLB issuance reached a robust $217.2 billion in the first quarter, on strong issuance during February. This 80.0 percent increase over the $120.7 billion issued in the first quarter of last year demonstrates the renewed reliance on the FHLBs as a source of liquidity and funding. Accounting for nearly half of total agency debt issuance, the agency is expected to continue its strong pace throughout the year until the credit markets fully recover.

Freddie Mac's debt issuance increased 30.0 percent to $93.6 billion in the first quarter of the year, compared to $72.0 billion in the same period of 2007. Issuance of debt by Fannie Mae increased to $93.0 billion, compared to $60.5 billion a year ago and $42.7 billion in the fourth quarter of 2007. Late in the first quarter, the Office of Federal Housing Enterprise Oversight (OFHEO) announced that it would reduce Freddie Mac's and Fannie Mae's capital surplus requirement from 30 percent to 20 percent. Long-term issuance by the Farm Credit System increased to $40.1 billion in the first quarter, following a strong $25.9 billion in the preceding quarter and well above the $12.1 billion issued in the first quarter of 2007. The Tennessee Valley Authority's issuance of long-term debt jumped to $1.57 billion in the first quarter, compared to $20.0 million in the same period of 2007.

SIFMA's recent Government Forecast[2] projects continued growth in federal agency debt issuance in the second quarter, reaching an expected $346.4 billion, compared to $234.1 billion issued in the second quarter a year ago. Subdued mortgage origination volume resulting from tightened credit underwriting standards and continued weakness in the housing market presents a downside risk to the projected issuance growth.

[2]The most recent SIFMA Government Forecast can be found at: http://www.sifma.org/research/pdf/GovForecast0408.pdf

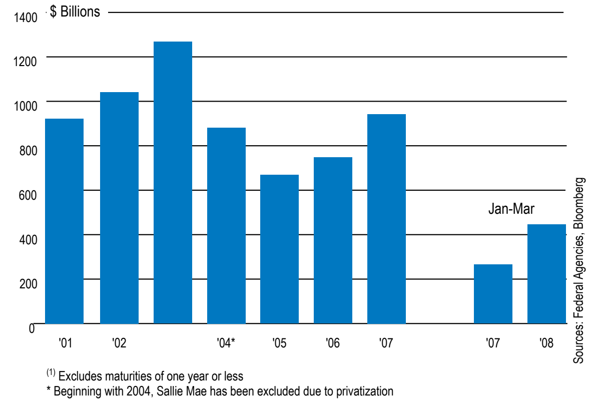
Long-Term Federal Agency Debt Issuance

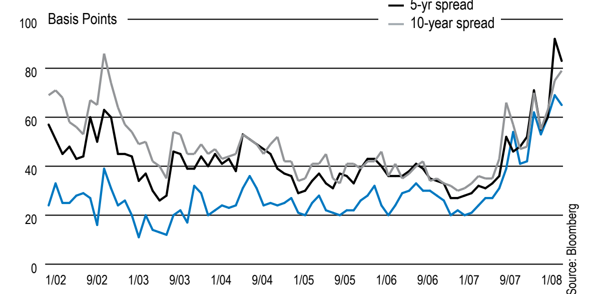
$ Billions	2007	2007:Q1	2008:Q1	% Change*	$ Change*
FHLB[1]	495.2	120.7	217.2	80.0%	96.5
Freddie Mac	191.1	72.0	93.6	30.0%	21.6
Fannie Mae	190.8	60.5	93.0	53.7%	32.5
FCS[2]	64.6	12.1	40.1	231.4%	28.0
TVA[3]	1.1	0.0	1.6	8193.51%	1.6
Totals	942.8	265.3	445.5	67.9%	180.2

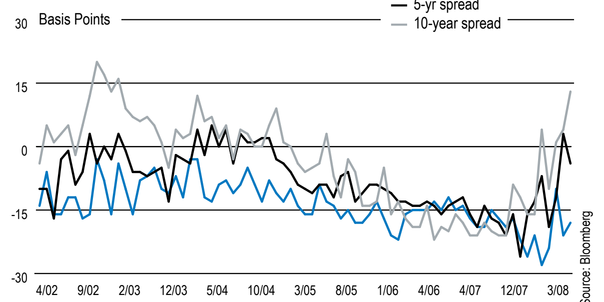
*Percent and amount change between 2007:Q1 and 2008:Q1

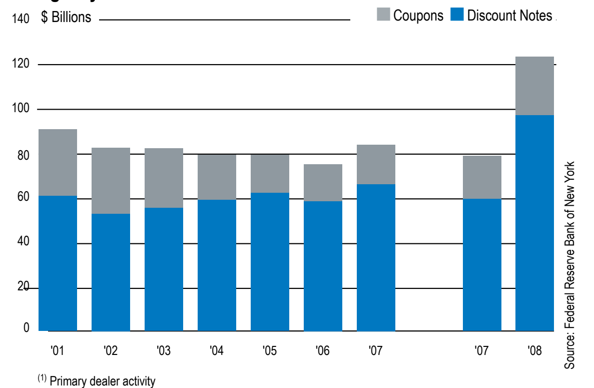
Source: Bloomberg and Federal Agencies

[1] Federal Home Loan Bank System
[2] Farm Credit System
[3] Tennessee Valley Authority









Agency MBS Issuance Picks Up as Private-Label Market Recedes

Issuance of mortgage-related securities, including agency and non-agency pass-throughs and collateralized mortgage obligations (CMO), totaled $377.5 billion in the first quarter of 2008, compared to $396.6 billion in the preceding quarter and $540.4 billion in the first quarter of last year.

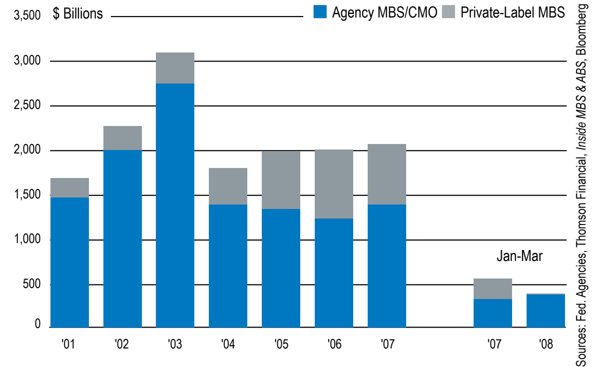
There are several widely publicized factors affecting the mortgage-related securities market and leading to the decline in new-issue volume. They include a deteriorated housing market, fewer mortgage originations, tighter underwriting standards, record delinquency and foreclosure levels, diminished market liquidity and turmoil in the global credit markets. The widely followed S&P Case-Schiller Home Price Index, for example, reports declining residential home values, with the index at 206.52 in its most recent reading (January 2008), a 10.7 percent decline from January 2007. The Federal Reserve's most recent Senior Loan Officer Opinion Survey in May reported tighter underwriting standards for both prime and subprime mortgages. The current interest rate environment does provide opportunities for qualified borrowers to refinance higher-rate and adjustable-rate mortgages, especially those mortgages that qualify as conforming loans.

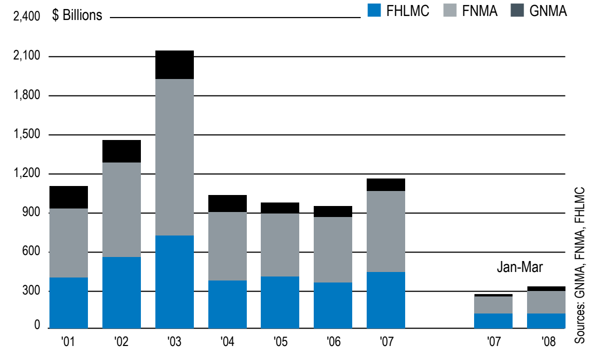
Agency Issuance Compensates for Private-Label Decline

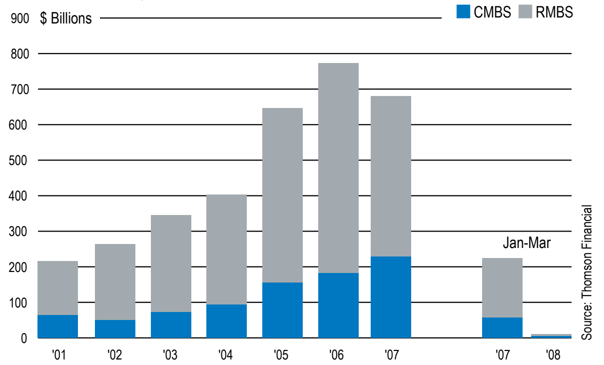
Issuance of agency mortgage-backed pass-throughs totaled $321.6 billion in the first quarter, an increase of 22.6 percent from the same period last year. Agency CMO issuance decreased to $45.5 billion in the first three months, a decline of 17.4 percent compared to the $55.1 billion issued a year earlier. The higher agency issuance levels reflect the interest rate spread between agency and non-agency securities of more than 125 basis points and the expanded capacity of the GSEs under the stimulus package. Agency issuance accounted for roughly 98 percent of total residential mortgage-related security issuance in the quarter.

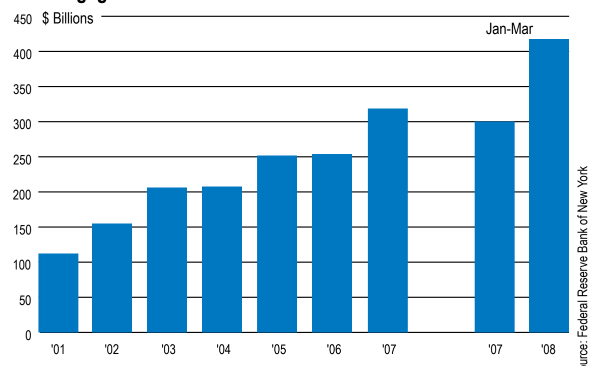
The private label market turmoil has engulfed higher quality as well as subprime product sectors. Private-label issuance includes both jumbo mortgages that exceed conforming loan size limits and higher credit-risk mortgages that do not meet underwriting guidelines. Non-agency residential mortgage-backed securities (RMBS) new issue volume decreased to $5.9 billion in the first quarter, a fraction of the $166.7 billion issued in the first quarter of last year. According to Inside MBS/ABS, subprime issuance fell to $2 billion in the first quarter, from $13.5 billion in the fourth quarter of 2007 and $93 billion in the first quarter a year ago.

Commercial mortgage-backed securities (CMBS) issuance totaled $4.5 billion in the first quarter, down 92.2 percent from the same period a year ago, and by 84.3 percent compared to the fourth quarter of 2007. The CMBS sector which had been thriving on a strong commercial real estate environment that benefitted from sustained economic growth and supportive credit markets in recent years, is showing signs of weakness, as economic growth and consumer spending have slowed, and financing conditions have tightened. However, delinquencies have ticked up only marginally and are not expected to deteriorate as in the residential market. The lower issuance is attributable to the sharp spread widening reflective of global market conditions during the quarter. Spreads did tighten to some extent late in the quarter following the Federal Reserve actions to open up the markets. The projected prolonged economic slowdown and instability in the credit markets constrain the CMBS outlook. Fitch, however, recently estimated that 88 percent of floating-rate CMBS deals are exercising the option to extend their financing period based on the expectation that credit market conditions will become more stable over the next year.









(1) Primary dealer activity

Total ABS Issuance Drops on Reduced Liquidity, Credit Concerns; Home Equity ABS Issuance Much Lower but Credit Cards Pick Up

Asset-backed securities (ABS) issuance declined by 39.8 percent to $57.5 billion in the first quarter, a sharp drop from the historically low fourth-quarter 2007 volume of $94.7 billion. First-quarter issuance was also 82.0 percent lower than in the first quarter a year ago. The reduced volume is largely attributable to conditions in the subprime mortgage and home equity loan (HEL) sectors. As with spread products generally, ABS credit spreads have widened across ABS product sectors, beginning in the second half of 2007 and continuing through the first quarter of 2008. UBS reported recently that the unusually wide spreads on non-mortgage-related consumer ABS have been driven more by sharply diminished liquidity than collateral performance trends. The underlying collateral performance has deteriorated severely in mortgage-related sectors and, to a lesser degree, in below-prime consumer ABS. Although there has been some weakening in virtually all consumer credit sectors, credit quality has been relatively stable in non-mortgage consumer prime auto and credit card products. Consumers' financial strength is a justifiable concern, given the anticipated slower economic and employment growth, housing weakness, higher energy and food prices, and elevated consumer debt levels. In addition, the Federal Reserve's Senior Loan Officer Survey is reporting tighter underwriting standards for consumer loans. Taking into account all of these factors, ABS issuance volumes are expected to remain subdued for the balance of 2008.

Leading ABS Sectors

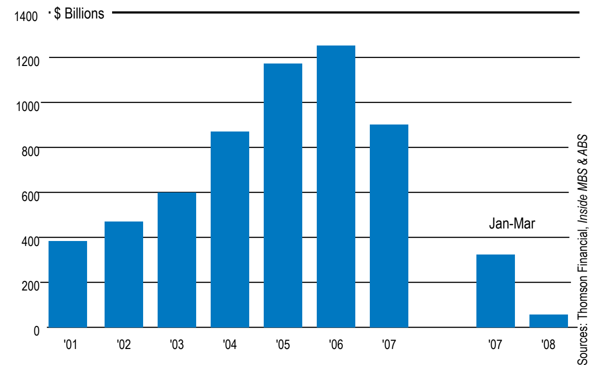
Credit card ABS was the largest issuing ABS sector for the third consecutive quarter at $28.1 billion in the first quarter. Credit card issuance increased by 14.4 percent on a linked-quarter basis and by 10.4 percent compared to the first quarter a year ago. Credit card ABS issuance will be affected by the recent uptick in delinquencies and anticipated slower employment and income growth. As declining home prices reduce mortgage equity withdrawals (MEW), consumers have substituted credit card for mortgage-related borrowing. Revolving consumer credit (credit card) borrowing growth has exceeded total consumer credit growth for each of the last 6 quarters, based on the most recent Federal Reserve data.

Auto loan ABS first-quarter issuance was $9.3 billion, a 49.7 percent decline from the fourth quarter and 36.8 percent lower than the first quarter of 2007. Auto loan issuance is being adversely affected by rising subprime auto loan delinquencies and a continued slide in auto sales.

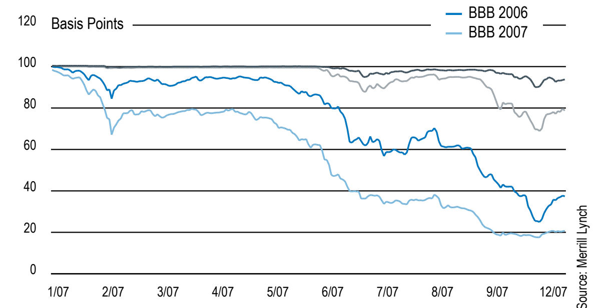
Student loan ABS issuance fell to $8.2 billion, or by 33.8 percent, from fourth quarter 2007, when $12.4 billion was issued. Student loan ABS issuance was also 69.4 percent lower than in the first quarter a year ago, when $26.7 billion was issued. Student loan issuance is also being adversely affected by reduced liquidity in student ABS market. Current conditions have led some issuers to evaluate whether to remain or exit the market.

The HEL ABS and mortgage ABS primary markets were virtually closed in the first quarter. HEL issuance volume was only $2.0 billion, a drop of 89.8 percent from the fourth quarter. As a stark point of comparison, issuance in the first quarter of 2007 was $100.9 billion. Similarly, mortgage ABS, including non-jumbo transactions comprising first-lien mortgage loans with weighted average FICO credit scores of less than 674 and subprime mortgages was virtually closed, with only $0.1 billion volume in the first quarter, or 81.6 percent less than the slow fourth quarter, only $0.6 billion issued. Low issuance volumes will continue in the lower credit quality non-agency mortgage-related sectors.

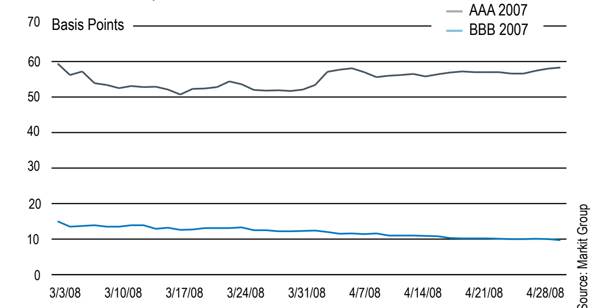
Issuance of Asset-Backed Securities
2001–2008:Q1



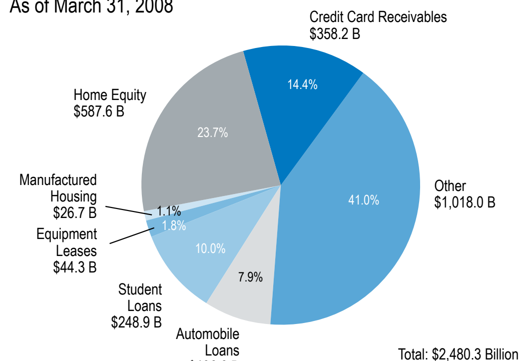
ABX.HE Credit Spreads
Jan. 2007–Dec. 2007



ABX.HE Credit Spreads
Mar. 2008–Apr. 2008



ABS Outstanding by Major Types of Credit*
As of March 31, 2008



*Percentages may not add due to rounding.

Global CDO Issuance Drops on Weak Liquidity, Subprime Deterioration

Global Collateralized Debt Obligation (CDO) issuance fell in the first quarter on greatly diminished liquidity, de-leveraging, subprime mortgage deterioration and valuation uncertainties. Following weak volumes in the fourth quarter and second half of 2007, global funded CDO volume fell to $11.7 billion in the first quarter of 2008, compared to $47.5 billion in the fourth quarter of 2007 and $186.5 billion in the first quarter of a year ago. Cash flow and hybrid CDO volume was $10.67 billion in the first quarter, compared to $31.26 billion in the fourth quarter and down 92.4 percent from the same period from a year ago. The synthetic funded CDO primary market was virtually closed, with only $0.2 billion issued in first-quarter 2008 compared to $5.2 billion in the fourth quarter of 2007. Market value CDO volume similarly and dramatically declined to $0.9 billion in the first quarter of 2008 from $11.0 billion in the fourth quarter of 2007. Based on CDO purpose segmentation, arbitrage CDOs represented 89.4 percent of global volume for first quarter of 2008, despite declining by 73.6 percent from the fourth quarter and by 93.3 percent from the first quarter a year ago, when $156.8 billion was issued.

Collateral and Currency Sectors

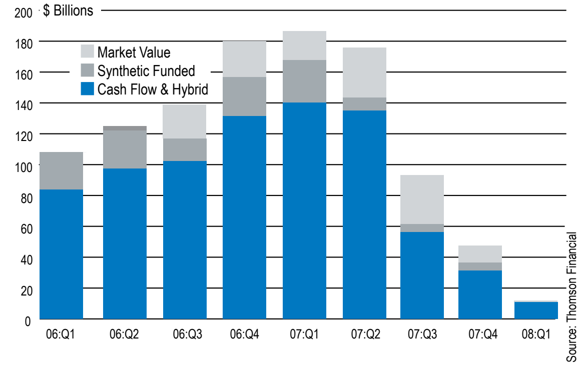
Although the structured finance (SF) collateral group encompasses a wide range of collateral types, the group is dominated by mortgage-related (largely subprime) and home equity collateral. Credit quality deterioration, diminished liquidity and weak housing market trends brought SF CDO issuance to a virtual halt. SF CDO volume fell to $4.7 billion in the first quarter, compared to $23.5 billion in the fourth quarter, and $101.0 billion in the first quarter a year ago. CDOs backed by high-yield loans, or collateralized loan obligations (CLO), were the highest collateral sector for the second consecutive quarter despite a 56.8 percent linked-quarter decline to $5.8 billion in the first quarter. While there has been an uptick in defaults in 2008 from the historically low default rate in 2007, the collateral performance outlook for CLOs will undoubtedly remain superior to that of SF CDOs. For that reason, and the fact that CDO structures are generally simpler than those of SF CDOs, CLO volumes are more likely to recover in the near term than SF CDOs.

The dollar-denominated segment of CDO issuance accounted for 58.4 percent of global issuance in the first quarter of 2008 despite a 77.7 percent decline in first-quarter 2007 to $6.8 billion. Euro-denominated CDO volume ranked second at $3.6 billion, down 73.9 percent from fourth-quarter 2007. The 2008 euro-denominated volume of $3.57 billion was much lower than in the first quarter of 2007, when $47.5 billion was issued.

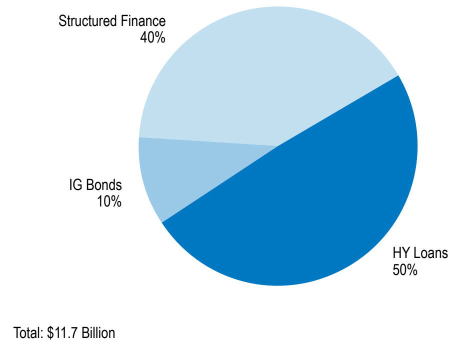
Counting the Carnage: Downgrades Continue to Accelerate

CDO rating downgrades dominate the landscape, of which most were of the ABS or SF CDOs. As of April 15 year-to-date, there were 1,041 ($382 billion) CDO downgrades, compared to 29 ($2.3 billion) upgrades, with the majority of the downgrades linked to structured finance collateral, according to Deutsche Bank. There were 578 AAA-rated rating downgrades ($287 billion) and 627 ($301 billion) on rating-watch negative through April 15. Furthermore, S&P downgraded 47 CDO classes to "D" from five SF CDO transactions. S&P, indicating that there would probably be insufficient funds to cover required termination payments to the CDS counterparty. Separately, the rating agency's downward adjustment of subprime RMBS recovery assumptions at the end of April will, in turn, lower SF CDO ratings.

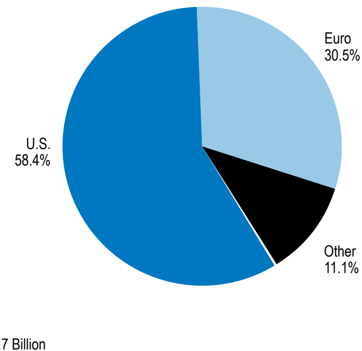
Global CDO Issuance by Transaction Structure
2006:Q1–2008:Q1



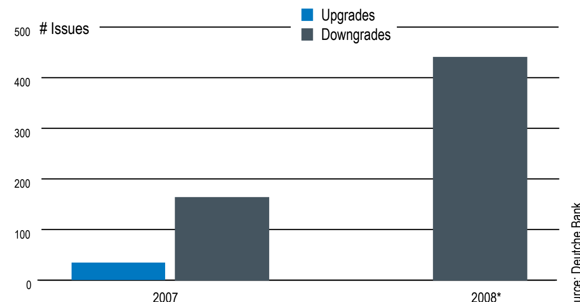
Global CDO Issuance by Underlying Collateral
2008:Q1



Global CDO Issuance by Currency
2008:Q1



ABS CDO AAA-Rated Rating Actions
2007 vs. 2008



*As of March 2008

Repo Average Daily Outstanding Increases

The average daily volume of total outstanding repurchase (repo) and reverse repo agreement contracts totaled $7.06 trillion in the first quarter of 2008, a 21.5 percent increase over the $5.81 trillion during the same period in 2007. Daily outstanding repo agreements averaged $4.30 trillion in the first quarter, a 20.4 percent increase compared to $3.86 trillion during first quarter 2007 while average outstanding reverse repo increased to $2.76 trillion, 23.2 percent above from the $2.24 trillion in the same period a year ago. The data represent financing activities of the primary dealers reporting to the Federal Reserve Bank of New York and include repurchase and reverse repurchase agreements involving U.S. government, federal agency, agency mortgage-backed and corporate securities.

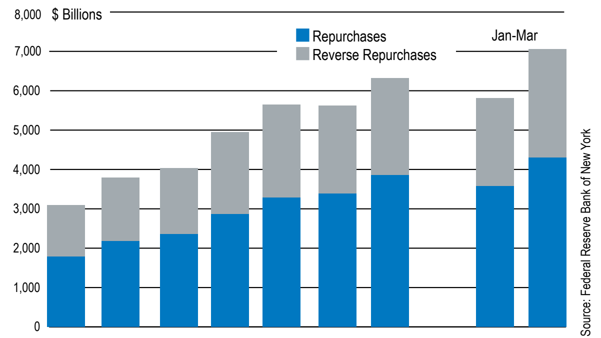
The Fixed Income Clearing Corporation's Government Securities Division (GSD), an SEC-registered clearing agency, facilitates orderly settlements in the U.S. government securities market and tracks repo trades settled through its system by product type. Over $142.5 trillion in repo trades were submitted by GSD participants in the first quarter of 2008, with an average daily volume of approximately $2.3 trillion. Transactions involving Treasury notes accounted for the largest share of GSD's repo activity, $94.6 trillion, or 66.4 percent of total volume. Treasury bonds accounted for an estimated $11.0 trillion, or 7.7 percent of the total. Treasury bills accounted for $9.8 trillion of the activity for the period, while federal agency non-mortgage securities accounted for $15.9 trillion, or 11.2 percent of first-quarter volume.

CP Outstanding Decline Slows in the First Quarter; Money Market Outstanding Rises Slightly

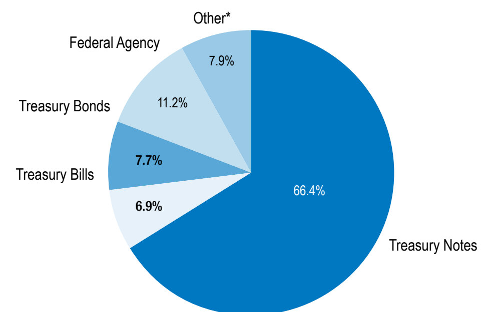
The outstanding volume of total money market instruments, including commercial paper (CP) and large time deposits, totaled more than $4.20 trillion at the end of March 2008, a 2.7 percent increase from the end of the fourth quarter. CP outstanding totaled $1.78 trillion at the end of March, a modest decline from the $1.79 trillion at the end of the fourth quarter in 2007, and fell further to $1.76 billion by the end of April.

Financial CP outstanding increased to $833.7 billion as of the end of the first quarter, 3.7 percent above the $804.3 billion outstanding at the end of December 2007. Non-financial CP outstanding stood at $163.8 billion at the end of March, a 1.4 percent decrease from $166.2 billion at the end of the fourth quarter. Non-financial CP outstanding fell significantly in March, declining more than 12.4 percent in that one month. Slower economic growth and reduced demand for debt-funded acquisition bridge financing has lowered issuer demand. Asset-backed commercial paper declined by 4.0 percent in the first quarter to $783.6 billion, due in large part to the aftermath of market dislocations, expiration of some mortgage collateralized programs and sponsors bringing more assets onto their balance sheet. Similar to the Fed's introduction of the Term Auction Facility in December, the Term Securities Lending Facility and Primary Credit Dealer Facility have helped to eased pressure on the commercial paper market as rates dropped through March. However, the 90-day CP rate rose in April as the market remains under pressure amid concerns about the effect of a slower economy and consumer credit weakening on ABCP. As noted in a recent JP Morgan report, concerns about the banking sector continue to weigh heavily on the short-term markets, as expressed by the elevated LIBOR-to-Treasury spread.

Financing by U.S. Government Securities Dealers
Average Daily Amount Outstanding 2001–2008:Q1



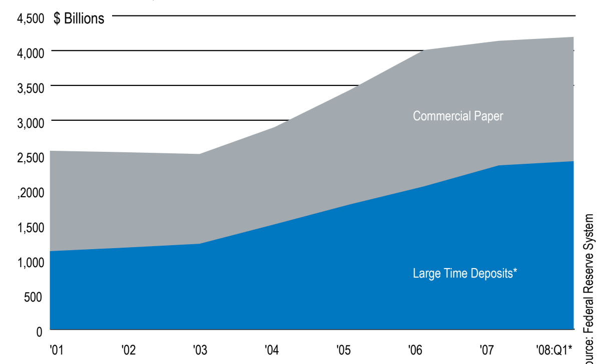
Repo Trades Submitted to the GSD
2008:Q1



Total: $142.5 Trillion

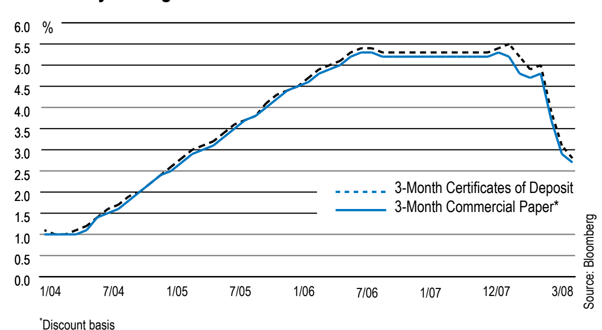
* Includes Discount Agency, Forward Starting Generic Repo Trades, STRIPS, TIPS Bonds, TIPS Notes

Outstanding Money Market Instruments
2001–2008:Q1*



* SIFMA estimates

Domestic Money Markets Interest Rates
Monthly Averages Jan. 2004–Mar. 2008



*Discount basis

Corporate Bond Issuance Slows in First Quarter as Sector Performance Is Weakened by Credit Market Conditions, Slower Economy; Signs of Recovery in April

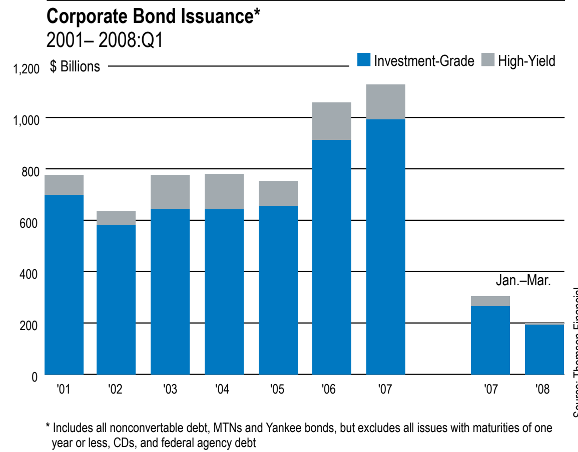
After a record year in 2007, a result of a strong first half, total corporate bond issuance fell in the first three months of 2008 on continued turmoil and uncertainty in the credit markets, increased volatility, reduced profit and economic trends, and sharply widening corporate bond credit spreads. Total corporate bond issuance fell to $198.5 billion in the first quarter of 2008, a 53.0 percent decline from the first quarter in 2007 and a 17.6 percent below the $240.9 billion issued in fourth-quarter 2007. The corporate issuance decline, though, was relatively modest compared to other credit market sectors, in particular, securitized and structured products. Greater credit market stability following the Federal Reserve's aggressive response in March, culminating in the Bear Stearns resolution, helped reduce spreads and improved sector performance at the end of the quarter and into April. As we have suggested in recent Research Quarterly reports, the spread widening since the middle of last year was driven more by technicals or, better stated, reduced investor demand, than fundamentals. Spreads had widened beyond what the near-term default outlook would generally imply. The effect of a projected increase in default rates, below-trend growth, the rising level of downgrades, higher funding costs and the unsettled financial industry situation indicate that there is downside risk exposure in corporate credit fundamentals. Financial sector capital requirements should boost investment-grade issuance for the balance of the year, and the improved pricing at the end of the first quarter and into the second should raise issuance from a historically low first quarter. The combination of slower growth, the sharp drop in debt-financed corporate acquisition and a more risk-sensitive investor community will keep volumes below last year's record levels, although, April volume was historically strong.

Credit Quality Risk Rising; Spreads Spike in First Quarter, Gain in April

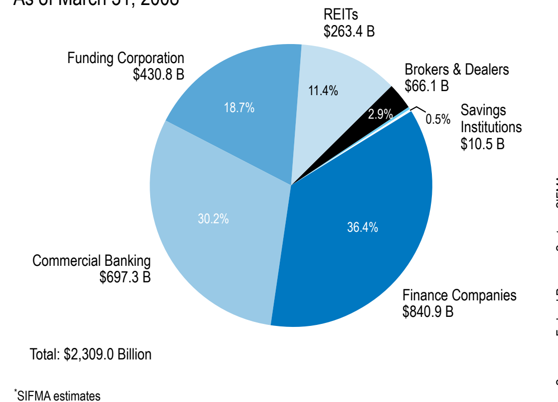
While fundamentals are looking weaker than a year ago as the economy slows and faces increased recessionary risk, corporate finance is in a fundamentally better position and less leveraged than consumer credit, and especially, the beleaguered mortgage sector. Over the last five years, aggregate corporate leverage has declined compared to rising consumer leverage ratios. Based on firms reporting earnings through April, profits are lower than a year ago due to weakness in the financial-related industries. Most non-financial corporations appear to be beating estimates, while financial industry uncertainty, loss exposure and capital replenishment continue to weigh heavily on the market.

Default rates have risen from historically low rates through the first three months of 2008 of the year. According to S&P Global Fixed Income Research, the number of global defaults has already equaled the total number of defaults in all of 2007 (22), with 4 additional defaults reported through the first three weeks of April. The S&P default rate was 1.40 percent as of the end of March, compared to 0.97 percent at the end of 2007, with the baseline forecast for a 4.7 percent rate a year from now.

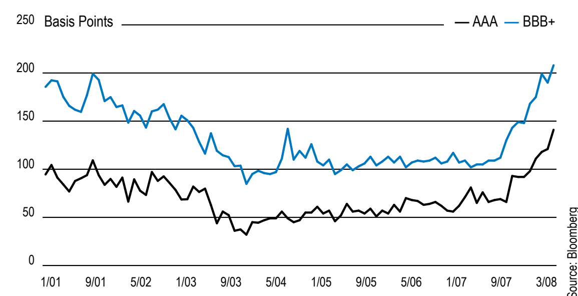
Corporate bond credit spreads continued to widen significantly during the first three months of 2008, though spreads recovered late in the quarter and through April. The JP Morgan JULI investment-grade index spread tightened from 217 basis point (bps) mid-March to 173 bps at the end of April. The Merrill Lynch high-yield index spread stood at 821 bps at the end of March, up from 592 bps at the first of 2007. As the end of April, the spread tightened to 782 bps. The one-month Merrill high-yield return of 256 bps in April was the third highest in the series which goes back more than 20

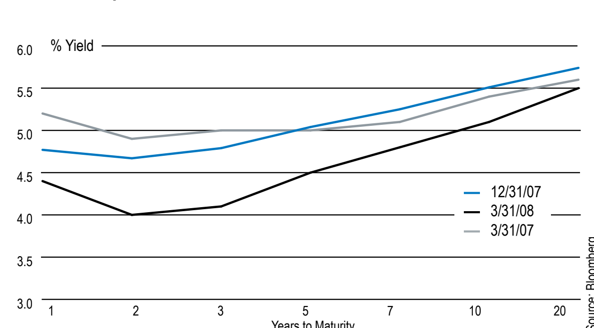


* Includes all nonconvertable debt, MTNs and Yankee bonds, but excludes all issues with maturities of one year or less, CDs, and federal agency debt



*SIFMA estimates





years following the worst quarter in the 23-year history of the Merrill index. The credit derivative swap (CDS) market followed a similar pattern, and the cash/CDS negative basis increased during April. The CDX.HY spread widened to a peak of 767 bps on March 7 and 684 bps at quarter-end, then tightened 593 bps at the end of April.

Investment-Grade Volume Weaker in First Quarter; Off Record Levels of a Year Ago

Non-convertible investment-grade issuance decreased 27.4 percent to $192.6 billion, in the first quarter of the year, down from $265.3 billion a year ago and down 7.9 percent on a linked-quarter basis.

Consistent with the financial sector's capital raising strategies, financials remain the dominant investment-grade issuing sector with commercial banks, investment banks and other credit institutions accounting for nearly 50 percent of investment-grade volume similar to first quarter levels a year ago. Investment-grade issuance will benefit from financial sector capital needs and the increasing volume of redemptions. JP Morgan is projecting $45 billion in monthly redemptions over the balance of the year.

High-Yield Issuance Falls Dramatically in Q1

Non-convertible high-yield debt issuance declined to $5.9 billion in the first quarter of 2008, 84.6 percent lower than the $38.4 billion volume in first quarter 2007, and 81 percent from the $31.7 billion level in the fourth quarter of last year. The improved pricing in April suggests a pickup from the historically low first-quarter volume but well below that of recent years. Restaurants and hotels were the largest sector, accounting for 39.0 percent of total high-yield issuance. Manufacturing, which had been the leading high-yield issuance in previous quarters, dropped to third with a 15.2 percent share.

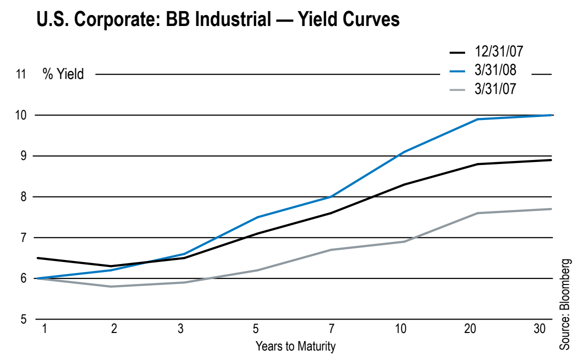
Convertible, Medium-Term Notes Issuance Decline in First Quarter

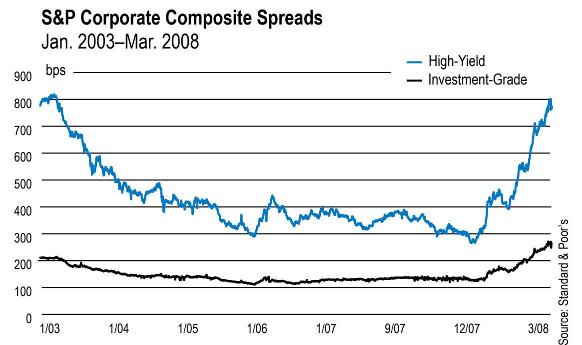
Convertible issuance (including investment grade and high yield) declined during the first quarter of 2008 to $6.5 billion, down 69.9 percent from the $21.6 billion issued in the first quarter a year ago and 63.1 percent lower than the fourth quarter of 2007. The decline reflects the volatile credit market conditions and recent equity market trends and outlook through the quarter.

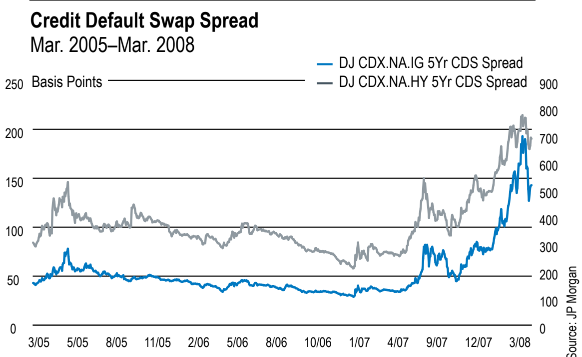
Medium-term notes (MTNs) issuance decreased to $48.5 billion in the first quarter, down 54.5 percent from the same period a year ago and 8.5 percent lower on a linked-quarter basis.

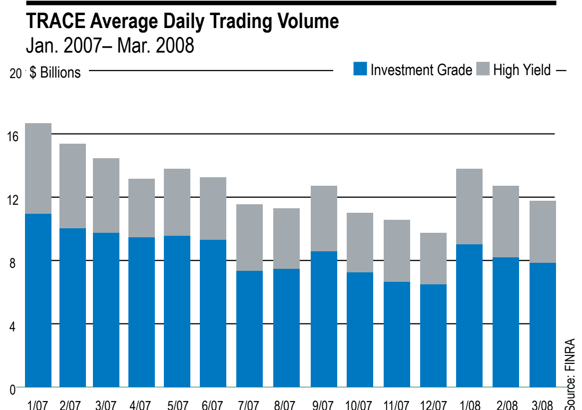
Trading Volumes Decreases in the Fourth Quarter

According to the NASD's TRACE system, estimated investment-grade average daily trading volume increased in the first quarter to $8.4 billion, 23.5 percent above the $6.8 billion traded in the fourth quarter but 17.6 percent lower than the $10.2 billion traded during the first-quarter 2007. High-yield average daily trading volume increased to $4.4 billion in the first quarter, up from $3.7 billion in the fourth quarter of 2007 but down from $5.3 billion from the first quarter a year ago. The year-over-year declines are indicative of reduced liquidity under current market conditions.









Market Corrects on Continued Credit Market Uncertainty, Elevated Volatility and Slower Economy, Rebounds in April; Trading Volume Rises

The stock market continued to be affected by the credit market stress and its impact on the broader economy. The Dow Jones Industry Average (DJIA) declined by 15.34 percent over 105 trading days from the date the record was set on October 7, 2007, of 14,164.53 to March 10, 2008. Over the last 57 years, there have been 16 severe corrections, eight of which have turned into bear markets. Despite the lower equity index levels, the price-to-earnings (P/E) ratio rose. There has also been a rising equity risk premium since year-end which has depressed stock prices. Subsequent to the Fed's series of actions to free up the credit markets, the equity markets, especially financials, have shown signs of recovery. The three major equity indices all rose during the month of April. The outlook for the equity market depends on the credit market recovery and how that affects the economy and investor risk appetite.

A spate of economic data reports, especially in the housing and consumer spending sectors confirm a weaker economy and rising recessionary risk. The Federal Reserve's most recent "Beige Book" published in April, reports slowing economic activity in nine of the 12 Federal Reserve districts. The March retail sales growth rate was the slowest in 13 years. Significantly lower number of mergers and acquisition (M&A) activity, 50.2 percent below that of a year ago, was another reason for the lower equity index levels. As a recent S&P analysis concluded, equity values tend to rise during the latter stages of an economic downturn.

For the quarter, the DJIA declined by 7.6 percent, the S&P 500 declined 9.9 percent and the NASDAQ fell 14.7 percent. On a linked-quarter basis, the DJIA lost 0.7 percent, S&P 500 6.9 percent and the NASDAQ 5.9 percent. To give perspective, the S&P 500 decline of 9.9 percent in the first quarter ranks in the top 40 of quarterly S&P 500 percentage declines. As of March 31, the DJIA closed at 12,262.89, S&P 500 closed at 1,322.70, and NASDAQ closed at 2,279.10.

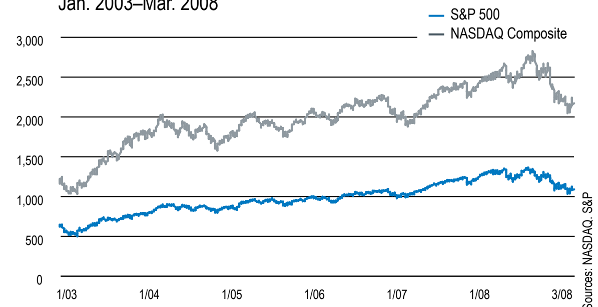
Share Trading Volume Continues to Rise to Record Levels

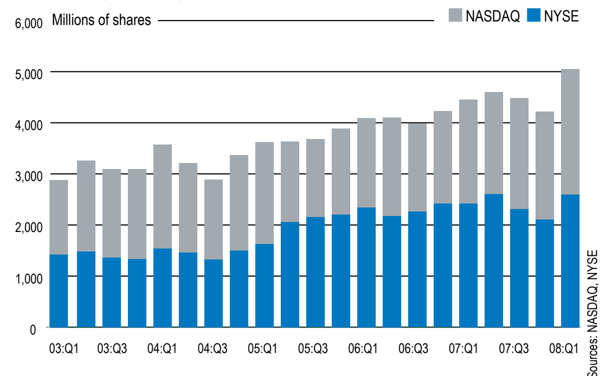
In the first quarter, average daily share volume increased by 23.1 percent on the New York Stock Exchange (NYSE) and 16.2 percent on the NASDAQ on a linked-quarter basis. Compared to the first quarter a year ago, NYSE volume rose 28.1 percent, the NASDAQ by 13.7 percent. Both the NYSE and NASDAQ set average share trading volume records for the quarter of 2,597.6 billion shares and 2,448.8 billion shares, respectively.

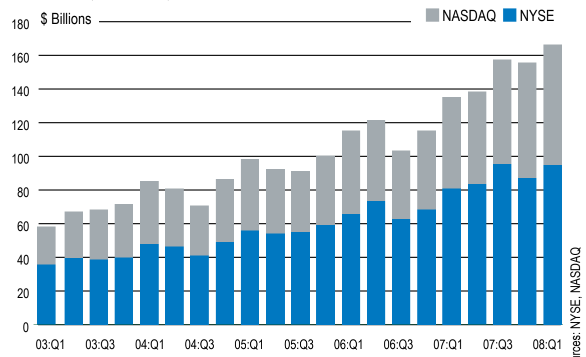
The NYSE's average daily dollar trading value reached $94.8 billion, in the first quarter of 2008 or up 8.8 percent compared to the fourth quarter. Average daily dollar trading value on the NASDAQ reached $71.5 billion, up 4.3 percent from the fourth quarter of 2007. The NYSE dollar volume fell just short of the $95.5 billion record set in the third quarter of 2007 and on NASDAQ was the highest since 2000, when the daily average volume was $80.9 billion. Compared to the first quarter a year ago, the NYSE average dollar volume increased by 17.2 percent and the NASDAQ by 32.2 percent.

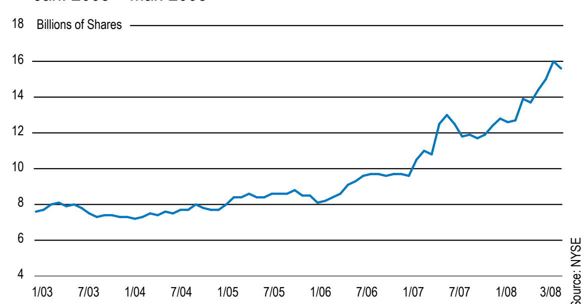
Short Interest Sets Record in Q1

The NYSE short interest volume declined to 15.6 billion shares in the first quarter. NYSE short interest increased by over 2.84 billion shares, or 22.3 percent, compared to December 31 or year-end 2007. Short-selling activity remained above the 10 billion-share level for the 20th consecutive









reporting period. The March 31 short interest represented 4.1 percent of the total shares outstanding on the NYSE. Short interest peaked at 16.01 billion shares, which was recorded on March 15, 2008, just prior to the announcement of the Federal Reserve facilitated JP. Morgan's acquisition of Bear Stearns.

Total Corporate Underwriting

First-quarter underwriting volume was $322.7 billion on 472 deals, the lowest volume recorded since second quarter 2007, compared to $461.9 billion in the fourth quarter. The lower volume is attributable to the continued deterioration in the credit market conditions. Compared to the first quarter a year ago, volume fell 65.5 percent, to the lowest level since the second quarter of 1997.

Reflective of the more difficult equity market conditions in the first quarter, closed end fund offerings dropped to $3.3 billion on 10 transactions, a significant decline from $4.6 billion in the fourth quarter. About 75 percent of the underwritten volume occurred in January, and there were no new closed end fund underwritings in March. Preferred stock underwritings grew to $32.9 billion on 18 deals in the first quarter, up 14.2 percent on a linked-quarter basis and 156.7 percent compared to first-quarter 2007. The preferred stock volume growth in the quarter was the result of financial company capital replenishment. Financial institutions accounted for 12 of the 18 preferred stock deals in the quarter.

Combining corporate debt (straight bonds and securitizations) and equity underwriting, the securities industry raised $322.7 billion in the first quarter of 2008, a decline of 30.0 percent from the previous quarter and 65.5 percent below the same, year-earlier quarter. The decline was directly attributable to the dormant lower-quality non-agency mortgage ABS and non-agency MBS sectors, down 82.6 percent and 95.3 percent, respectively.

Total Initial Public Offering (IPOs) and "True" IPO Markets Quiet

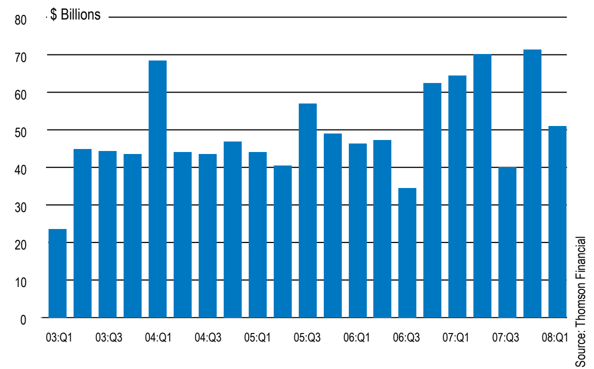
IPOs raised $4.4 billion in the first quarter, the lowest quarterly volume since the first quarter of 2003 and a 78.5 percent decline from the previous quarter, indicative of depressed market conditions. "True" IPOs, which exclude closed end fund IPOs, were $1.1 billion, 92.1 percent below the $14.5 billion raised in the fourth quarter of 2007 and 88.0 percent lower than in the first quarter a year ago. The average monthly issuance for the quarter was $0.4 billion, compared to $4.2 billion during full-year 2007. This is the lowest quarterly dollar volume underwritten since the first quarter of 2003, when $0.2 billion was offered. The IPO backlog in dollar terms picked up marginally to $37 billion on 116 deals, compared to $32.5 billion on 122 deals in the pipeline at year-end.

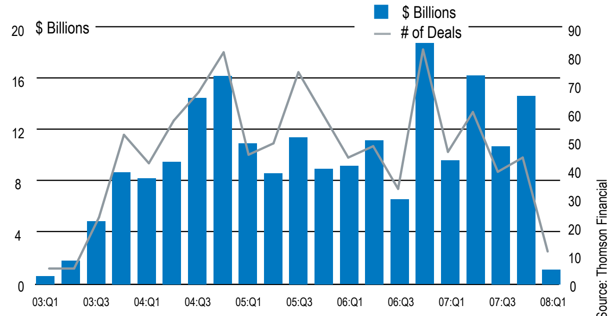
Fourth-Quarter Secondary Offerings Lower

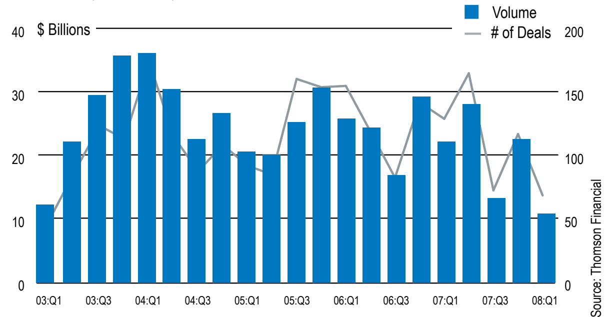
The total value of first-quarter secondary underwritings was $13.6 billion on 11 deals, a 41.6 percent decline from the fourth-quarter level of $23.4 billion, 47.0 percent less than in the first quarter a year ago and was the lowest volume quarter since the first quarter of 2003 ($10.1 billion underwritten on five deals). Despite the subpar quarter, secondary underwritings still exceeded $10 billion for the 38th consecutive quarter.

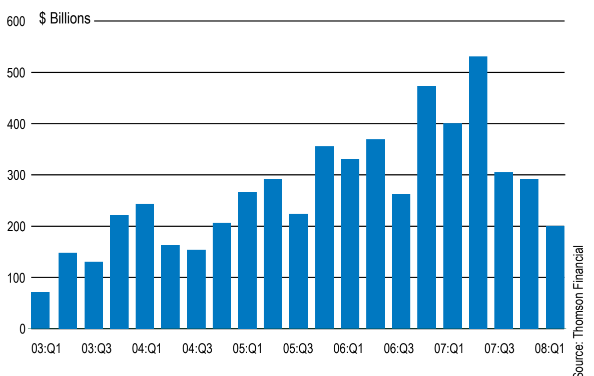
U.S. M&A Volume Drops to Lowest Level in 14 Quarters

Following the strong first half of 2007, M&A volume slipped in the second half and continued to slide in the first quarter of 2008. The tighter financing environment dramatically reduced debt-financed acquisitions, including leveraged buy-outs (LBOs). In the first quarter of 2008, announced









deal volume was $200.5 billion, compared to $291.5 billion in the fourth quarter of 2007, a 31.2 percent decline on a linked-quarter basis, and was 50.2 percent less than in the first quarter a year ago. The first quarter was the lowest volume quarter since the third quarter of 2004. The number of announced M&A deals declined 12.3 percent from the fourth quarter and 17.4 percent from the first quarter a year ago.

P/E Rises but Remains Below 10-Year Average

The S&P 500 P/E ratio stood at 19.72 at the end of March, having risen 15.6 percent over the past year and by 5.8 percent during the fourth quarter, but it remains below the 10-year average. The higher P/Es reflect the effect of below-trend economic growth on earnings and the effect of financial sector loss provisioning. Another valuation measure is the equity risk premium, or the earnings yield (inverse of the P/E ratio), compared to the 10-year Treasury yield. The risk premium has risen during the first quarter. According to a recent JP Morgan report, the risk premium should be lower relative to the recent spike but will be elevated over the next cycle. The market recovery will depend on credit market stability and pickup in economic growth.

Share Buyback Volume Lower in Weaker Market

In a reversal of recent trends, corporate share repurchases declined in the first quarter with first-quarter buyback volume down on the NYSE and NASDAQ by 26.9 percent and 68.1 percent, respectively. The announced dollar volume on the NYSE was $76.8 billion on 46 programs and on the NASDAQ $7.46 billion buyback, on 26 programs. The lower buyback levels were a reflection of capital conservation and management strategies and the downshift during the quarter in equity prices.

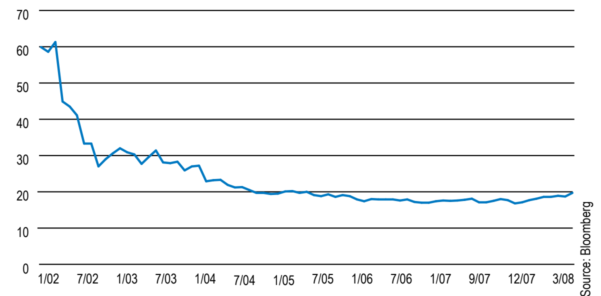
CBOE Volatility Index Rises

The Chicago Board Options Exchange Volatility Index, or VIX, ended the quarter at 25.61, the lowest month-end close of the turbulent first quarter. The months of January and February saw a close of 26.20 and 26.54, respectively, with a peak of 32.24 on March 17. The peak coincided with the onset of a series of actions by the Fed to restore market stability, culminating in the JP Morgan acquisition of the Bear Stearns situation. The VIX remained well above the 5-year and 10-year averages. Current market conditions suggest that volatility is likely to remain elevated, certainly relative to levels in the first half of 2007.

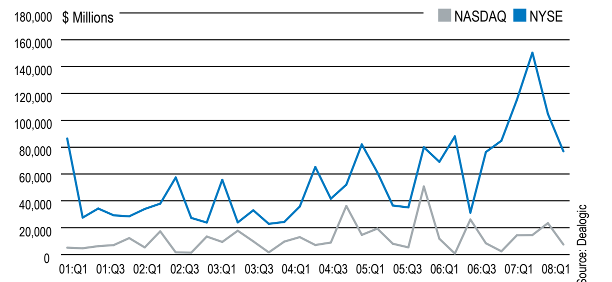
Venture Capital /Private Equity

Venture capital investments in the U.S. remained on a growth trajectory in the first quarter, the fifth consecutive quarter in which over $7 billion was invested. However, capital disbursements declined by 8.5 percent to $7.1 billion, from $7.8 billion at the end of the fourth quarter 2007. Compared to the first quarter a year ago, private equity investments were down 4.81 percent from $7.5 billion. The number of private equity deals declined by 11.8 percent to 922 deals in the first quarter from 1,045 deals in the fourth quarter, which was the highest in two years.

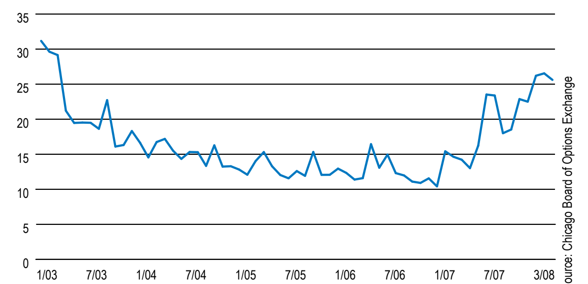
S&P P/E Ratio
Jan. 2002–Mar. 2008



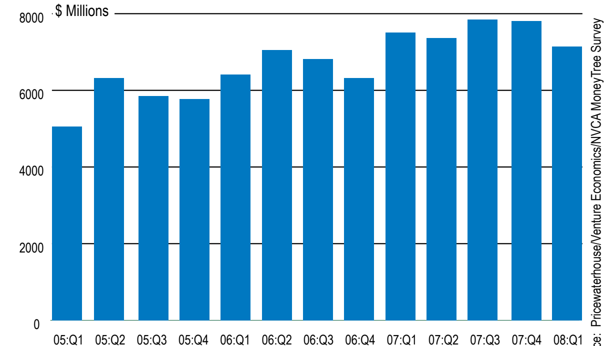
NASDAQ and NYSE Share Buybacks
2001:Q1–2008:Q1



SPX Volatility Index (VIX) Close
Jan. 2003–Mar. 2008



Venture Capital Investment in U.S. Companies
2005:Q1–2008:Q1



First Quarter 2008: Leveraged Loan Market Review

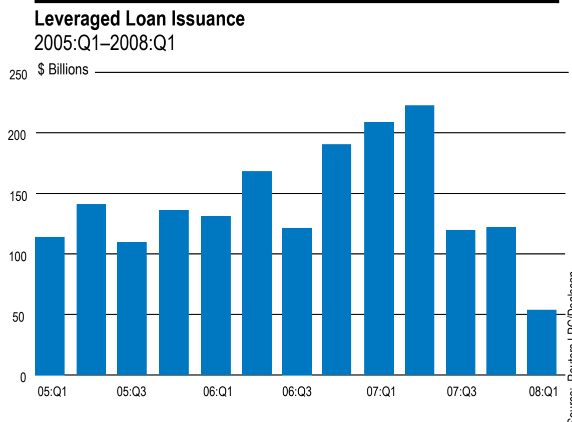
"Clearly the U.S. economy is going through a very difficult time." These were Mr. Bernanke's concluding words as he spoke before the Joint Economic Committee just days after the end of the first quarter. Since last summer, conditions across the credit markets have continued to deteriorate, and the economy increasingly became subject to recessionary risk. By the end of March, market conditions weakened further, exemplified by announcements of multibillion dollar write-downs on subprime related securities, collateralized debt obligations (CDOs) and leveraged loans. The Bear Stearns situation and the Federal Reserve response exemplified credit market conditions late in the quarter. The considered judgment was that inaction would have resulted in greater harm to the broader banking sector and markets.

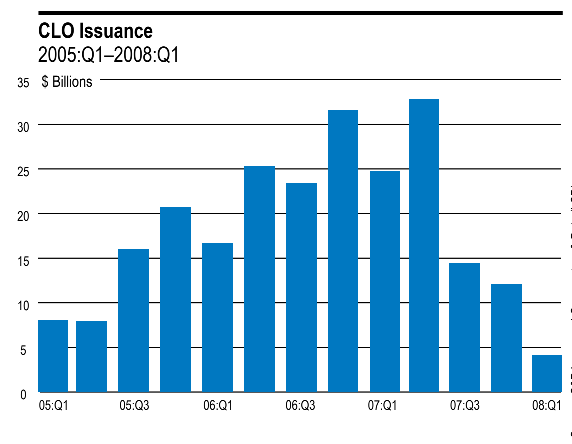
Issuance Falls On Weaker Investor Demand, Market Technicals

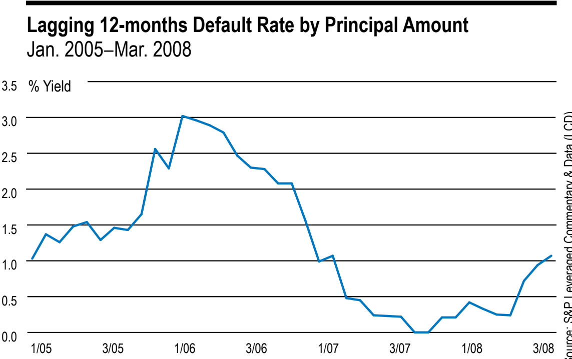
Feeling the pain of the credit crunch, the leveraged loan market encountered a more volatile and less liquid market by the end of the first quarter, which has been the worst three-month period recorded by the loan market. Following a disastrous second half of 2007, the leveraged loan market entered a period of falling demand and historically low issuance. First quarter 2008 leveraged loan issuance tumbled 74 percent from a year ago, to $54 billion, representing the largest year-over-year decline on record. Lenders revisited their return profile and reassessed their risk appetite. As a result, tighter loan structures once again dominated issuance, with no covenant-lite issuance in the quarter (compared to full-year 2007 volume of $100 billion). Issuance of second-lien-loans, which have an aggressive risk and return profile, also plummeted. A record second lien volume of $30 billion was issued during 2007. Similar to covenant-lites, second liens also lost their appeal to investors. By the first quarter, second-lien issuance slowed to a trickle, totaling only $1.5 billion. Those new loan issues that were able to clear the market during the quarter had the more restrictive pre-2007 terms and conditions. Spreads increased considerably, a process that began during the second half of last year. With investor demand weakening, loan originators not only had to offer increased spreads but also began offering "sweeteners" such as original issue discounts (OIDs) and LIBOR Floors in an attempt to lure lenders. All-in BB/BB- spreads soared to 400 basis points in the first quarter, from 165 basis points in the first half of 2007, while all-in B+/B spreads increased to 524 basis points from 220 basis points.

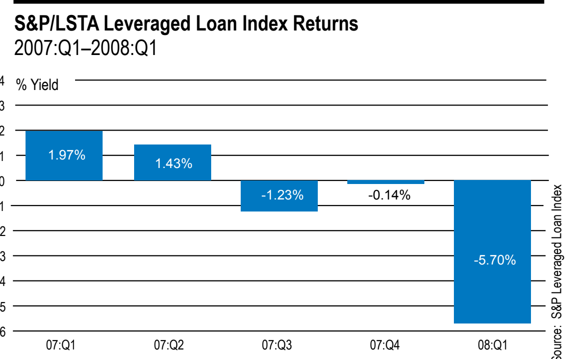
One could say that the story of weaker investor demand for leveraged loans begins and ends with the collateralized loan obligation (CLO) market. Since 2005, CLOs have been the major funding source of leveraged loans and helped propel the growth of the asset class. These CLO structures have not only provided a continual source of demand in the primary market but also constant upward bid pressure in the secondary market. During the second quarter of last year, CLOs digested 60 percent of the primary issuance pipeline. In addition, the CLO buy-and-hold mentality kept loan prices stable and volatility low. However, beginning in the third quarter of last year, CLO demand began to retrench as a massive supply of new issuance saturated the market. The slower demand for CLOs coincided with record supply and subprime contagion. The CLO market virtually shut down as the cost of financing AAA liabilities skyrocketed. As a result, CLO issuance quickly dropped. During the second half of 2007, issuance fell to $26.5 billion and slipped further to $4.2 billion in the first quarter of this year, marking the lowest issuance volume in four years.

[3] The author of the Leveraged Loan discussion is Ted Basta, Loan Syndication and Trading Association (LSTA), Vice President of Market Data & Analysis









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The loan funding void was further exacerbated by hedge funds facing margin calls and existing CLOs with total return swaps suffering forced unwinds. Some hedge funds were even forced to close. At the same time, the Federal Reserve reductions of the target fed funds rate sent three-month LIBOR down to 2.71 percent from a high of 5.70 percent during mid-September of 2007. The Fed initiated the rate cuts to benefit the overall economy. Ironically, the effect reduced total returns on bank loans, making them less appealing to high-yield lenders, who had provided liquidity to the credit markets during the latter half of 2007. Consequently, high-yield and cross-over lenders retreated from the leveraged loan market, further weakening secondary market liquidity. Daily access funds (funds that may be bought and sold on a daily basis) suffered $325 million of redemptions during March, following the record $1.3 billion in redemptions during February. By quarter's end, daily access funds had recorded nine consecutive months of net outflows, and, over this nine month period, the amount of assets under management had shrunk 42 percent to 12.6 billion since mid-July.

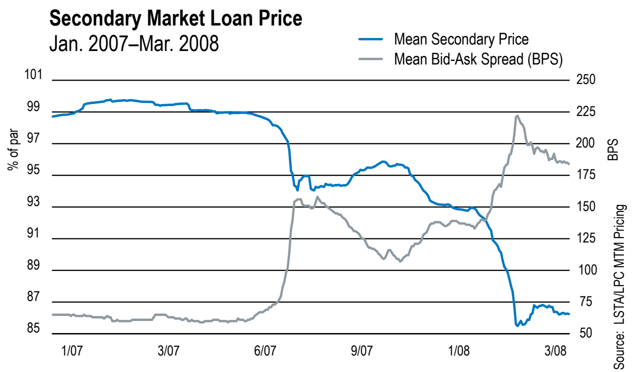
Default Rate Rises from Historically Low Level; Negative Returns for the Quarter

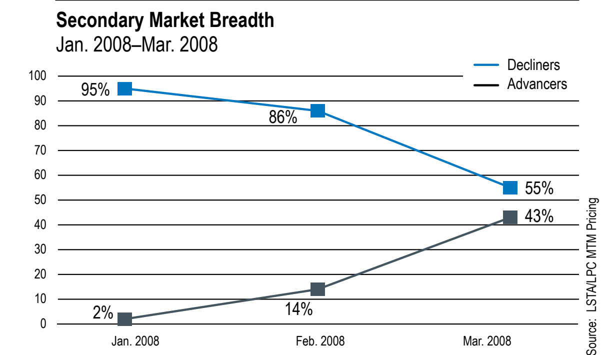
The weaker market conditions were due to technical factors, that is, supply and demand imbalance, but fundamentals have now begun showing signs of strain. During the first quarter this year, thirteen institutional loans defaulted, compared to only seven during 2006 and 2007. Thus, the lagging 12-month loan default rate based on principal amount spiked during first quarter to a 16-month high of 1.07 percent as of March 31, from 0.24 percent at year-end 2007. Although higher, the rate is still well below the historical average of 3.24 percent. The default rate may reach or exceed the long-term average level. Even if default rates reached that level, the risk-adjusted returns of leveraged loans should remain attractive relative to other asset classes. The attractive returns under such a scenario, however, would be accompanied by a higher level of volatility and rising default rate expectations.

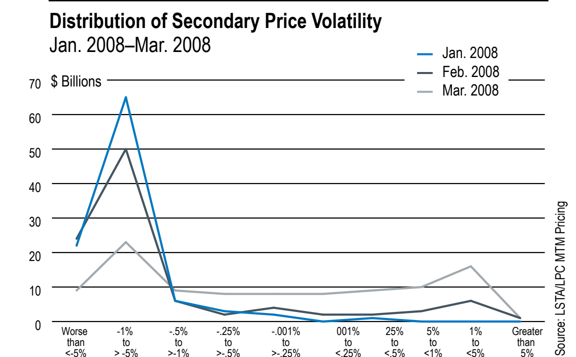
The first-quarter return of the S&P/LSTA Leveraged Loan Index (LLI) encapsulates the state of the loan market. The LLI generated a 5.7 percent loss, marking the largest quarterly loss on record, and has now tallied three consecutive quarters of negative returns for the first time in its history. The previous low return, -1.23 percent, occurred in the third quarter of 2007. As returns have fallen, volatility has been on the rise. Last year, the annual standard deviation of LLI monthly returns surged to 1.34 percent from just 0.16 percent during 2006. By month-end March that volatility measure rose to 1.73 percent. Most ominous was that the increased volatility measurement is a direct result of the immense downward pricing pressure in the secondary market.

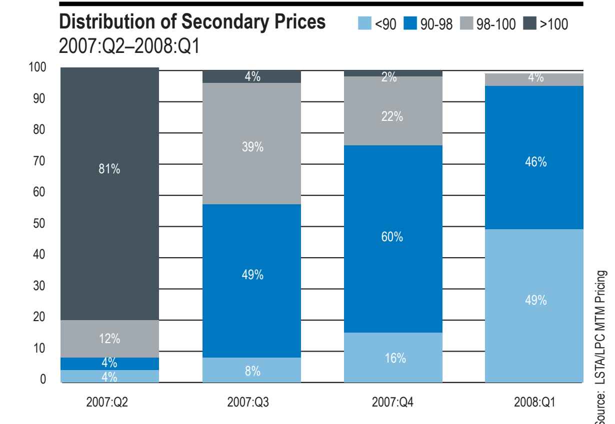
Illustrative of the downward price pressure is the LSTA/LPC mark-to-market pricing (MTM) dataset of U.S. term loans quoted by three or more broker dealers. Since the beginning of the third quarter, secondary prices have fallen precipitously as bid-ask spreads have widened to historical levels. This trend worsened during first-quarter 2008, with the mean MTM price hitting a record low 85.48 on February 13. By quarter-end, the dataset was priced at 86.24, down 664 basis points, or 7 percent, from the third quarter level. The bid-ask spread, commonly used as a benchmark of liquidity, surged to 184 basis points.

There were MTM price gains greater than price losses on only 17 of the first 60 trading days. Although overall market price movement was negative, the advancer/decliner ratio did improve during each successive month of the quarter. Decliners outpaced advancers by a ratio of 48 to 1 during January,









6 to 1 during February, and only 1.3 to 1 during March. The distribution of significant price change during the first quarter 2008 was skewed to the negative side. However, the negative skew became less pronounced as the quarter progressed. For example, 95 percent of all January price changes were lower than negative 0.5 percent, with 65 percent recording declines between -1 percent and -5 percent. By March, these numbers improved to 41percent in the “worse than -0.5 percent” price change category and 23 percent in the -1percent to -5 percent category. Loans experiencing greater than -5 percent declines, also showed improvement from January to March, decreasing from 22 percent to 9 percent.

The distribution of secondary MTM prices further illustrates the depressed state of secondary price levels. The percentage of loans priced between 98 and 100 fell to 4 percent during March, from 10 percent during January. The percentage of loans priced between 90 and 98 also fell by quarter’s end, to 46 percent from 58 percent during January. While these segments declined in size, the “less than 90” price category grew considerably. The downward price migration into the below 90 range was quite evident. By the end of March, 49 percent of prices were below-90, a dramatic increase from the 16 percent figure reported at year-end, and the 4 percent figure a year ago.

In conclusion, the leveraged loan market will continue to face stiff head-winds as it encounters the credit and liquidity crunch environment. Although there are massive challenges to open up the market, the recent reduction of the forward calendar is certainly a positive. The calendar, which peaked during last July at $237 billion has been reduced to $110 billion during the quarter from $156 billion at year-end. The continued reduction of the calendar is a major contributor to a return of stability to the leveraged loan market.

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