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Capital Market Issuance Down 11.6 Percent to $1.6 Trillion in Second Quarter 2010

Markets have been preoccupied for much of the past year with the progress and shape of financial regulatory reform. Shortly after the end of the second quarter, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) was passed and signed into law by President Obama. Dodd-Frank touches almost every aspect of the U.S. financial system, expanding regulatory oversight, creating new regulators, and mandating changes in business practice, among many other provisions.

There are hundreds mandated regulatory actions that must be competed and regulations that must be implemented over the next several years. While largely supportive of the need for some fundamental regulatory overhauls, there is broad industry concern revolving around the continued constriction of credit availability, anemic economic recovery and stagnant employment growth, all which will be further impacted by the implementations of many areas of regulatory reform.

During the second quarter, $1.6 trillion in securities were issued, a decline of 11.6 percent from $1.8 trillion in 1Q’10 and down 23.7 percent year-over-year (y-o-y) from $2.0 trillion in 2Q’09.

Municipal issuance totaled $100.2 billion in the second quarter, a decline of 9.8 percent from 2Q’09. The taxable share of issuance edged up to 32.8 percent from 32.6 percent in Q1’10, in part due to steady BABs issuance as well as a moderate increase in the non-BAB taxable share due to the authorization direct payment options on certain bonds in Q1’10, such as lean renewable energy bonds (CREBs).

While net treasury issuance fell 5.5 percent to $588.6 billion in 2Q’10 from $623.1 billion last quarter, 2Q’10 issuance is 10.3 percent above 2Q’09 issuance of $533.5 billion, partly due to Treasury’s Supplementary Financing Program (SFP). The SIFMA Government Forecast Survey predicts net treasury issuance will rise again in 3Q’10.

Federal agency debt issuance totaled $232.7 billion in 2Q’10, down from $307.6 billion in 1Q’10, and was down almost 26 percent y-o-y. The two largest agencies, Fannie Mae and Freddie Mac, were recently delisted from the NYSE stock exchange at the end of 2Q’10.

Total mortgage-related issuance decreased significantly to $356.5 billion in 2Q’10, a 45.7 percent decrease y-o-y from $656.1 billion. The large decrease in mortgage-related issuance, or more accurately, the unusual increase of issuance in 2Q’09 was chiefly due to the one-off issuances of agency mortgage portfolios in May and June of 2009.

Corporate bond issuance fell significantly to a total of $162.7 billion in the second quarter, down 43 percent from 1Q’10 and 36 percent from 2Q’09. Investment grade corporate issuance decreased more than high yield issuance. Refinancing pressures remain high in the U.S. While there was a decline in corporate defaults during the second quarter, this was overshadowed by worries over the possibility of an increase of defaults in over the next few years.

Equity market issuance rose again, totaling $47.9 billion in 2Q’10, a decline of 22.6 percent y-o-y. Although there was a significant increase in IPO activity y-o-y from the doldrums experienced in early 2009, secondary market issuance decreased significantly y-o-y, although both were up compared to 1Q’10.
According to Thomson Reuters, long-term municipal issuance volume, including both taxable and tax-exempt issuance, totaled $100.2 billion in the second quarter of 2010, down 3.6 percent from $104.0 billion in 1Q’10 and 9.7 percent below that in 2Q’09. Excluding taxables, tax-exempt issuance totaled $72.7 billion, an increase of 6.1 and a decline of 16.6 percent, respectively, from 1Q’10 and 2Q’09.

Taxable issuance modestly gained additional market share in 2Q’10, claiming 32.8 percent of all municipal issuance compared with 32.5 percent and 20.8 percent, respectively, in 1Q’10 and 2Q’09. While Build America Bonds (BABs) have accounted for the majority of taxable municipal issuance (76.7 percent of all taxables issued in 2Q’10), approximately $2.4 billion in non-BAB taxable bonds were issued following the enactment of the Hiring Incentives to Restore Employment Act (HIRE Act).

Tax-exempt issuance continued to lose ground to taxables in the second quarter, with issuance of $66.3 billion, a decline of 3.2 percent from 1Q’10 and 23.9 percent from 2Q’09. The decline stands in stark contrast to tax-exempt fund inflows, which remained strong throughout 2Q’10; according to Investment Company Institute (ICI), inflows for the first half of 2010 into tax-exempt municipal funds have totaled $19 billion, a rise from $13 billion in 1Q’10 and $17.0 billion in 2Q’09.¹

¹ Investment Company Institute, Long-Term Mutual Fund Flows
Eurozone sovereign debt concerns came to a head in 2Q’10, culminating in a €750 billion rescue package aimed at assuaging nervous investors. While the related “flight to quality” drove Treasury yields down across the yield curve, municipal yields were not similarly impacted, resulting in widening spreads between the 10-year AAA G.O. and Treasury yields; the ratio widened above 100 percent, ending at 104 percent at the end of 2Q’10, a ratio last seen in May 2009. The ratio averaged 91.7 throughout 2Q’10, higher than the 82.6 percent average in 1Q’10, but below the 110.22 average in 2Q’09.

BAB issuance continued strongly throughout 2Q’10, with $25.1 billion sold, a modest decrease of 6 percent from 1Q’10 but still 60.9 percent that in 2Q’09, when the program officially began.

Issuance of variable rate demand obligations (VRDOs), long-term municipal bonds with a floating interest rate that resets daily or weekly and contains a put feature, continued to decline, with $4.0 billion issued in 2Q’10, a 4.3 and 57.6 percent decline from 1Q’10 and 2Q’09, respectively. Demand remained weak as investors continued to disfavor tax-exempt money market funds for more competitive returns elsewhere. The SIFMA Municipal Swap Index, a 7-day high-grade market index comprised of tax-exempt VRDOs, ended at 0.25 percent end-June, averaging 0.29 throughout 2Q’10.

Government Update
On July 21, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. The Act directly impacts the municipal sector, containing provisions relating to financial advisors, municipal derivatives, swaps participation by state and local government, MSRB board composition, SEC divisions, rating agencies, and others.

H.R. 5893 was introduced in the House in July, which introduced provisions for: extending the BABs program through 2012; extending the AMT holiday by one year; extending bank-qualified bond limit for 2011; allocating additional funds to RZEDBs ($15 billion) and RZFBs ($10 billion), exempting water and sewer facility bonds from private activity caps; and extending direct payment options for state housing agencies in lieu of tax credits.

Credit Quality Trends & Credit Enhancement
Credit enhancement for municipal bonds continues to wane. Non-enhanced issuance in 2Q’10 comprised 84.8 percent of total issuance, down from the 89.7 percent share in 1Q’10, but above the 82.4 percent share in 2Q’09. Insured bond issuance of $7.1 billion, represented 7.1 percent of total enhanced issuance, up modestly from 6.3 percent in 1Q’10 but down from a 9.4 percent share in 2Q’09.

According to a June 2010 Nelson A. Rockefeller Institute of Government report, while two states (New York and California) reported growth in collections, 34 states saw declines in their overall tax collections in 1Q’10. Additionally, revenue growth was not particularly organic, as much of it could be attributed to enacted tax increases and tax processing changes.

The report also noted that after accounting for inflation, state tax revenue was at about the same level as ten years ago, although the nation’s population has increased by approximately 10 percent during that period. Overall, while positive figures are beginning to trickle in, the road to fiscal recovery remains “bumpy.” State tax revenue is driven largely by retail (31 percent) and income (36 percent) taxes, both correlated to unemployment, which remains stubbornly high; and budgetary problems have been pushed out from the near-term into subsequent fiscal years. Continued revenue weakness will require states to pursue additional measures to close budget gaps.

2 According to ICI, tax-exempt money market funds ended 2Q’10 with $345.9 billion in assets under management (AUM), a decline of $27.5 billion from 1Q’10. Since the beginning of 2009, tax-exempt money market fund AUM has declined by approximately $155.6 billion, or 31 percent.

3 See SIFMA Dodd-Frank Resources for more details.

Jump in Bill Issuance; Concerns Over Cooling Recovery, Shift to Deflation

Total second quarter net issuance of U.S. Treasury securities was $343.6 billion, down nearly 29 percent from the prior quarter’s $483.2 billion. Notably, total net issuance excluding cash management bills (CMBs) fell to $(45.4) billion in the second quarter from 1Q’10’s $353.2 billion. This significant drop in net issuance reflects the increased use of short-term CMBs in the second quarter, up from approximately 7 percent of total gross Treasuries issuance in 1Q’10 to 18 percent in 2Q’10. However, there was also a moderate 4.1 percent rise in total redemptions (for all bills and coupons) quarter-over-quarter, and a 47 percent jump alone in gross bill redemptions over this same time horizon may have partially offset the increase in CMBs.

Approximately $601.6 billion of Treasury coupons (notes and bonds) were issued in the second quarter, nearly 13 percent above the $533.3 billion issued in the same year-ago period. Excluding redemptions, coupon issuance was $404.5 billion, 6.6 percent below 1Q’10’s $433.2 billion but 9.2 percent above the $370.3 billion in the same year-earlier period.

Total amount of Treasury securities issued were nearly $1.8 trillion in the second quarter, roughly in-line with the amount issued in the same year-earlier period.
SIFMA’s recently completed quarterly Government Forecast survey of U.S. primary dealers projected total net issuance of $399.0 billion for the upcoming third quarter, compared with the net $343.6 billion issued in the second quarter and $392.5 billion issued in 3Q’09.

The expected increase in total debt issuance projected for 3Q’10 may partly reflect increasing worries regarding stagnant employment growth, a cooling economic recovery, deflationary pressures, and the potential need for additional stimulatory measures by the U.S. government.

Total 2Q’10 net issuance of $343.6 billion was in-line with Treasury’s May marketable borrowing estimate of $340 billion. Cash management bills accounted for nearly 18 percent of total gross issuance in the second quarter (as opposed to the approximate 7 percent in 1Q’10), which may be partly due to the increase in the Supplementary Financing Program (SFP) from $5 billion to $200 billion in late February of this year. Regular series bills, notes and bonds all fell as a percentage of total gross issuance quarter-over-quarter (q/q).

Treasury had also estimated an end-of-June cash balance of $280 billion (included $200 billion for the SFP). Looking ahead, Treasury’s estimates for 3Q’10 include $376 billion in net issuance of marketable debt and an end-September cash balance of $270 billion (including $200 billion for the SFP again). SIFMA’s Government Forecast survey forecast that Treasury will finish the third quarter with a cash position of $272.5 billion (including the SFP increase). SIFMA’s Government Forecast survey forecast that Treasury will finish the third quarter with a cash position of $272.5 billion (including the SFP increase). TIPS issuance have continued to increase, from $18.4 billion in 1Q’10 to $19.8 billion for the second quarter this year. Treasury announced in its May refunding statement that it plans to increase the frequency of TIPS auctions as well as decrease the sizes of longer-term coupon auctions going forward.

Second quarter gross coupon issuance volume increased 12.8 percent year over year (y/y) from 2Q’09’s $533.3 billion, but declined 3.4 percent from 1Q’10’s $623.1 billion. Gross redemptions of coupons increased nearly 4 percent q/q and 21 percent y/y to $197.1 billion in 2Q’10.

Gross issuance of T-bills fell 3.7 percent from $1.64 trillion in 2Q’09 to $1.58 trillion in 2Q’10, including cash management balances, but jumped more than 36 percent from 1Q’10’s $1.16 trillion. Gross issuance of CMBs alone jumped nearly 200 percent q/q. Gross redemptions of T-bills, however, also grew approximately 47 percent q/q to $1.6 trillion from 1Q’10’s $1.1 trillion.

Daily trading volume of Treasury securities by the primary dealers averaged $528.5 billion in the second quarter, 12.1 percent greater than 1Q’10’s $471.5 billion and nearly 32 percent higher than 2Q’09’s $400.6 billion average volume recorded.

**Economic Recovery Slowing; Fed Exit on Hold; Regulatory Reform Creates New Challenges**

The Federal Reserve began offering term deposits through its Term Deposit Facility (TDF) in the second quarter, through which certain institutions would earn interest on such reserve balances held at the Fed. However, sentiment has largely shifted from considering the potential implementation of exit strategies to waiting and watching for signs of continued economic growth. A number of key factors have led to increased economic uncertainty: the unemployment rate still hovers near 10 percent; the housing market has seen lulls in new starts and actual deterioration in some instances; European sovereign debt worries have driven up market volatility and investor hesitation; and record-high deficits. Previously incipient inflationary expectations, however, have begun to shift to deflationary concerns.

The 2-year Treasury yield was 0.61 percent at the end of the second quarter, down 41 basis points (bps) from 1.02 percent at the end of 1Q’10. The 10-year Treasury yield fell 87 bps to 2.97 percent at the end of the second quarter from end-1Q’10’s 3.84 percent. As a result, the 2-year to 10-year yield spread narrowed by 46 bps to 236 bps from 282 bps at end-1Q’10.

Survey respondents expected yields to rise and spreads to widen during the third quarter and remainder of 2010. However, the increases predicted are from the historically low levels reached during the second quarter. These lower yields were driven by a combination of factors such as European sovereign debt worries, deterioration in some housing markets and stubbornly high unemployment rates, which contributed to rising demand for relatively safe-haven Treasury debt.

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5 SIFMA Government Forecast, July 29, 2010
Agency LT Debt Issuance Continues to Drop; Treasury Report on GSEs in 2011

Federal agency long-term debt (LTD) issuance was $232.7 billion in the second quarter, a decrease of nearly 26 percent from the $313.8 billion issued in the same year-ago period. As of June 30, overall average daily trading volume of agency securities (coupons and discount notes) by the primary dealers was approximately $70.7 billion for 2Q’10, a decrease of 15.9 percent from end-2Q’09’s average daily trading volume of $84.1 billion.

Federal Home Loan Banks (FHLBs) second quarter bond issuance was $143.6 billion, 3.3 percent below 1Q’10’s $148.4 billion issued. Total FHLB bonds outstanding were $665 billion as of June 30, approximately 2.6 percent below the $682.7 billion outstanding at end-1Q’10. FHLB global debt issuance (bonds separately issued under the Global Debt Program, which was initiated in 1994 to specifically target the foreign investor pool) totaled $69.3 billion, nearly 25 percent lower than then $92.3 billion issued in 1Q’10. Total FHLB global debt outstanding at the end of the second quarter was $348.4 billion, little changed from the $342.3 billion outstanding at the end of 1Q’10.

The Dodd-Frank Act signed into law by the President on July 21 conspicuously avoided the topic of GSE reform, Treasury Deputy Secretary Neal Wolin in his Keynote Address at SIFMA’s July 15 2010 Regulatory Reform Summit” reported that Treasury will put out a report outline its proposals and recommendations early next year.6

Fannie Mae’s gross short-term debt (STD) issuance was $146.2 billion in the second quarter, while gross long-term debt (LTD) issuance was approximately $101 billion. Fannie Mae’s outstanding debt rested at $860.8 billion as of the end of 2Q’10, of which $256.3 billion was short-term and $604.4 billion was long-term, compared to the $207.8 billion in LTD and $576.3 billion in STD outstanding at the end of the first quarter.

Freddie Mac’s second quarter gross debt issuance totaled $198.2 billion, a 23.4 percent drop from 1Q’10’s $258.8 billion gross issued. Total debt outstanding fell slightly to $809.3 billion at end-June from $833.4 billion at end-March.

Total bond issuance by the Farm Credit System, the oldest GSE, which was created to fund loans to those in the farming and agricultural businesses, totaled $29.5 billion in the second quarter, 27.6 percent above 1Q’10’s $23.1 billion in bonds issued. The Tennessee Valley Authority (TVA) filed their first quarter results with the SEC as of April 30, in which it reported short-term debt outstanding of $2.2 billion and long-term debt outstanding of $20.8 billion7.

Primary dealers polled by SIFMA for the Government Forecast survey8 expected gross coupon issuance levels by the four largest agencies to increase 41 percent to $327 billion in 3Q’10 from the $232.1 billion recorded in 2Q’10.

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7 Second quarter TVA financial results have not been provided yet.
8 SIFMA Government Forecast, July 29, 2010
Total Repos and Reverse Repos Unchanged Y/Y; Spreads Widen

The average daily amount of total outstanding repurchase (repo) and reverse repo agreement contracts was $4.51 trillion through the first half of this year, roughly unchanged from the average daily outstanding in the same year-ago period. Daily average outstanding repo transactions totaled $2.55 trillion year-to-date, down 4.2 percent from the $2.66 trillion recorded in the same year-ago period, while reverse repo agreements averaged $1.96 trillion, up 4.9 percent from the $1.87 trillion daily average outstanding during the same year-ago period.

The Federal Reserve Bank of New York (FRBNY) began testing tri-party reverse repos in late 2009 in preparation for their potential use to drain extraordinary reserves from the U.S. banking system when it may be deemed necessary. These repo data represent financing activities of the 18 primary dealers reporting to the FRBNY and includes repos/reverse repos using U.S. government, federal agency, agency mortgage-backed, and corporate securities as collateral. FRBNY also published their final recommendations in the second quarter for reforming the current tri-party repo infrastructure.

Money market rates overall rose through the second quarter, and spreads widened. 3-month LIBOR rates rose to 53.4 basis points (bps) at the end of the second quarter from 29.2 bps at the end of 1Q’10. The overnight indexed swaps (OIS) rate, a commonly used measure of liquidity and stress, was unchanged quarter over quarter (20 bps at the end of 2Q’10), although it rose up to 25 bps intra-quarter. The 3-month Treasury bill yield also picked up slightly, rising to 18 bps as of June 30 from 16 bps at end-March.

The LIBOR-OIS 3-month spread, an important indicator of liquidity and marketplace lending risk, jumped significantly to 33.2 bps at end-2Q’10 from 8.9 bps at the end of 1Q’10. The spread between the 3-month T-bill and LIBOR rate, or the TED spread, is another measure for liquidity and credit risk in the marketplace, and more specifically reflects how likely banks may default on loans. The spread also rose to 35.4 bps at the end of 2Q’10 from 13.2 bps at the end of the first quarter, an indicator of worsening (or assumption for worsening) credit conditions as sovereign debt concerns...
and a slowing recovery may have dragged on market confidence.

**Total CP Outstanding Continues to Decline**

The outstanding volume of total money market instruments (MMI), including commercial paper (CP) and large time deposits, totaled over $2.9 trillion as of the end of 2Q’10, 5.1 percent below the $3.08 trillion as of the end of 1Q’10 and 13.5 percent below year-ago volumes. CP outstanding totaled approximately $1.04 trillion at the end of the second quarter, down 4.4 percent from end-1Q’10’s $1.09 trillion recorded and an over 15 percent decline from the outstanding volume for the same year-ago period. Financial CP outstanding declined 9.2 percent to $514 billion at the end of 2Q’10 from $566.2 billion at end-1Q’10. Non-financial CP outstanding rose for the second consecutive quarter to $115.6 billion at quarter end from $108.7 billion at end-1Q’10.
MORTGAGE-RELATED SECURITIES

Issuance of mortgage-related securities, including agency- and non-agency pass throughs and collateralized mortgage obligations (CMOs), totaled $356.5 billion in the second quarter of 2010, a decline of 8.4 percent and 45.7 percent, respectively from 1Q’10 and 2Q’10. The relatively steep decline in issuance y-o-y in the second quarter stems largely from the one-off issuance of MBS collateralized by seasoned mortgages from agency portfolios in May and June of 2009, but, as in prior quarters, agency issuance continues to dominate the market.

New and existing home sales experienced a small uptick at the beginning of 2Q’10 as homebuyers rushed to complete applications to qualify for the federal housing tax credit, which expired in April. Similar to the uptick in November 2009 (when the first homebuyer tax credit was scheduled to expire), home sales experienced a sharp drop after the expiry as sales were most likely “frontloaded” from existing expected sales.

Agency Issuance; Delisting; Tightened Standards
Agency mortgage-related issuance in 2Q’10, including FDIC securitized transactions, totaled $354.4 billion, comprising 99.4 percent of all mortgage-related issuance for the quarter.

The Federal Reserve, now one of the largest holders of agency MBS, began conducting coupon swaps in the end of June in order to facilitate the settlement of outstanding unsettled trades.
On June 16, both Fannie Mae and Freddie Mac notified NYSE (as well as the Chicago Stock Exchange for Fannie Mae) of their intent to delist their common and preferred stock listings. While the Dodd-Frank Act is silent on the future of the two agencies under conservatorship, outside of a requirement for Treasury to study the issue and issue recommendations and a report to Congress, it remains unlikely that the issue will be addressed in the near-term.

At the end of April, Fannie Mae tightened its transaction standards for the purchase and securitization of adjustable rate mortgages (ARMs), including interest only (IOs) and balloon loans, in order to “protect consumers from potentially dramatic payment increases and to help ensure that borrowers who hold these types of mortgages can sustain them beyond the initial interest rate period.” The move echoes Freddie Mac’s changes in 1Q’10, when they announced their plans to cease purchasing IO-only mortgages after September 1, 2010. At the same time, the agency also announced increased penalties for strategic defaulters, imposing a seven-year lockout policy on eligibility for a Fannie Mae-backed mortgage loan.

The FDIC issued $233 million of notes in a single structured securitized transaction through its Structured Sale Guarantee program in the 2nd quarter, comprised of commercial real estate, making the transaction its fourth structured note issuance in 2010.

Non-Agency Issuance: Commercial, Residential
Eleven CMBS deals totaling $3.3 billion were issued in 2Q’10; four were re-REMIC transactions and the balance conduit/fusion or other types of deals. Net issuance continues to remain negative, as approximately $769.1 billion remained outstanding in non-agency CMBS end-June, a decline of 1.8 percent from 1Q’10 and 11.8 percent from the peak at 4Q’07.

The TALF for new CMBS closed quietly at the end of 2Q’10, with the three second quarter auctions attracting no bids for financing. To date, the November 2009 TALF auction remained the only auction with bids for financing new CMBS.

In the non-agency RMBS space, the first jumbo RMBS in two years closed at the end of April (Sequoia Mortgage Trust 2010-H1, “Redwood”), but the market remained otherwise quiet. Notably, Markit launched its PrimeX indices at the end of April, a set of CDS indices designed to provide synthetic exposure to the non-agency RMBS market, previously only available in relatively liquid form for the subprime (ABX) and CMBS (CMBX) markets. According to DTCC data at end-June, trading has been active for PrimeX in the two months following launch, with more that 350 contracts based on the PrimeX.ARM indices and nearly 500 on PrimeX.FRM for gross notional amounts of $4.8 billion and $9.1 billion respectively ($1.3 billion and $1.4 billion, respectively, on a net basis).

Dodd-Frank Promises Further Changes to Mortgage Space
The Dodd-Frank Act, passed shortly after the end of the second quarter, mandated numerous studies and rule-making relating to financial regulatory reform. For the mortgage-related market, risk retention requirements of upwards of 5 percent of credit risk (unhedged) may be required, although certain carve outs are available in the mortgage market for “qualified residential mortgages.”

12 Fannie Mae, April 30, 2010, Fannie Mae Changes Criteria for Purchasing and Securitizing Adjustable-Rate Mortgages (ARMs)
13 Freddie Mac, February 25, 2010, Freddie Mac Announces That It Will Cease Purchases of Interest Only Mortgages
14 Fannie Mae, June 23, 2010, Fannie Mae Increases Penalties for Borrowers Who Walk Away
15 FDIC, Press Release, May 24, 2010, FDIC Closes on Sale of $233 Million of Notes Backed by Commercial Real Estate Loans
16 Markit PrimeX summary
17 For more information and detail, please see SIFMA’s Dodd-Frank Information page.
Asset-Backed Market & CDO

Asset-backed securities issuance in the second quarter of 2010 totaled $57.8 billion, a decline of 21.3 percent and 49.1 percent, respectively from 1Q’10 and 2Q’09. Second quarter issuance, similar to that in the first quarter, was led by the auto sector ($13.1 billion, or 51.1 percent of all issuance), followed by student loans ($3.6 billion), other ($3.4 billion), and credit cards ($3.1 billion).

Tightened underwriting standards and improved financial conditions of issuers, particularly auto finance companies, may ultimately benefit collateral performance, although the various new rules, proposed or to be implemented (e.g., FDIC safe harbor rules, SEC’s Reg AB proposals, the Dodd-Frank Act) will likely continue to hamper issuance for at least the remaining half of 2010. However, the performance of the underlying collateral in structured finance securities, however, remains correlated to U.S. unemployment, however temporary or structural it may be, as high unemployment generally means “depressed personal income, reduced consumer spending, and, consequently, higher consumer collateral delinquencies and losses.”

Global funded collateralized debt obligation (CDO) issuance totaled $819.7 million in 2Q’10, a decline of 65.4 percent and 56 percent, respectively, from 1Q’10 and 2Q’09. Two cashflow deals were issued in the second quarter: one arbitrage deal comprised of high yield loans, the other a balance sheet deal comprised of other assets.

Dodd-Frank Act, Regulation AB Changes

The Dodd-Frank Act mandated numerous rule-making procedures and studies relating to the asset-backed market. In particular, rules regarding risk retention, the use of representations and warranties, credit rating agencies, and requirements for reporting, disclosure, and registration are all heightened, which has played out to some extent shortly after the bill signing in the ABS primary market. On May 3, the SEC issued a very significant and lengthy regulatory proposal that would amend fundamental aspects of Regulation AB, Rule 144A as it relates to MBS and ABS, and many other securities regulations. Certain of the provisions contained in the Dodd-Frank Act, however, overlap those in the SEC’s rule proposal, and it remains unclear how these will be harmonized.
Corporate Bond Issuance Fell in 2Q’10; High Yield Issuance Soared

Total corporate bond issuance was $154.6 billion in 2Q’10, a 29.3 percent decline from the $218.8 billion issued in 1Q’10, and a 36.5 percent decline from the $243.6 billion in 2Q’09. This decline was concentrated in investment grade (IG) bonds, which contracted by 43.3 percent y-o-y. Year-to-date, however, high yield (HY) issuance has doubled compared to same period in 2009 and is on pace for a record breaking year as issuers took advantage of both low rates and open markets.

According to the NASD’s TRACE data, IG average daily trading volume decreased to $10.3 billion end-June from $12.4 billion in end-March and $14.1 billion end-June 2009. The HY average daily trading volume fell to $4.2 billion end-June, down from $5.9 billion end-March and $5.2 billion end-June 2009.

Spreads Widen In 2Q’10; Yields Below 5-Year Average

Spreads for AAA- and BBB-rated corporates continued to tighten briefly in 2Q’10 until end-April (67 and 138 bps, respectively), and then widened due to eurozone sovereign debt concerns as investors sought safety in Treasuries. Spreads for AAA- and BBB-rated corporates ended wider at 90 and 159 bps end-June, respectively, compared to 75 and 147 bps end-March and 101 and 268 bps end-June 2009.

Yields, however, for AAA- and BBB-rated corporate bonds continued to fall in 2Q’10, ending at 387 bps and 456 bps, respectively, from 459 bps to 531 bps in 1Q’10. Yields remain approximately 22 percent lower than the 5-year average for both AAA- and BBB-rated corporates (490 and 588 bps, respectively).

Credit Metrics Improve Slightly

According to S&P, year-to-date 42 issuers have defaulted worldwide, 30 of which were from the U.S. Distressed exchanges continued to remain one of the primary reasons for default, with a third of all U.S. defaults stemming from distressed exchanges.

Downgrades continued to slow slightly in 2Q’10, with the upgrade to downgrade ratio ending at 93/53 in 2Q’10, from 57/62 in 1Q’10. Downgrades by number and dollar amount were from consumer-oriented sectors: media and entertainment (10 downgrades, $37.8 billion), followed by retail/restaurants (5 downgrades, $22.7 billion). While the 12-month trailing HY default rate has declined to 5.99 percent end-June from 9.99 percent end-March, S&P noted that the continued overhang of leveraged corporate issuers could make default risk beyond the one-year horizon increase.
Equity markets fell in the 2Q’10 by an average of 11.2 percent from their end-1Q’10 levels. Among the major indices, the Dow Jones Industrial Average (DJIA) fell 10 percent in the quarter, with the NASDAQ declining 12.1 percent and the S&P 500 falling 11.6 percent.

**NYSE & NASD Daily Share Volume Up**
The New York Stock Exchange’s (NYSE) 2Q’10 average daily share volume rose to 2.2 billion shares from last quarter’s 1.7 billion shares, though still below the 2.4 billion average daily share trading volume in 2Q’09. The 2Q’10 increase is significant, however, because it marks the return to the 2 billion plus share level for the first time since 2Q’09. The NYSE’s average daily dollar trading volume increased to $57.7 billion from the previous quarter’s $45.5 billion, and was also above the 2Q’09 daily average of $50.0 billion.

NASDAQ’s average daily share trading volume increased to 2.5 billion shares in 2Q’10 from 2.3 billion shares in 1Q’10 and unchanged y-o-y. NASDAQ’s average daily dollar trading volume increased to $57.7 billion from last quarter’s $50.6 billion, and experienced a 36.7 percent improvement y-o-y.

**Short Interest Rises**
NYSE short interest stood at 14.1 billion shares at the end of 2Q’10, a slight increase from last quarter’s 13.9 billion, but below 2Q’09’s close of 15.6 billion.

**Market Structure: Circuit Breaker Changes**
On May 18, 2010 the U.S. Securities and Exchange Commission (SEC) released the preliminary results from its study of the causes of the May 6 “Flash Crash,” during which the equities and futures markets plunged five percent in a span of less than ten minutes. In its report, the SEC alluded to several possible factors that could have caused the dip and quick recovery: a lack of liquidity, the common use of “stub quotes,” the use of market orders and stop-loss market orders, a link between the decline of equity indices and the selling off of individual securities.22 In response to the “Flash Crash,” the SEC and FINRA adopted a stock-by-stock circuit breaker on June 10, which will temporarily stop trading on any stock in the S&P 500 if its price moved by 10 percent or more in a five minute period.23 On June 30, the SEC announced that it was also considering expanding the rule to apply to all Russell 1000 index securities and certain ETFs.24

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Equity Underwriting
Total equity underwriting rose slightly in 2Q’10 from 1Q’10 in total volume ($47.9 billion up from $41.1 billion), although it fell by number of deals (249 from 274). Compared to the record setting issuance volume in 2Q’09, however, total equity underwriting decreased significantly, down 58.8 percent in dollar volume, but only 9 percent in deal number.

Equity underwriting still remained above the 5-year average in terms of both number of deals and dollar volume for the fifth consecutive quarter. Total number of deals beat the average by 27 percent while dollar volume was slightly above the 5-year average by 3 percent.

IPO Market Uptick
“True” initial public offerings (IPOs), which exclude closed-end fund IPOs, rose to $5.1 billion on 39 deals in 2Q’10 from $4.8 billion on 33 deals in 1Q’10. However, the average deal size again fell quarter-over-quarter, this period by 9.4 percent. The trend of significant year-over-year improvement continued, with 226 percent increase in deal value and a tripling in deal number compared to the same quarter last year.

Secondary Offerings Also Rises
Secondary market issuance increased in 2Q’10, totaling $38.1 billion, up 25 percent from $30.5 billion last quarter, although the number of deals fell to 199 from 224 last quarter. The average deal value for the quarter was $191.4 million, up to from last quarter’s $136.3 million. Secondary issuances were down sharply from the 2Q’09’s $108.3 billion total on 256 deals, the highest value of the decade. The 2Q’09 total, however, which resulted from massive capital raising campaigns by financial institutions as a result of the Supervisory Capital Assessment Program (SCAP), should be viewed as an outlier; the decade’s quarterly average is $28.3 billion.

U.S. M&A Increases
Announced U.S. mergers and acquisitions (M&A) dollar volume increased 18 percent to $199.9 billion in 2Q’10 from $169.4 billion in 1Q’10. Deal volume, however, decreased to 1,767 deals from 1,916 deals.

The most active M&A sectors were financials, telephone-integrated, and oil exploration and production, in size order. The largest deal was the acquisition of Qwest Communications International by CenturyLink Inc for $22.2 billion.25

25 Bloomberg. MAATUS Index. M&A Transaction Value US.
P/E Ratio Falls Slightly
The S&P 500’s P/E ratio averaged 16.4 in 2Q’10, falling 9 percent from the preceding quarter’s average of 18, and still below the inclusive 5-year average of 17. The 2Q’10 ratio is still higher than its 14.4 average a year ago of in 2Q’09. The decline was partly a sign of apprehension among equity investors due to high volatility and economic uncertainty throughout the second quarter, which drove prices lower. Higher earnings in the quarter put also a downward pressure on the ratio, with earnings per share in the S&P 500 index 14 percent higher than in 1Q’10.

Buybacks Rise on NYSE, Fall on NASDAQ
The number of corporate share repurchases increased on the NYSE to 112 deals totaling $78.3 billion in 2Q’10, compared to the 107 buybacks totaling $89.1 billion in 1Q’10. On the NASDAQ, the value of buybacks substantially rose to $23.8 billion on 88 deals in 2Q’10 from only $8.9 billion on 93 deals the previous quarter. Both NYSE and NASDAQ have seen marked increases in stock repurchases over the last year, when the lowest amount of activity in the decade was recorded in 2Q’09, with only 1 buyback on the NYSE and none on the NASDAQ.

CBOE VIX Rises Sharply
The Chicago Board Options Exchange Index (VIX), a popular measure of market volatility, closed the quarter at 34.54, nearly double the end-1Q’10 level. The average value over the first quarter was 26.25, higher than the previous quarter’s average of 20.15. The VIX did not come near its credit crisis high of 60.9, but still rose continuously for every month of the quarter. Volatility rose this past quarter, unsurprisingly, as investors confronted a sovereign debt crisis in Europe, rising concerns over a double-dip recession in the US, an equity market “flash crash” in early May, and the final drafting and passage of financial reform regulation.

Venture Capital on the Rise
Venture capital investment increased significantly in 2Q’10, bouncing back from a particularly weak first quarter. Total venture capital investments increased 34 percent to $6.5 billion on 906 deals, the highest level since 2Q’08.

The software and biotechnology industries were the largest and second largest industries, respectively, in venture capital investments. In 2Q’10 there were 229 deals in the software industry, generating slightly over $1.0 billion. The biotechnology industry and medical device and equipment industry, which suffered last quarter from the uncertainty of the then looming healthcare reform, recovered strongly in 2Q’10. Total venture capital investment in biotechnology increased 57 percent to $1.3 billion from $824 million last quarter, while the medical device and equipment industry increased 46 percent to $755 million from $517 million last quarter.
Derivatives in the Second Quarter\textsuperscript{26}

Derivatives gross notional outstanding at the top 25 U.S. financial holding companies remained unchanged in 1Q’10 at $293.0 trillion; the five largest financial holding companies accounted for slightly over 95 percent of that total. On a y-o-y basis, gross notional outstanding has remained virtually unchanged, increasing slightly from $291.5 trillion in 1Q’09.\textsuperscript{27}

Notional Value Breakdown

Interest rate swaps continue to be the largest derivative category, at $170.7 trillion or 58 percent of all derivatives on a gross notional basis, while forwards, options, futures, and credit derivatives making up significantly smaller subsets. Interest rate and foreign exchange (forex) swaps have recently taken a larger share since lows at the end of 2008, while credit and equity-linked swaps have shrunk in relative proportion.

Credit Derivatives

In the wake of the financial crisis, the credit derivatives market experienced a steep downturn in the gross notional outstanding of credit default indices and a nominal decrease in the gross notional value of credit default tranches. However, the gross notional outstanding of single name credit default swaps (CDS) rose from 2008 to 2009 by $300 billion as the value of other credit derivatives (credit default index and tranche) fell.\textsuperscript{28}

The increase in single name CDS contracts and the gross notional value of outstanding single name CDS is due in part to debt concerns of eurozone sovereigns: gross notional outstanding for sovereign single name CDS increased over 1Q’10 in absolute terms, as well as relative to total gross notional outstanding for CDS.

Dodd-Frank Act Derivatives Impact

The recently signed Dodd-Frank Act contains many provisions impacting the derivatives markets. Although the specific application of the derivatives section of the Dodd-Frank Act has been left mainly to the SEC and CFTC, there are a number of provisions that are expected to have profound impacts on these markets.\textsuperscript{29}

This section was written by William Beshears and Jonathan White.
Primary Loan Market: Second Quarter Review

Primary loan market volume reached a total of $1.26 trillion during the first half of 2010, up 36 percent compared to the $976.1 billion raised during first half of 2009. Much of this growth took place during the second quarter with volume having climbed 52 percent to $723.3 billion from $476.9 billion in 2Q’09.

Though a long way from its pre-credit crisis high, leveraged loans recorded their third consecutive quarterly increase in 2Q’10 ($178.6bn). Companies looking to refinance their pre-existing debt accounted for 42 percent ($74.5 billion) of leveraged loan volume, the highest proportion on record. Eight out of the 10 largest sectors by leveraged refinancing volume saw increases of at least 29 percent versus 2Q’09 levels. The oil & gas sector led the way having captured 13 percent of all leverage refinancing in 2Q’10, up substantially from only 3 percent in 1Q’10.

Refinancing facilities also played a vital role in the investment grade market with volume having reached $232.2 billion in 2Q’10, up 282 percent from just $60.7 billion in 2Q’09. This marked the second highest quarterly volume on record and accounted for 43 percent of total investment grade loan volume. This advance however was not seen in all parts of the globe. Europe and North America for example saw volume rise 188 percent and 275 percent respectively, while Japan’s investment grade refinancing loan volume fell 78 percent to $1.9 billion, the lowest level recorded since 2002.

Bank and financial borrowers continued their re-entrance into the credit markets having taken out a total $99.2 billion in syndicated loans in 2Q’10. It was the fourth straight quarterly increase which began in 2Q’09, at which time volume stood at $33.8 billion. Corporate borrowing also saw substantial expansion during this same period, up 45 percent to $602.8 billion from $415.8 billion.

Pricing on syndicated facilities continued to inch its way lower with leveraged loans averaging 394 bps in 2Q’10, down from 416 bps in 1Q’10. It was the first time margins on leveraged loans fell below the 400 bps mark since 4Q’08 (339 bps). Investment grade pricing also fell to 184 bps from 203bps during this same period.

As of the end of 2Q’10, and excluding revolver facilities, there is an expected $362.5 billion in syndicated primary market loans due to mature by the end of this year and $829.3 billion due to mature by the end of 2011. Volume for maturing loans is expected to hit a peak level of $934.6 billion in 2013.

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