



RICHMOND CAPITAL MANAGEMENT  
*Experience, Knowledge, Service*

Third Quarter 2009

*Interest Rate Trends*

Quarterly Newsletter

Interest rates reversed course from the second quarter and declined in the third quarter of 2009. In the ongoing battle between the forces of inflation and deflation, deflation (and the fear of further deflation) won out for the period. The yield curve flattened with the 2 year Treasury note declining 16 basis points in yield, while the 10 year note fell 22 basis points and the 30 year bond fell 28 basis points.

Index Returns			
	Qtr.	1 Yr.	3 Yr. Ann.
<b>Barclays Aggregate</b>	3.74%	10.56%	6.41%
<b>Barclays Govt/Credit</b>	4.16%	11.46%	6.25%
<b>Barclays Int. Govt/Credit</b>	3.25%	10.01%	6.15%

Source: Barclays Capital

As of September 30, 2009

Treasury Market Yields		
	9/30/09	6/30/09
<b>2 Year</b>	0.95%	1.11%
<b>5 Year</b>	2.31%	2.56%
<b>10 Year</b>	3.31%	3.53%
<b>30 Year</b>	4.05%	4.33%

Commodities		
	9/30/09	6/30/09
<b>Oil (\$ bal)</b>	\$76.91	\$77.83
<b>Gold (\$/oz.)</b>	\$1,027.60	\$950.10
<b>CRB Index</b>	259.39	249.96

Spread Product (Spread to 10 Yr. Treasury)		
	9/30/09	6/30/09
<b>10 Yr. "A" Corp</b>	+1.89%	+2.72%
<b>GNMA Current Coupon</b>	+0.94%	+1.05%
<b>10 Yr. "AA" Municipal</b>	-0.58%	-0.08%

**Inflation and the Federal Reserve**

The Federal Reserve's favorite inflation barometer, the PCE Core Deflator, was reported at 0.1% on October 1st, which converts to a mild year-over-year reading of 1.3%. "Inflation under control" has also been evidenced by the CPI Index. At last reading (September 16th), the CPI printed at 0.4%. On a year-over-year basis, CPI is in negative territory at -1.5%, as the index works through the energy price spikes of last year. CPI Ex-Food and Energy year-over-year is 1.4%. Tame inflation data has allowed the Federal Reserve the latitude to continue to keep short-term rates low. In the September FOMC statement, the Federal Reserve stated that they expect to hold the Fed Funds rate near 0% yield "for an extended period." With regard to quantitative easing, the Fed will wind down Treasury purchasing at the end of October but will maintain MBS purchasing through March of 2010.

**Economic Indicators**

Although pricing pressures are absent, some economic indicators have begun to show life.

- The **Case-Shiller Home Price Index** rose 1.61% in July which is the third consecutive month of increase. Year-over-year the index is still down -13.3%, but the steep decline witnessed over the last three years has halted.
- U.S. **employment** statistics have been ugly, but recently have been falling at a decreasing rate. The Nonfarm Payroll data fell -263,000 jobs in September compared to the -600,000 declines in the spring of this year. The

Unemployment Rate rose 0.1% to the high level of 9.8%.

- Final **GDP** for the 2nd quarter was reported at -0.7%. Economic growth as measured by GDP has been negative for 4 quarters, but government stimulus is expected to turn the indicator positive in the 3rd quarter. According to many economists, stimulus programs such as "cash for clunkers" are temporarily supporting the consumer. Evidence can be seen in the October 1st **Personal Income and Spending** figures which were positive at 0.2% and 1.3% respectively.

- Conference Board **Consumer Confidence**, however, fell in September to 53.1 from 54.5. This series indicates ongoing worries about unemployment and future economic growth.

**Conclusions**

Economic data is still very mixed and the financial markets are sending conflicting signals. The stock market reflected economic optimism, putting in an outstanding 3rd quarter performance with the S&P 500 up +15%. Meanwhile, the long end of the bond market has also had a significant rally which might indicate the possibility of a slowdown. This is not the first time that the two markets offer seemingly opposite forecasts.

# Capital Structure Matters

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**Over the past year, we experienced the most tumultuous financial markets since the great depression. During this period, capital and liquidity for companies were paramount.** This challenging environment forced corporate treasurers to be more creative in raising capital. For instance, banks were initially only able to issue debt backed by a government guarantee (through the TLGP program). As liquidity gradually improved, banks were again able to issue debt and more recently preferred and common equity. Additionally, the government has also stepped in through the Troubled Asset Relief Program (TARP) and purchased preferred equity in a number of financial companies. **The capital structure has gotten a lot more complex with the issuance of these forms of capital.**

**The recent failure (or near failures) of several large institutions demonstrates that recovery values for investors depend heavily on where investors stand along the capital structure.** Common equity holders are at the bottom of the capital structure and stand to lose most of their investment in a bankruptcy or forced takeover. Following common equity in the capital structure is preferred equity which trades per share and has a stated dividend rate. **Debt securities are the highest in the capital structure with regards to recovery and can be broken down into subordinated debt, senior debt and secured (collateralized) debt.** The secured debtors have the first right to assets of a company in the event of bankruptcy because the debt they hold is backed by specific collateral. Senior and then subordinated debt holders come next in line for any unencumbered assets that a bankrupt institution still possesses.

Looking at recent corporate events where investors lie along the capital structure becomes increasingly important. As an example, Fannie Mae and Freddie Mac, the two largest issuers of residential mortgages in the United States, were put into conservatorship in September 2008. In the process of the “takeover” by the U.S. government, all common and preferred shareholders lost most, if not all, of their value. However, both senior and subordinated bondholders were protected and those bonds are now actively trading at very tight spreads to U.S. Treasuries. In another instance, Washington Mutual’s demise in the fall of 2008 was unique in the fact that the FDIC accommodated the acquisition of the bank by JP Morgan. All depositors of the institution were protected but all shareholders were effectively wiped out. Interestingly, Washington Mutual bond holders were left with some value due to holding company assets held outside the bank. Consequently, the senior holding company debt is trading at 85% of face value and subordinated holding company debt is trading substantially lower at around 65% of face value. The debt trades at a discount as investors continue to grapple with recovery value of the residual bankrupt institution.

When liquidity in the capital markets evaporated at the end of last year, government officials became increasingly aware of the need to protect and free capital on companies’ balance sheets. To calm investors’ fears, the Federal Reserve purchased preferred equity in numerous companies through the government program TARP. **As the markets have settled and liquidity improved, market participants are taking stock of how the financial system treated different investors. Bondholders have been reassured that their higher position in the capital structure indeed makes them a safer asset class than equity capital during financial crisis. The bigger the financial crisis—the bigger the reminder that capital structure matters.**