Fixed Income Market Commentary

June 2011

What Happens in Vegas…

Key Points:

- I finally made it to Las Vegas
- A history of gaming financed with junk bonds
- Greece is back in the news headlines

Better late than never, I guess. In May I made my first trip to Las Vegas; one that I don't think I'll ever forget. Let me state right off the bat that, other than staying up way past my normal bedtime, nothing silly or regrettable happened; after all, I am the always responsible "bond guy." People say that New York City is the city that never sleeps, but as far as I can tell that designation should belong to Vegas.

As a bond guy, the real eye-opener for me was the vast collection of casinos and entertainment venues, all of which I knew had been financed by the bond market. Las Vegas' Strip has been almost entirely financed and built with junk bonds.

Some of those bonds have done okay while others have not. For example, the Stratosphere Hotel (where I "tested" the "Insanity" ride with a few colleagues high above the city) was financed by bonds that ended up in default. Caesars Palace, a hotel complex with a long history and many ownership changes, was taken private for more than $30 billion a few years ago with financing provided by junk bonds. The owners, who have combined it with Harrah's, now want to sell stock to raise cash so they can reduce the company's high level of leverage (borrowed money). Across the street, the $1.6 billion Bellagio Resort, owned by MGM Resorts, was also financed with junk.

Repaying all those junk bonds, or simply keeping up with the interest payments is a tall order during a recession, which is why so many gaming companies have had trouble over the past couple of years. But today, from my vantage point, Las Vegas appears to be recovering from some of the recession's ill effects, though the housing market remains moribund at best.

With the gaming sector such a big part of the high yield bond universe, I called Sandy Rufenacht, the manager of the Aquila Three Peaks High Income fund. Few people know the high-yield market better than him. "People want to have fun", he told me as we discussed how resilient Las Vegas is. "As an investor, the gaming sector is attractive because of the very predictable level of cash flows and good collateral. The high barriers to entry and government oversight make this a good area to invest in."

Rufenacht does have some concerns about the fast moving cycles for this kind of entertainment. Right now, he says the Los Angeles visitors making the 300-mile drive across Route 15, must cope with gas selling at more than $4 per gallon, which can take a bite out of their spending at the casinos. Of course, the casino operators would prefer that money to be spent there instead.

You win some, you lose some. Las Vegas, a city built by junk bonds, appears alive and well. How investors in Sin City bonds will fare is still to be seen. A little luck will probably help, though.

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The **Municipal bond** market was the top performer in May as shown in our data box below and that asset class has now pretty much recovered from the beginning of the year swoon over misplaced implosion fears. Contributing to the performance is a supply shortage as new issue volume continues to shrink dramatically versus year ago levels, down 40%+. The bottom line is that state and local governments plan on spending less and that means less borrowing. As a result munis have lost some of their cheapness compared to other options. However, they do remain attractive on a relative to Treasury basis. One segment of the muni market that stands out with outsized performance is BABs **- Build America Bonds**. I have not included them in our box, but the BABs market was on-fire again last month with a return of 4.4%. YTD these taxable munis are up an eye-catching 11.6% These are high quality securities overall, but they do carry a bit more market risk with their long average life judging by the index at 28 years+.

Greece has returned to the front pages of the bond market this past month and it is not a success story from where we were a year ago when that nation's first bailout was orchestrated. The nation is back in need of additional aid. The country was downgraded again, and the yield on Hellenic 10-year bonds is hovering around 16%. The country's 2-year bonds trade at levels around 24%, reflecting the risk that the country will not be able to pay investors back in full or on time. This reminds me of one of my favorite bond market quips: the yield is always highest right before there is no yield at all. I'm not trying to stir up the pot here, but the issue boils down to this: can Greece grow out of its own problems with a combination of austerity measures (very unpopular) and intervention? The louder officials say they won't restructure (meaning a haircut to bond investors in one form or another) the more I expect to see a restructuring. It is not as easy as just ripping the band aid off and restructuring. Even though few can claim to be overly surprised if they do a restructuring, there will still be serious repercussions around the region and other area economies negatively impacted. Stay tuned.

Barclays Fixed Income Index Returns Through 5/31/11

	Duration	May	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.32	0.01%	0.09%	0.22%	0.37%	2.44%
US Treasury Index	5.45	1.56	2.57	5.87	-3.57	13.74
US TIPS Index	4.88	0.31	4.97	6.31	11.41	-2.35
US Aggregate Bond Index	5.19	1.31	3.02	6.54	5.93	5.24
US Govt / Credit Index	5.61	1.46	3.09	6.59	4.52	5.70
US Credit Index {A2}	6.50	1.53	4.17	8.47	16.04	-3.08
US High Yield Index {B1}	4.33	0.49	6.01	15.12	58.21	-26.16
Caa component	3.49	0.22	7.12	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.43	1.30	4.30	12.84	34.23	-14.75
Municipal Index	8.41	1.71	4.06	2.38	12.91	-2.47
Municipal Index - 5 Year	3.85	1.21	3.13	3.40	7.40	5.78

Source: Barclays Capital

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