

Fixed Income Markets Overview & Outlook

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President

Mr. Henderson established Cavanal Hill Investment Management's (Cavanal Hill) fixed income philosophy and process in 1993 while serving as the firm's Director of Fixed Income Strategy and as a Portfolio Manager for the taxable and tax-exempt fixed income and money market strategies. Prior to joining Cavanal Hill, Mr. Henderson was the Head Taxable Fixed Income Trader for Bank of Oklahoma's Capital Markets group. Mr. Henderson received a Bachelor of Business Administration in Finance from Southern Methodist University in 1989.

Keys to Watch

- U.S. economic data
- Europe's sovereign debt crisis
- Municipal bond issuance

Q: How did the bond market perform during the quarter?

A: All major sectors of the investment-grade U.S. bond market posted positive results during the third quarter, bolstered by a flight to quality and a major selloff in equity markets. In this climate, the broad bond market benchmark—the Barclays Capital U.S. Aggregate Bond Index—returned 3.82%, compared with a nearly 14% decline for the S&P 500 Index. Economic growth slowed, recession

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the Barclays Capital U.S. Treasury Index. Longer-term Treasuries fared particularly well, as the Federal Reserve (the "Fed") launched another stimulus program ("Operation Twist") aimed at driving down long-term interest rates. For example, the

total return on the 30-year bond topped 31% for the quarter. Credit-sensitive securities generally lagged the broad bond market average, while high-yield corporate bonds declined more than 6% due to their correlation with the stock market.

Treasuries, given the rapid yield declines during the quarter. As a result, yields on municipals were particularly attractive relative to Treasuries. Many pundits believe the market may have moved into a "new normal" with regard to the yield relationship between municipals and Treasuries. With nominal yields unusually low in both markets, investors may be able to purchase municipal bonds offering the same yields as a comparable-maturity Treasuries. Such environments historically have presented good buying opportunities.

September represented the sixth-straight month of positive returns for the municipal market, bolstered by strong demand and light supply. Supply remains approximately 40% lighter in 2011 compared with 2010. Issuers bringing bonds to the market are being rewarded with historically low borrowing rates, which translate to interest cost savings.

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fears re-emerged, the United States lost its stellar long-term credit rating from Standard & Poor's, and Greece came closer to defaulting on its sovereign debt, which, combined with the mounting debt problems in other European nations, put the entire European Union banking system at risk. These factors helped fuel a flight to quality that pushed U.S. Treasury yields to record lows and propelled the Treasury market's outperformance for the quarter, with a total return of 6.48% for

Q: How did the municipal market fare?

A: The municipal market had a strong quarter, as yields tracked the Treasury market and fell steadily throughout the period. Fixed-income investors generally shrugged off the U.S. credit-rating downgrade, and the flight-to-quality trade remained in play as economic uncertainty abounded. Yields dropped further after the Fed announced the details of "Operation Twist." Nevertheless, the municipal market had a difficult time keeping up with

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Q: What is your outlook for the fixed income market?

A: Looking ahead, interest rates, and inflation are likely to remain low in an environment of slow growth and overall economic uncertainty. In addition, the instability of European sovereign debt and the inability so far of policymakers to construct a solution to the mounting problem likely will add to the uncertainty. Against this backdrop, the risk aversion that characterized the third quarter may continue.

While it appears municipal bond investors will be facing a low-rate environment in the near future, municipal investors will be looking for buying opportunities if the supply/demand dynamic becomes imbalanced. The fourth quarter is

traditionally a time when issuers bring deals to the market. Greater supply means investors should be able to lock in attractive yields, given the larger selection of bonds.

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