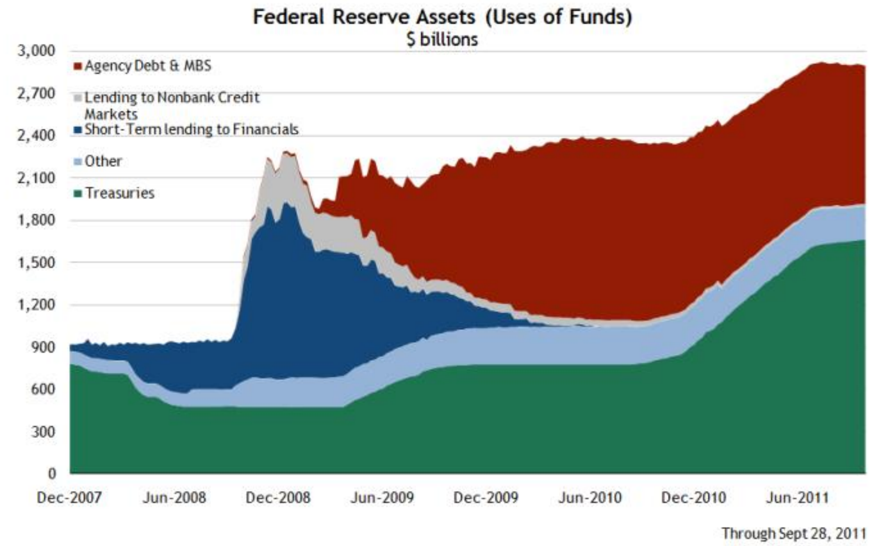
October 5, 2011

Financial Highlights

Federal Reserve

Summary

Between September 21 and September 28 the balance sheet decreased by $6.9 billion, remaining essentially unchanged at $2.9 trillion.

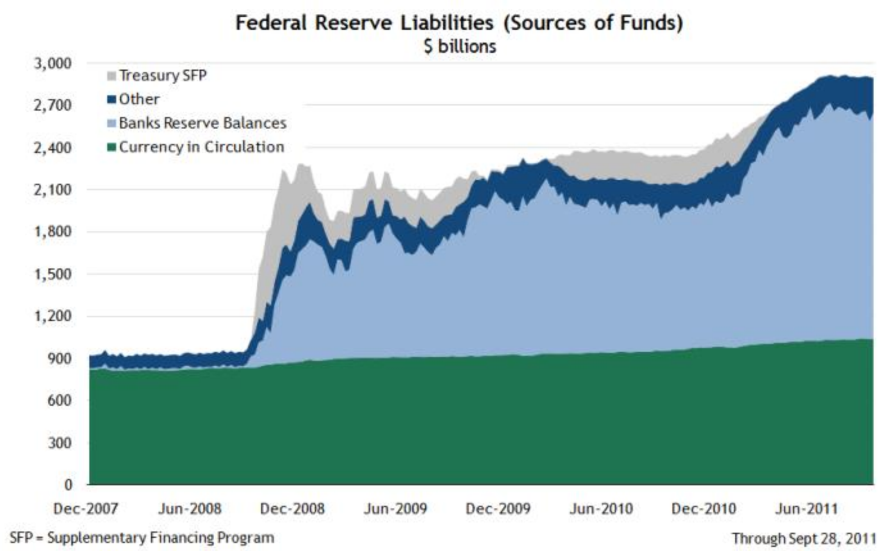


Source: Federal Reserve Board

- Treasuries increased $1.6 billion while agency debt and MBS decreased $8.4 billion.
- According to the New York Fed's tentative outright Treasury operation schedule, and in line with the newly announced maturity extension program, the desk plans to purchase approximately $44 billion in Treasury securities with remaining maturities of six to 30 years and sell approximately $44 billion in Treasury securities with remaining maturities of three years or less over the month of October.
- As of October 3, 2011, principal payments from agency debt and agency MBS will be reinvested into agency MBS instead of into Treasuries.

Bank reserve balances with the Federal Reserve increased $60 billion while nonreserve deposits with the Federal Reserve declined $33 billion, and the Treasury's general account with the Federal Reserve decreased $29 billion.

As of September 28, 2011, bank reserve balances are $1.6 trillion.



Source: Federal Reserve Board

Assets: Lending to nonbanks—TALF, CPFF, AMLF, and MMIFF; Short-term lending to financials—discount window, TAF, currency swaps, PDCF, and repos; Misc.—Maiden Lanes I, II, and III, credit to AIG, and other Fed assets. **Liabilities**: Other—Reverse repos, Treasury cash holdings, and deposits with Federal Reserve Banks other than reserve balances and excluding the Supplementary Financing Program.

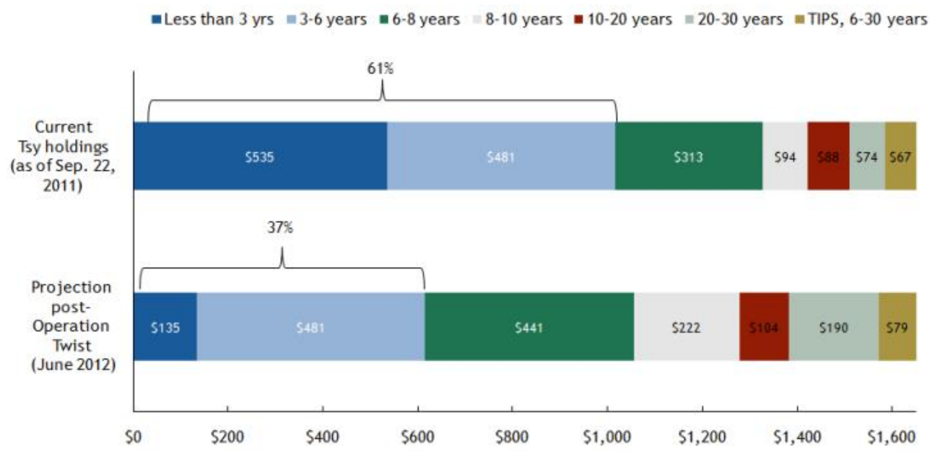
Federal Reserve

Summary

According to information regarding the maturity extension program, the Desk plans to purchase $400 billion in par value of Treasury securities with remaining maturities of six to 30 years and sell $400 billion with remaining maturities of three years or less by June 2012.

The result will be a Treasury portfolio of the same size but longer average maturity.

Federal Reserve Treasury Portfolio- Current and projected
$ billions



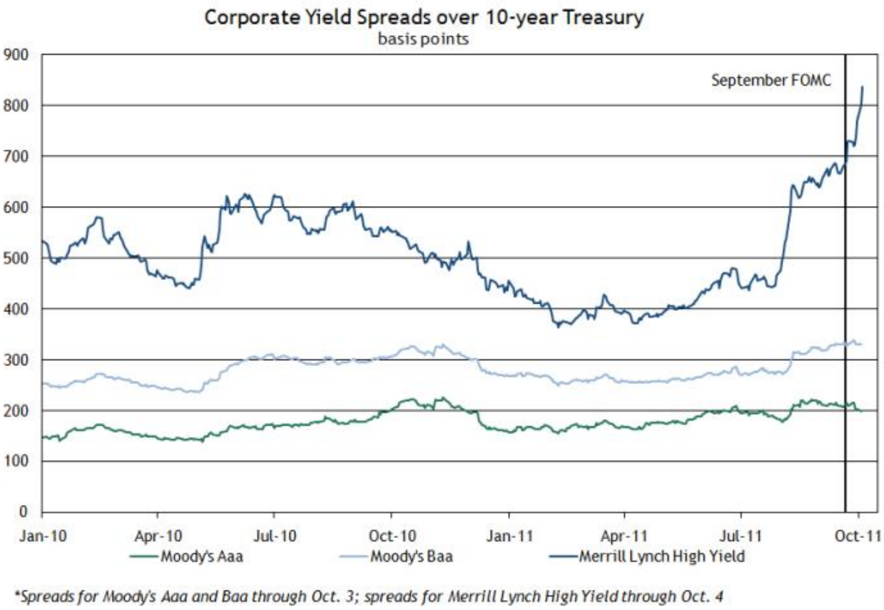
Source: New York Fed

- As of September 22, 2011, 61 percent of Treasury securities held by the Federal Reserve had maturities of fewer than six years (not including TIPS). After the maturity extension program concludes in June 2012, 37 percent are expected to have maturities of fewer than six years.
- Increasing demand for longer-term securities through this program is expected to drive down the interest rate on longer-term Treasury bonds. If the interest rate on longer-term Treasury bonds falls, the cost of long-term borrowing more generally could also fall, encouraging investment by consumers and businesses.

Corporate Bonds

Summary

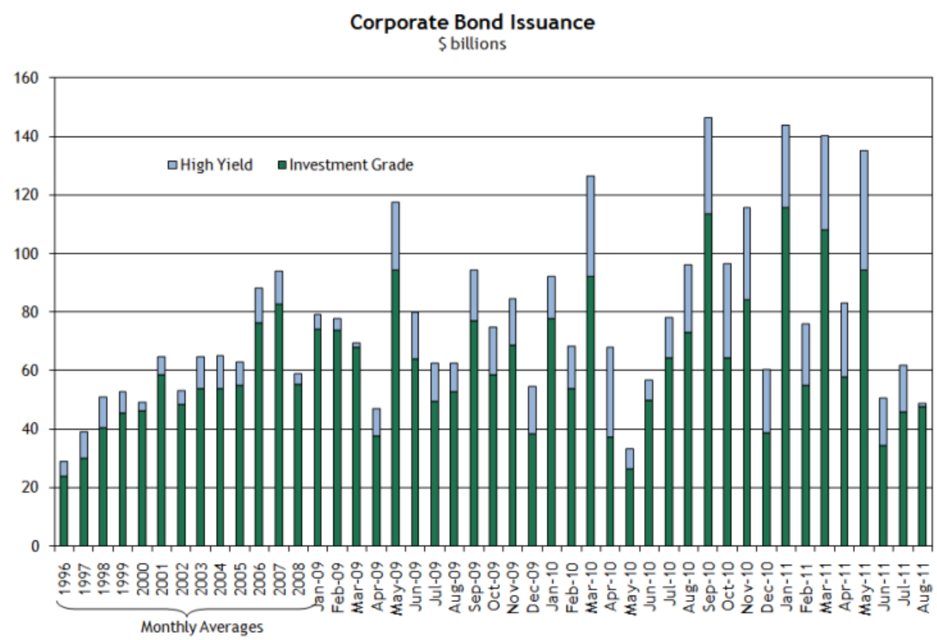
Since the September FOMC meeting, spreads on investment high-yield corporate debt have continued their recent climb, while those for investment-grade debt are either little changed or slightly improved.



Source: Merrill Lynch, Moody's, Federal Reserve Board

- Since the September FOMC meeting, corporate yield spreads for junk debt have continued to rise, with the Merrill Lynch High Yield Index up 147 basis points (bps) to 8.37 percent above the 10-year Treasury.
- Higher-quality bond spreads fared better, as Moody's Aaa–rated bond spreads *narrowed* by 16 bps (over the 10-year bond). The Baa-rated spreads were little changed, rising 5 bps.

U.S. corporations accessed the bond market for $48.5 billion in August, according to SIFMA. High-yield issuance has all but evaporated, nearing 2008 lows.



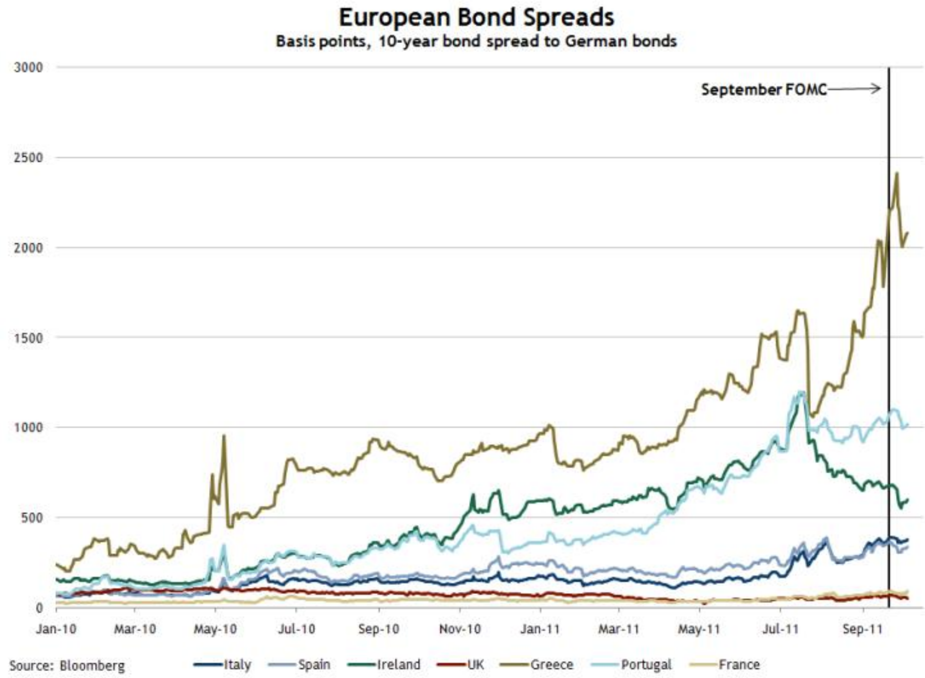
Source: SIFMA

- According to SIFMA, U.S. corporate bond issuance hit $48.5 billion in August 2011, and high-yield debt issuance was only $1 billion of that, the lowest amount of such issuance since the depths of the financial crisis in 2008.

Europe

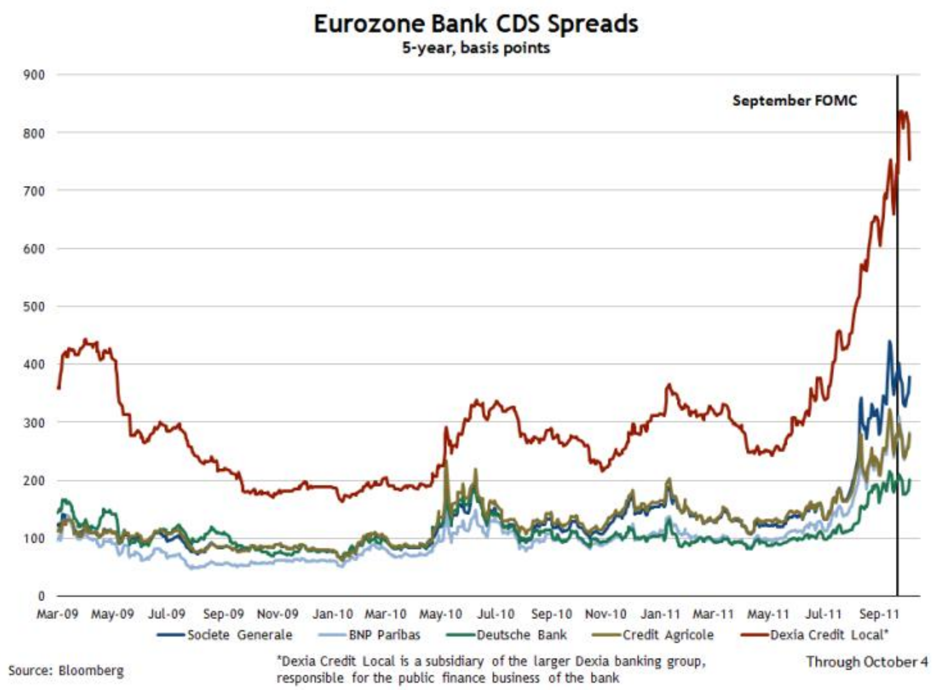
Summary

European bond spreads remain elevated for Greece and Portugal, have been trending downward for Ireland, and are so far contained for Spain and Italy.



- Since the September FOMC meeting, the 10-year yield spread between Greek and German bonds has tightened by 332 bps. The yield spreads for Portugal and Ireland have both also tightened, by 77 bps and 59 bps, respectively. Spanish spreads are relatively unchanged.

Several Eurozone banks, and in particular the Franco-Belgian bank Dexia, have experienced sharp widening in their CDS spreads (along with stock price declines) as worries mounted over their exposures to peripheral European sovereign debt as well as their ability to access short-term funding.

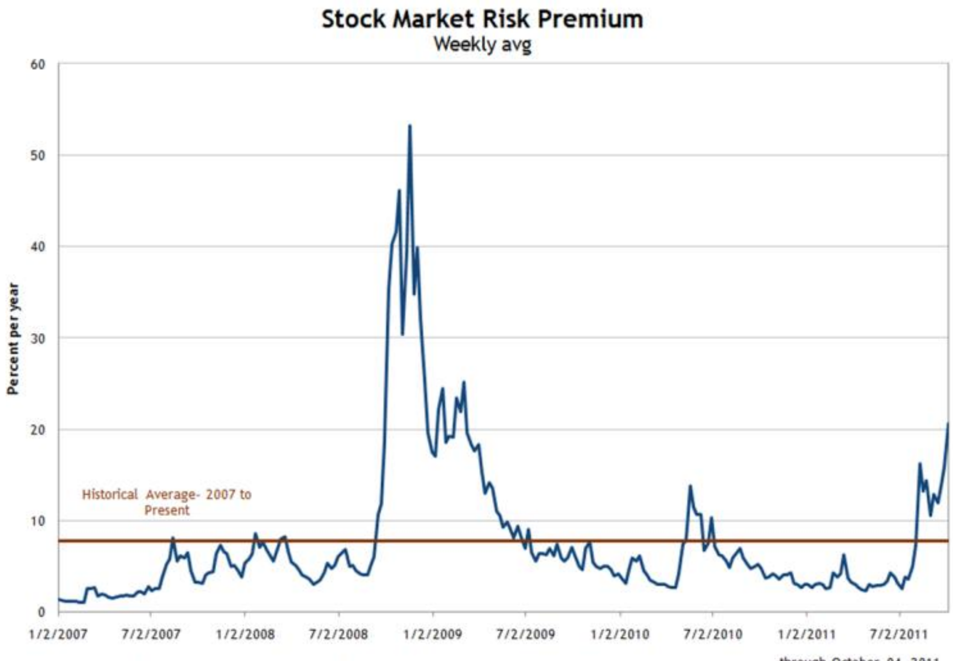


- Since September 1, the CDS spreads for several of French banks have widened noticeably. Through October 4, Societe Generale was up 95 bps, BNP Paribas was up 73 bps, and Credit Agricole was up 70 bps. Germany's Deutsche Bank has seen its CDS spread widen 30 bps over the same period.
- The Franco-Belgian bank Dexia has come under intense scrutiny regarding its ability to access short-term financing. This past week, the Belgian and French governments announced backstop support for Dexia, whose CDS spread has risen 148 bps since September 1.

Broad Financial Market Indicators

Summary

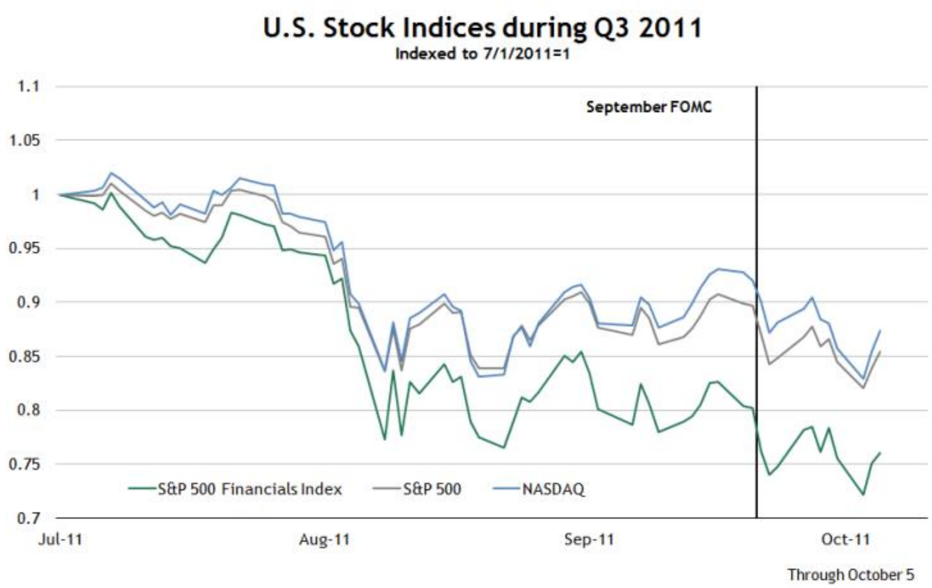
The premium that investors have demanded in order to invest in stocks has recently been rising, reflecting heightened risk aversion.



Source: FRB Atlanta Calculations, using VIX from Chicago Board Options Exchange

- In the most recent weekly average, the premium has risen to 20.66 percent per year, a noticeable jump from the previous weekly value of 15.94 percent and well above the average over the preceding four and a half years of 7.77 percent. This risk premium was the highest one since March 2009.

During the third quarter of 2011, U.S. stock indices broadly declined, with the S&P 500 and NASDAQ down more than 10 percent. The financials index of the S&P 500 was down more than 20 percent.



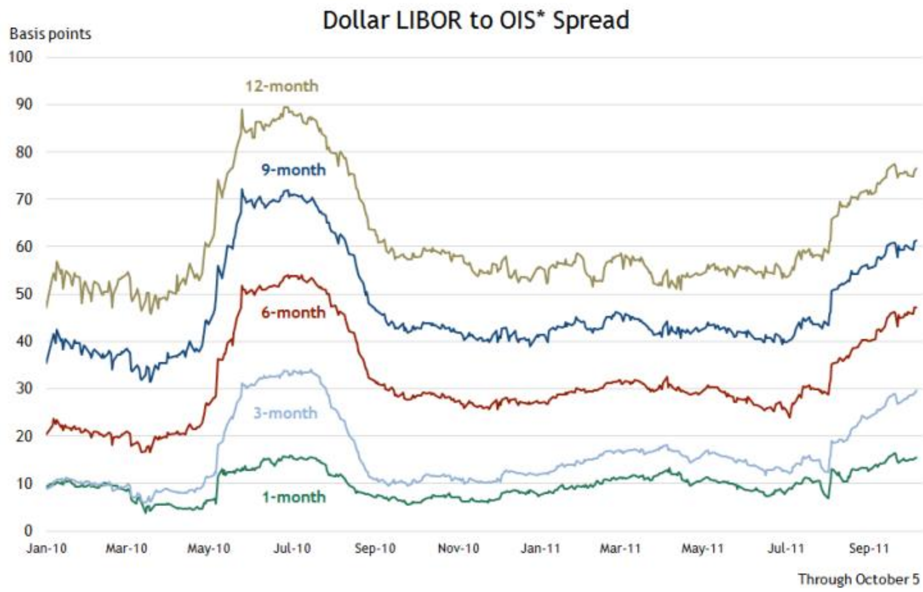
Source: Dow Jones, NY Times, WSJ

- Indexed to the start of the third quarter of 2011, U.S. stock indices broadly declined over the quarter. The S&P 500 was down 14.6 percent over the quarter (and through October 5, into the fourth quarter), led by the financials index declining 24 percent. The NASDAQ index was down 12.6 percent over the same period.

Broad Financial Market Indicators

Summary

LIBOR to OIS spreads for all tenors have been widening since late August. Since the last FOMC meeting, spreads are nearly 2-4 basis points (bps) higher for the three-to-12-month tenors and about 0.8 bps higher for the one-month tenor.

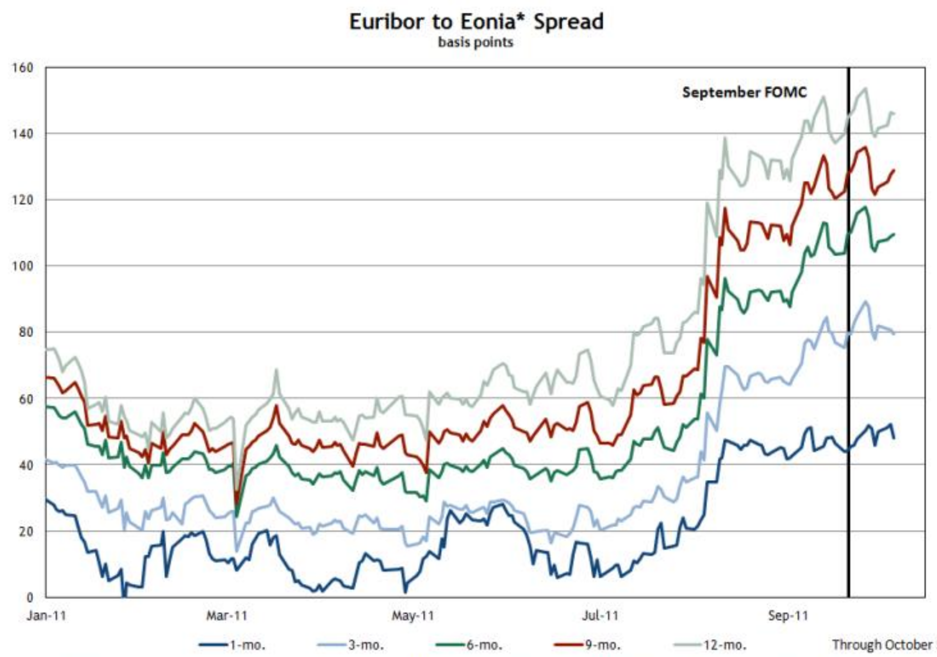


Source: British Bankers Association/Bloomberg

*Overnight Index Swap rate

- The LIBOR-to-OIS series shown above is denominated in U.S. dollars and reflects the spread between interbank lending rates offered and the overnight index swap (OIS) rate. The LIBOR panel used to create the rate is made up of 19 large international banks, based in the United States, Europe, and elsewhere. The OIS rate is a proxy measure for the expected effective rate on federal funds held over a given maturity.

The euro-based Euribor-to-Eonia spread has increased dramatically since early August. Over the past two weeks, however, the spread has been relatively flat for most tenors, except the one-month tenor, whose spread has risen 6 bps.



Source: Bloomberg

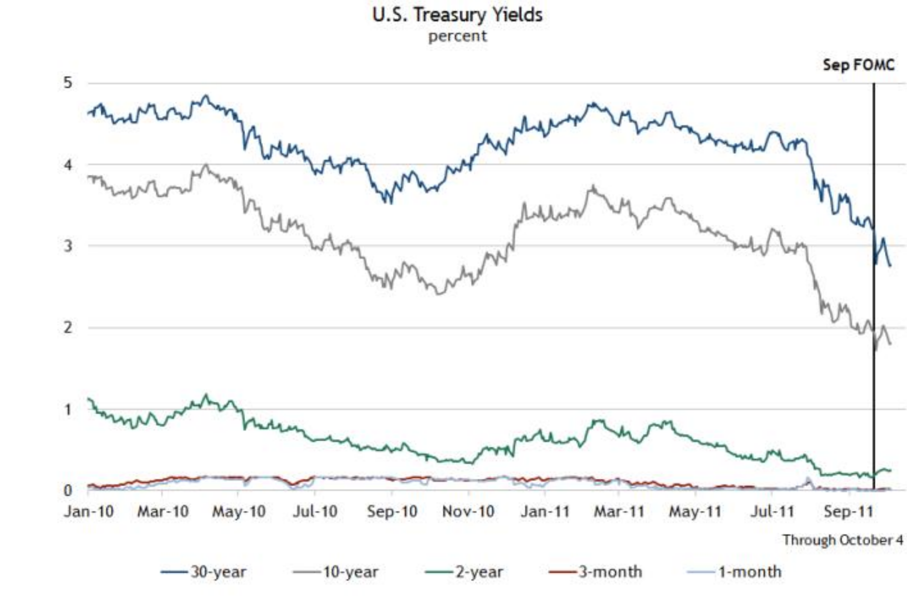
*Euro OverNight Index Average (EONIA) is the European-equivalent of the overnight interest rate

- The Euribor rates are offered interbank lending rates, denominated in euros and for a set of given maturities. The Euribor rate is determined by surveying 44 banks with the highest volume of business in the euro area, including four non-European banks. Eonia is the Euro Overnight Index Average swap rate on unsecured interbank lending in the euro area.

Broad Financial Market Indicators

Summary

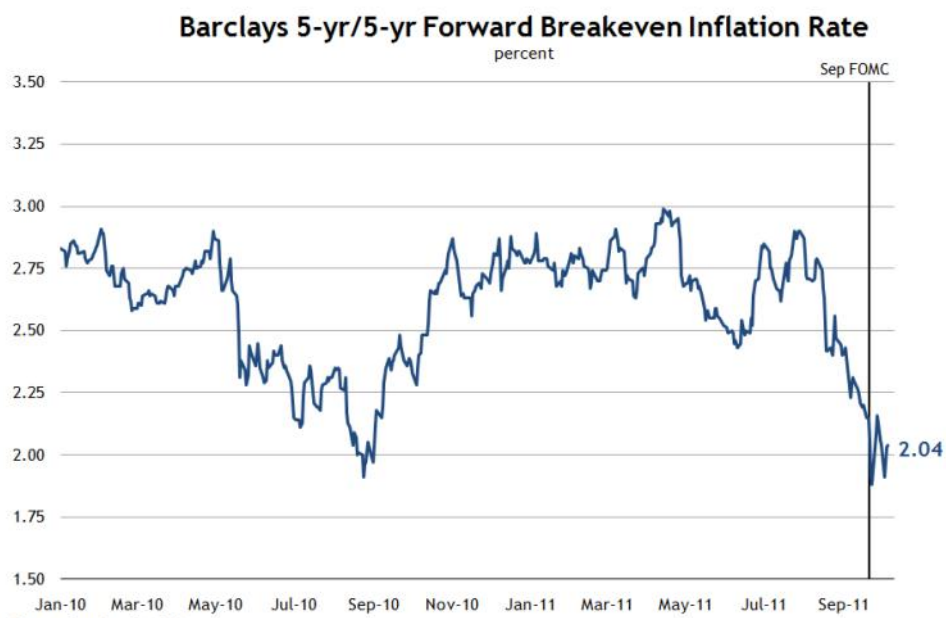
Since the September FOMC meeting, longer-dated Treasury yields have declined considerably.



Source: Federal Reserve Board/Haver Analytics

- Since September 21, the 30-year Treasury bond yield is down 26 bps to 2.77 percent, the 10-year yield is 7 bps lower to 1.81 percent, but the two-year yield is up 4 bps to 0.25 percent. The three- and one-month T-bill rates are both unchanged at 0.01 percent.

Breakeven inflation rates have moved sharply lower since late July.



Source: Barclays Capital

- Looking at one measure calculated by Barclays suggests investors see CPI inflation five to 10 years out as averaging about 2.04 percent as of October 5, 2011, which is about 10 bps lower over the week. Current breakeven rates are now close to recent lows of last year.