Development Company Finance LLC

Date: December 14, 2010

To: Certified Development Companies

From: Steve Van Order, DCFLLC Fiscal Agent

Subject: December 2010 SBA 504 Debenture Offering

On December 15, 2010, 550 twenty-year debentures totaling $302,536,000 will be funded through the sale of certificates guaranteed by SBA. Below are debenture pricing details:

Sale/Sale Comparison	Treasury	Swap Spread	Spread	Rate	T plus
2010-20L (12/07/10)	3.071%	+14.75 BP	50.15 BP	3.72%	64.9 BP
2010-20K (11/09/10)	2.581%	+17.25 BP	49.65 BP	3.25%	66.9 BP
Change	+49 BP	-2.50 BP	+0.50 BP	+47 BP	-2 BP

- The January offering will consist of *20- and 10-year debentures.*
- The ***cutoff date*** to submit loans to Colson for this offering is Tuesday **December 21.**
- A ***request to remove a submitted loan*** from a pool must be made through Colson Services by close of business Thursday, **December 30**.
- ***Pricing date*** is Tuesday **January 4**, on which the debenture interest rates will be set.
- The debentures will be funded on Wednesday, January 12.

The debenture interest rate rose 47 BP m/m. Since that pricing on December 7, however, the benchmark ten-year T-note yield has climbed another 30 BP to near 3.4%. The hypothetical debenture interest rate in the case of that treasury yield is roughly 4%. Back in October the 20-year debenture interest rate was 3.11%, a record low. So CDC's will want to keep this in mind in terms of managing borrower expectations. Any debenture interest rate under *5%* must be considered cheap financing but the sharp upward move in interest rates still may surprise some.

The trigger for the latest move up in interest rates came from last Tuesday's announcement of the White House/GOP deal for further economic stimulus that will be entirely funded with new treasury debt. Early estimates are that Treasury would have to increase borrowing in the bond market by at least $200 billion over the balance of FY 2011 compared to the current borrowing level. There was no hint from political leaders of any intent to eventually address the deficit impact of the new stimulus. In fact the White House deficit reduction panel's recommendations were rejected just days before. Bond investors were thin on patience with US policy makers and voted "no" the only way they can, by selling treasuries and pushing up market interest rates. Thin patience was not the only reason bond investors sold last week. Let's break out the various reasons treasury yields soared last week.

- *Shock of the stimulus announcement* on the heels of Mr. Bernanke's bond-bullish 60 Minutes comments. The shock came from the bond-bearish implication of more unexpected fiscal stimulus. Surprises always make markets move, often downward.

- *Need to set up for Treasury auctions.* After the stimulus (call it Stim2) deal announcement, the market quickly corrected yields to absorb the $66 billion in long-term treasury debt to be auctioned. Stim2 came on the morning of the first of three auctions of treasury debt last week.

- *Upward adjustment of 2011 growth estimates.* Roughly a 0.5 point boost to GDP is the early consensus on the growth impact of Stim2. Based on economic multiplier analysis Stim2 is not the most efficient fiscal policy. Federal transfer payments to states have a higher multiplier and they are not in Stim2.[1] But the US can use some fiscal policy support to avoid a stall-out in economic recovery.

- *Stim2 led to somewhat earlier expectations for the end of the Fed's super-easing cycle.* Better expected growth means less likely need for future Fed easing, and maybe even the need for the Fed to complete QE2. So the probabilities shifted in a bearish way for bond prices. The timing of the Fed's first lift of the Fed funds target rate came forward several months from out in 2012 to closer to the end of 2011. .

- *Few in DC in power care about the deficit.* As discussed, the Stim2 deal announcement came soon after the White House deficit reduction panel's recommendations were rejected. There will likely be no successful attempt to get the US budget house in order with interest rates this low so this rejection was no surprise. And, actually, the US has spare borrowing capacity[2] to tap. But the clear disregard for future US federal finances really added to the bear sentiment in the bond market.

The rise in bond yields in Q4 suggests we are in a new cyclical bear market in interest rates. The big piece of the puzzle missing to draw this conclusion, though, is a tentative signal from the Fed it is close to ending its easing campaign. That is traditionally the key sign the bull cycle is over in bonds and we are not close to getting that signal. Given the unusual nature of all things economic, fiscal and financial in this post-crisis phase, however, the bond market may be making its first bear move without waiting for that Fed signal. A take out of the 4% level on the ten-year note would be solid confirmation a new bear cycle has been underway.

For the Fed's part, right now it is deep into its super-easy monetary policy with QE2. QE2 purchases will act as a soft cap on interest rate rises, and an accelerator on interest rate drops. If economic growth in 2011 is firmer as now expected, assuming Stim2 passes, there will be no fundamental reason for interest rates to fall sharply and retest or approach cycle lows. For reference, the range on the ten-year T-note yield this cycle is 2.04% (December 2008) to 4.01% (June 2009 and April 2010). We recently are a bit on the north side of the mid-point of the range. Bears are eager to retest the 4% level but the treasury market is so oversold right now that some corrective rally seems likely in coming weeks.

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[1] As state and local governments stagger next year there will be a battle to get more federal funding for states. If more spending on states goes through there will be more federal borrowing to fund the spending.
[2] Especially when looking at federal interest cost as a percentage of revenues that stood at a 1999 level at the end of FY'10. This measure, of course, will increase now.