{Talk From The Trenches: Risk Is On; Fed ML2 Sales Suspended>}

By Isobel Kennedy

NEW YORK, July 1 (MNI) - The risk aversion trade was on a tear this week, and Treasuries were left in the dust, on asset allocation trades, a few uplifting economic releases and some good news from the New York Federal Reserve.

Stocks traded higher every day this week allowing the S&P 500 stock index to be up 5% on the year. Market sources reported asset allocation out of Treasury bonds into stocks for quarter end purposes all week.

Then on Friday, the national Institute of Supply Management (ISM) printed at 55.3 in June vs. 53.5 in May. Market expectations called for a print of 52.0.

The June manufacturing ISM text said, "expansion in the manufacturing sector for the 23rd consecutive month. New orders and production were both modestly up from last month, and employment showed continued strength with an increase of 1.7 percentage points to 59.9 percent. The rate of increase in prices slowed for the second consecutive month, dropping 8.5 percentage points in June to 68 percent. This follows a similar reduction of 9 percentage points in the Prices Index in May, and is the lowest figure since August 2010 when the index registered 61.5 percent. While the rate of price increases has slowed and the list of commodities up in price has shortened, commodity and input prices continue to be a concern across several industries."

This ISM report followed an uplifting Chicago Purchasing Managers release on Thursday that printed at 61.1 in June from 56.6 in May and expectations of a drop to 53.0.

Also helping risk assets and hurting Treasuries was some good news on the Greek front after the parliament approved an austerity implementation bill on Thursday.

The Treasury market was beaten down badly all week and the 10-year note rose in yield from an intra-day low of 2.84% on Monday to intra-day high yields of around 3.22% on both Thursday and Friday.

Market sources blamed lack of liquidity at quarter-end, the stock asset allocation trades and the end of the Federal Reserve's quantitative easing program on Thursday for some of the weakness.

The rally in risk assets, coupled with some breathing room on the Greek tragedy, surely contributed to the slide in Treasury prices.

The mood in non-agency market also improved this week on the better economic data, a proposal for a settlement on Bank of America's Countrywide legacy assets, and news that the New York Fed will suspend sales of mortgage assets from the Maiden Lane II portfolio until market conditions improved.

The Fed's asset manager for Maiden Lane II, Blackrock Solutions, held a conference call with the primary dealers late Thursday afternoon saying that further "bid-wanted-in-competition" or BWICs will be suspended due to market conditions.

A short while later, a New York Fed spokesperson said via email, "Given prevailing market conditions for non-agency RMBS, we do not anticipate any sales of bonds in the near term or until such time as the New York Fed deems it will achieve value for the public. At such time, the New York Fed through BlackRock Solutions, as investment manager, may resume the sale of securities from the ML II portfolio individually and in segments over time as market conditions warrant through a competitive sales process. There will be no fixed timeframe for the sales."

The New York Fed first annonced plans to sell the non-agency paper in this portfolio in late March. At first the sales were received warmly by the markets as investors were anxious to get a new infusion of these assets because they offered attractive yields.

But the market hit a speed bump in mid-May as a host of private investors also flooded the market with paper and the U.S. economy also hit a speed bump.

The price gains that this market had enjoyed earlier in the year eroded and the supply overwhelmed the market.

Right from the beginning, the New York Fed had said the sales would be predicated on market conditions.

The market had been expecting another sale to take place around the July Fourth holiday but market sources said the market could not take any more paper.

One portfolio manager that invests in these type of assets says the NY Fed suspended the sales "because the pain that ML2 inflicted on all risk markets (ABX/CMBX/HY) due to massive hedging needs and very limited flow in those hedges was under appreciated by the NY Fed, now they get it."

"The Fed clearly does not want to be in the mortgage market any longer than they have to," said Adam Murphy, President of Empirasign Strategies, "but the most important factor is the Fed wants to do right by the American taxpayer. And selling these bonds at distressed levels is doing a disservice to the taxpayer and the market."

Asset-backed and comercial-mortgaged-backed securities were enjoying a rally Friday along with stocks so perhaps the tide has turned for now.

Still, as one observer pointed out, the Fed will eventually have to sell the rest of the securities in the Maiden Lane II portfolio.

"But for now, they are not a forced seller," he said. "Maybe they can come back when conditions improve."

To date, the New York Fed has held nine BWICs on the Maiden Lane II portfolio. About $10 billion face value in paper has been sold out of the $13.4 billion put out for the bid.

In other news for the non-agency market, analysts have been busy dissecting this week's proposed Bank of America settlement on the legacy Countrywide assets which requires BOA to pay $8.5 billion to the trustee. It covers $424 billion in original principal balance in 525 first lien trusts and 5 second lien trusts.

First, the court date is not set until mid-November and there is some chance it will not get approved, sources say.

Also, some think that other investors might hold out for a bigger settlement.

But Amherst Securities said in a report this week that there are a few points to be made in general:

1) No disclosure on mechanics of allocation "puts investors in a precarious position when deciding whether or not to accept the offer;

2) It could mean improvements on the servicing side which is good for investors;

3) Other settlements could follow but "Countrywide is unique, so it s not clear how widespread agreements like this will be."

But Amherst does say it proves that investor "activism" is key and ther could be more of it in the months ahead;

4) The Attorneys' General settlement could be less.

"We have a hard time seeing a settlement with fines in the $20-$25 billion range, as originally discussed," Amherst says.

Despite the improvement in risk assets, volatility should surely continue in the financial markets.

Greece has gotten a band-aid for now. But how the U.S. economy behaves ahead and what happens to oil prices once hurricane season gets underway are other issues.

And it also remains to be seen how the markets and the economy behave now that the Fed's QE II is finished.

The debt ceiling issue is another very big risk for the markets.

Have a wonderful holiday weekend.

NOTE: Talk From the Trenches is a daily compendium of chatter from Treasury trading rooms, as well as some sister market trading rooms, and is offered as a gauge of the mood in the financial markets. It is not necessarily hard, verified news.

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