2011 Outlook

Janney Fixed Income Strategy

December 20, 2010

Investors are facing mixed performance, mixed messages, and the usual mixed metaphors when it comes to the macro and fixed income outlook.

CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

- **Economics/Macro:** We are forecasting US economic growth of between 2.5% and 2.9% aided by the recent tax cut stimulus, normalized consumer spending, and low to non-existent inflation pressures. The primary risk to our base case forecast is the potential for a reversal in recent wage growth to trigger a deflationary spiral, though Fed action is acting to limit the probability of such an outcome.
- **Interest Rates:** Despite the low inflation outlook, we see risks for the Treasury markets based on additional future supply if Congress fails to live up to its new fiscally conservative mandate.
- **Agencies:** Agency debenture issuance is headed lower for the coming year, which should provide a good basis for spread outperformance, though total returns will be captive to the Treasury markets and therefore the deficit.
- **Agency Mortgages:** Mortgages are setting up for a strong 2011 on reduced agency supply; as talk of prepayment risk translates into extension risk, we prefer 15yr over 30yr passthroughs and bank-type CMO structures.
- **IG Credit:** Investment grade credit spreads are trending near the tightest levels we can expect for 2011, which leaves the IG markets in a position to mimic the performance of Treasuries, even though supply will likely decline.
- **HY Credit:** High yield credit should prove easily the strongest performer within the fixed income markets, as defaults decline to below 2.0%, issuer liquidity improves, and additional dollars seeking higher absolute returns flow into risk assets.
- **Municipals:** We view the municipal markets as an attractive sector to be in 2011, as although M/T ratios are unlikely to decline, tax-exempt income offers greater risk-adjusted carry opportunities than in other markets.
- **Municipals:** Credit pressures from lower tax revenues, while substantial, are unlikely to result in a significant uptick in defaults within the GO and essential purpose revenue arenas.

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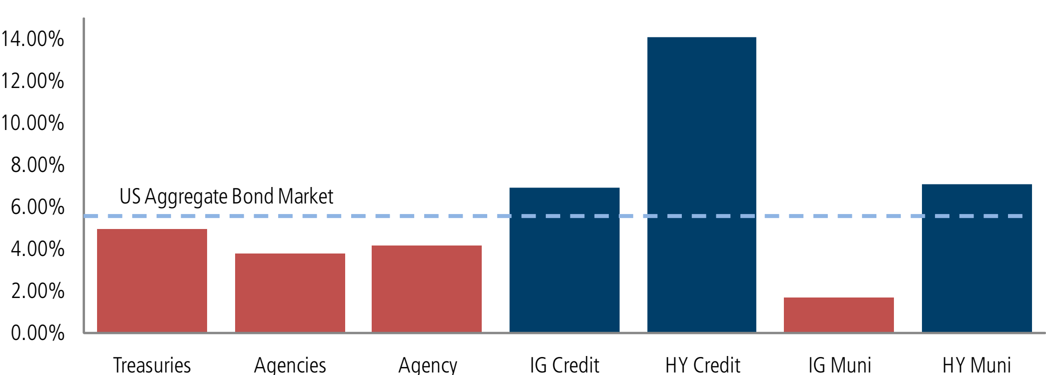
2010 Fixed Income Asset Class Performance



Source: Janney Fixed Income Strategy; Barclays

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

The currency markets are likely to offer better directional bets in 2011, as fundamental trends trump political rhetoric.

2011 Fixed Income Asset Class Outlooks

Asset Class	Postion	Comments
Treasuries	Underweight	7-10yr notes offer best risk/return tradeoff
Agencies	Underweight	Prefer callables over bullets or steps
Agency Mortgage	Overweight	Up-in-coupon, 15yr to outperform
Investment Grade Credit	Marketweight	Spreads largely captive to rates
High Yield Credit	Overweight	Falling defaults, continued demand
Municipals	Overweight	Fear of credit meltdown overblown

Source: Janney Fixed Income Strategy

2011 Favorite Macro & Fixed Income Trades

Area		Postion	Comments
US Economics	↑	Long US equities	Stable consumer spending to boost profitability
US Economics	↓	Short 5yr Breakevens	Cheap protection against downside risks of deflationary spiral scenario
Currencies	–	Long AUD vs USD Short EUR vs USD Long BRL	Australia big winner in commodites reflation scenario EU failing to deal with structural problems Brazilian Real hedged bet on 'feed the world' theme
Commodities	↑	Long coal	Chinese demand to require substantial imports in 2011
Commodities	–	Long gold vs short silver	Dodd-Frank restrictions set tone for reduced bank intervention in silver derivatives
Interest Rates	↓	Short 5yr note	Belly of the curve to be hit hardest in bear flattener
Agency Mortgages	↑	Long FN 30yr 5	Benign prepay environment
US Credit	↑	Long HY markets	Spread compression to continue in 2011
Municipals	↑	Long BABs	Future supply or not, sector cheap to IG corporates

Source: Janney Fixed Income Strategy

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

ECONOMIC OUTLOOK: BORING WITH A SIDE OF DEFLATION RISK

- The Great Recession is over. Long live the Not-So-Great Recovery! Economic trends in 2010 proved disappointing, despite hopes of a strong bounce back from the deepest recession in several decades.
- Our base case 2011 US forecast calls for the intermediate term pace of expansion to continue at a 2.5% - 2.9% pace, inflation pressures to remain extremely light, and the jobless rate to improve at a disappointingly slow pace to 9.0% by year end.
- Weak housing markets are likely to persist throughout the year, as distressed supply levels remain high and homebuyer demand virtually non-existent. We see a high likelihood of 7 – 10% decline in Case-Shiller home prices for 2011.
- Outside of this base case forecast, we view the greatest US economic risk for 2011 as that of a deflationary spiral as high unemployment has the potential to cut into wages, thereby creating a further business and consumer pullback.
- Fed policy response has nearly no ability to influence growth or unemployment trends at this juncture, but should prove useful in reducing the risks of a deflationary spiral emerging.

While we expect the domestic economy to expand in 2011, the pace will be somewhat below historical experience.

2011 Economic Outlook

Segment		2011 Performance	Comments
GDP Growth	↑	2.5% - 2.9%	Tax cut packages provides stimulus; stable but not exciting by historical standards
Consumer Spending	↑	2.8% - 3.2%	Consumers spend based on income growth; savings rate to remain high
Business Investment	–		Capital investment binge slowing; manufacturing outlook remains bright
Government	–	$1.4 - $1.6 tln deficit	Congress' handling of revenue and spending to affect long term growth
Housing	↓	Home pxs down 7-10%	Supply/demand imbalance remains severe
Inflation	↓	0.0% - 0.3% Core CPI	Deflationary spiral is biggest economic risk

Source: Janney Fixed Income Strategy

The dismal science seems to be getting more dismal and less science these days. It was about eighteen months ago that we started putting forth more detailed thoughts on a post-recession world, and most of those thoughts were fairly sobering, calling for sub-3% economic growth, low inflation, and elevated unemployment for an extended period. The typical models used to forecast economic performance meanwhile are growing increasingly unreliable, as current conditions and pressures are too complex to accurately assess with readily understandable mathematical models. That situation leaves us once again discussing the outlook in terms of forces and directions rather than in terms of precise numbers. On balance, however, it looks like 2011 will hold much of the same, with sub-3% growth, no inflation, and unemployment holding north of 9% through most of the year.

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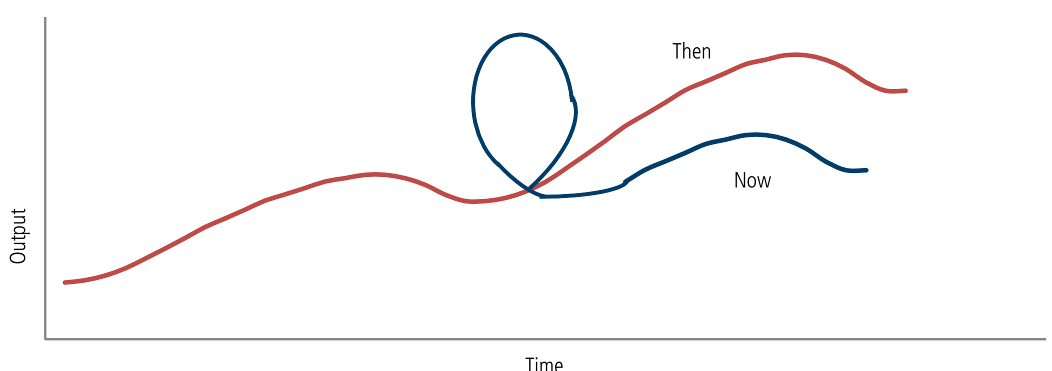
CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Traditional views of the business cycle hold that after recession comes recovery and after recovery, a stable state of optimal long term growth. Judging by popular rhetoric, the US economy today remains in a state of recovery, with consumer spending and business investment still rebounding from the depths of recession. There's just one problem. Recoveries—and this argument isn't mere semantic—are by their very definition transitory. They either become the dreaded double dips or they transition into trend growth. Given that the domestic recession ended nearly six quarters ago, there's no longer a meaningful basis to call the current economic environment a recovery, and, by implication, no longer a meaningful basis to hold that conditions will improve at an ever accelerating pace. Like it or not, the new era of sub-3% economic growth, barely enough to put a dent in the unemployment rate, is upon us.

Rethinking the Business Cycle

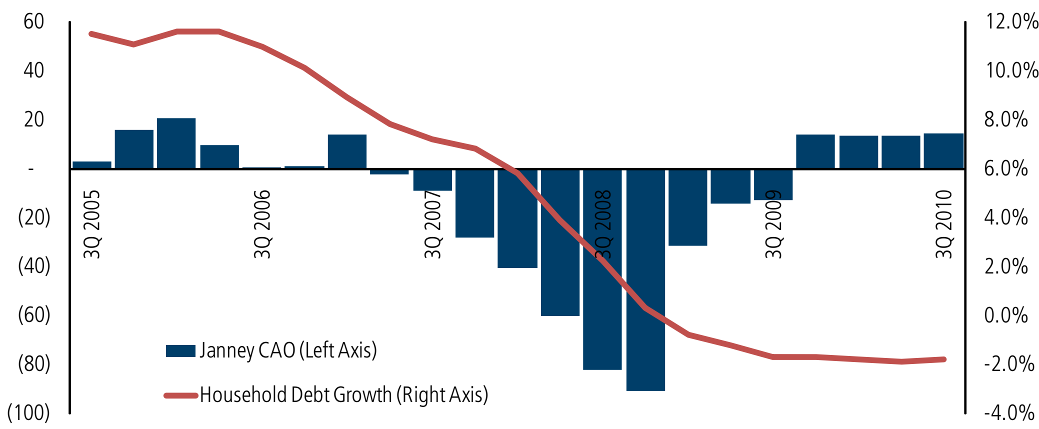


Source: Janney Fixed Income Strategy

Consumers are still in the early innings of deleveraging and low borrowing; slow spending growth, and high savings rates will persist for some years.

In terms of big picture pressures affecting the long term outlook, a shifting paradigm of consumer purchasing preferences takes the cake. Between 1980 and 2005, consumer spending expanded by approximately 8.3 times over, yet consumer incomes grew by a comparatively limited 5.6 times. The difference between those two expansions figures, a factor of 2.6 times, represents primarily the effects of consumer leverage, that has allowed spending to far outpace incomes. During the 2008 – 2009 financial crisis and recession, the consumer base experienced a new understanding of how badly this leverage can come back to bite, which in turn has generated a growing cultural distaste for borrowing. We see this distaste, along with an elevated level of consumer defaults, as the primary reason why demand for borrowing has dried up, as well as the primary reason why a major engine for economic growth is now affirmatively broken. Evidence for this assessment is clear in everything from monthly consumer credit data to a personal savings rate that's gone from near zero to the 5-6% neighborhood.

Consumer Borrowing Pullback Continues Despite Bank Willingness to Lend



Source: Janney Fixed Income Strategy; Federal Reserve

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Second on the list of big picture, long term pressures emerging as current issues is the American demographic profile. At present, 14% of the US population is at or above the traditional retirement age of 65, with another 11% now within ten years of that mark. With this aging population comes a transition from the most productive work years to must less productive ones, and, for our purposes, also lower income ones. Couple demographic growth with lengthening life spans as well as the financial crisis' impact on retirement portfolios, and the domestic economy is facing a meaningful income slowdown in the coming years. Moreover, those trends also imply that the consumer savings rate, now in the historically-elevated 6% neighborhood, will remain high, thereby providing support to the relatively low interest rate regime. As we posited, consumer spending is being increasingly driven by income rather than borrowing ability, which magnifies the natural effects of an aging demographic. Together, these two factors—a changing consumer culture and an aging population—represent the biggest source of intermediate to long term softness for US economic performance. For the coming year, these pressures are apt to display in consumer spending trends well below historical experience.

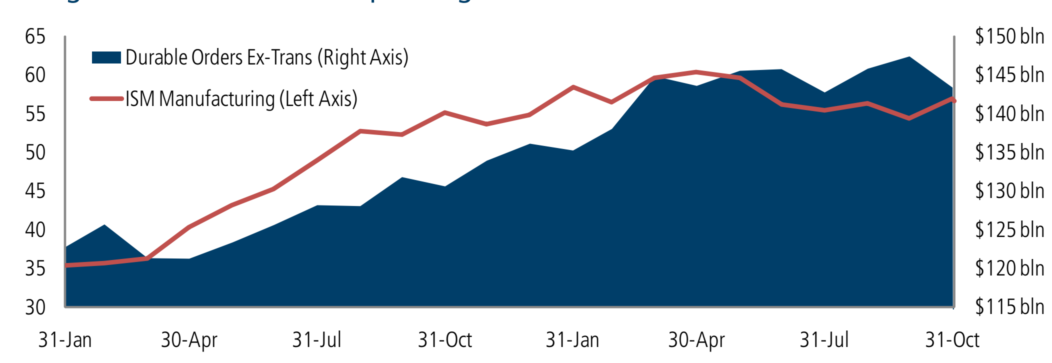
It doesn't take a Milton Friedman to figure out that an aging demographic presents a barrier to consumer spending growth.

Spend vs Save Decision Mirrors Demographic Trends

Source: Janney Fixed Income Strategy; Commerce Debt; Census Bureau

As promised, there was plenty of dismal in our consumer treatise, but it's often easier to discuss what's wrong rather than what's right with the world. In that sense, we can't lose sight of the fact that consumers are spending, if not at the pre-2007 rate we had come to expect. The recently-reached tax cut deal will certainly help in the consumer equation, and ultimately add 0.4% to 0.5% to GDP growth for 2011. Moreover, the business sector, while showing some initial signs of slowing, continues to spend on capital assets at a reasonably strong pace, as evidenced by the continually upbeat evolution of ISM and factory orders data. Demand from developing market economies for these capital goods should provide for further production strength in 2011 and likely beyond, though ultimately it'll be up to consumers in developing markets to determine whether export production growth is sustainable. Even if the progression of consumerism abroad occurs at half the pace it did here in the US, given much greater populations in countries such as China, India, and Brazil, it's easy to envision a scenario in which consumer exports play a role in generating long term growth.

Strong ISM Reflects Business Spending



Source: Janney Fixed Income Strategy; ISM

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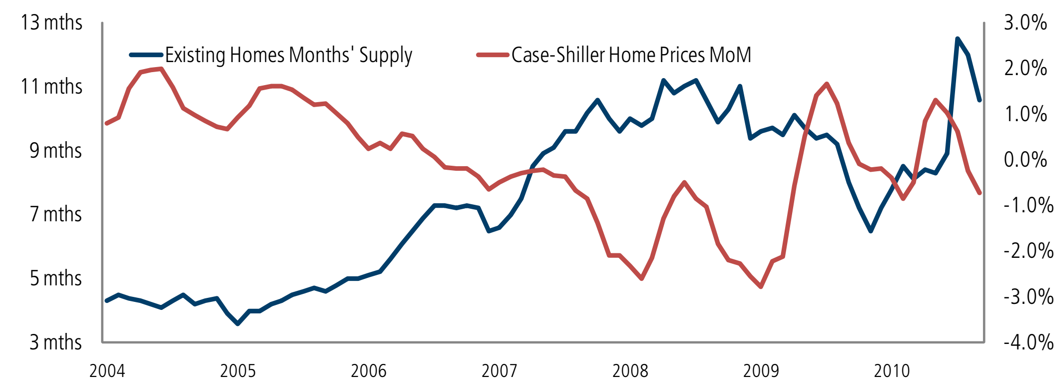
CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Enough of a reprieve: while factory production represents a bright spot in our base case expectations for 2011, the housing markets represent a bit of a black spot. In the wake of the homebuyer tax credit both existing and new home sales have plunged, reaching record lows over the summer. While we've seen a rebound of about 15%, the current pace of sales nonetheless belies an anemic level of homebuyer demand. Current supply is quite high relative to this limited demand, and the supply/demand ratio is actually worse than it was prior to the 2006 – 2008 housing downturn.

Home Prices Remain Sensitive to Elevated Supply Conditions

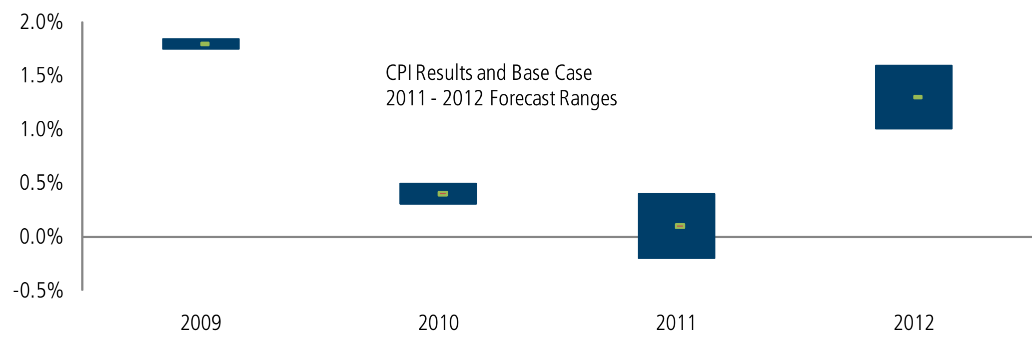


Source: Janney Fixed Income Strategy; National Association of Realtors; S&P/Case-Shiller

Inflation remains a distant risk against a backdrop of a net decline in the money supply vs 2007, slow spending growth, and slack production capacity.

Moreover, distressed housing supply from foreclosures in process and properties on bank balance sheets has created a shadow supply not represented in the ratios. Considering that the housing markets are just that, a market, the mechanism for re-aligning supply and demand is price. Judging by early post-sales crash housing values, the second round of price slides has already begun and considering the recent increase in mortgage rates, we are calling for a housing price decline of 7 – 10% in 2011 with a probability of an additional 3 – 5% in 2012. Further price declines will prove painful, but given recent experience, we believe that consumers are better equipped to handle further weakness in a less destructive way. For that reason, the second downturn in prices should have less of a deleterious effect (including, notably, fewer foreclosures) than did the first.

Inflation Should Prove Benign Through 2012



Source: Janney Fixed Income Strategy; Labor Dept

Outside of our base case, the most prominent risk remains that of a deflationary spiral. Worker wages have proven remarkably sticky, held in place by productivity gains that have occurred as fast as payrolls have been cut. The problem comes if these gains slow without a rebound in aggregate demand, threatening wage levels and encouraging firms to hold off on hiring in the hope that labor will be cheaper in the future. That situation weakens employment and creates a consumer spending downdraft, thereby further discouraging hiring until the cycle begins to slow. While—to borrow and bend Milton Freidman's words—inflation everywhere is always a monetary phenomenon, deflation probably isn't. The problem with deflationary spirals is that they're very rare (so we have little empirical data on the topic), they're very slow to start, and once they do, their momentum is hard to reverse. With the Fed acting aggressively, we remain confident the US economy can escape the spiraling black hole, but it nonetheless remains the most likely alternate scenario to our outlook.

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Interest Rates: Supply, Enter Stage Left

- The US rates sector is right on the precipice of significant change, though it has remained in a similar position for more than a year and may continue to teeter through 2011.
- With economic growth slow to moderate and the risk of deflation prominent, we see little risk of an inflation-driven rate spike in the next several years and little to no chance that the Fed will enact tightening policy in the next twelve months.
- Real interest rates, driven by the dollar's performance and future supply/demand trends, will be the real driver of change in 2011, and real rates are notoriously hard to predict.
- When it comes to the precipice, look to Congress to set the tone on technicals, with revenue raises and spending cuts suggesting lower long term supply and a refutation of fiscal conservativism suggesting elevated long term supply.
- As the calendar transitions into 2011, we are taking a slightly more defensive stance and recommend underweighting duration, though the seven year area of the curve offers value.

Rates are set to creep begrudgingly higher in 2011, though low inflation should keep the long end contained.

2011 Interest Rate Outlook

Segment		2011 Performance	Comments
Money Market	—	Neutral	Anchored by Fed policy
Short Rates	↓	Higher	2yr to have worst risk/return tradeoff on curve
Intermediate Duration	↓	Moderately Higher	7yr best risk/return tradeoff on curve
Long End	↓	Slightly Higher	Supply risks substantially more problematice for long end

Source: Janney Fixed Income Strategy

For all the talk of unprecedented low interest rates and the absolute requirement that rates rebound aggressively in the face of Fed money printing, you'd think that inflation was in Zimbabwe territory by now. While the risks are increasingly tilted towards higher rather than lower rates for the longer end of the curve, we see no immediate indication of the type of inflation that could generate a sharp upward spike in interest rates—quite the opposite, in fact, judging by our aforementioned deflation risk. The scenario in which inflation remains stagnant but rates rise is a curious one, but that's our primary view for 2011, and a little rate market philosophy may help to illuminate that assessment. We tend to view the interest rates markets as subject to three major factors: the evolution of economic conditions, market technicals (e.g., supply and demand), and policy, all of which, to one degree or another, feed back into each other. Making matters more complicated, economic conditions tend to alter rates through inflation whereas market technicals affect real interest rates and fiscal/monetary policy some combination of both.

For 2011, it appears that economic conditions will take a back seat to technical drivers of interest rates, and those technicals are, in turn, increasingly captive to the offsetting policy forces of Congress (supply) and the Federal Reserve (demand). The last several months of 2010 are teaching investors that the balance between these two factors has grown somewhat tenuous, and an increase in either side—supply being the more likely at the moment—can result in a rapid movement in real interest rates. Take the recent tax cut deal, for example, which looks to add around $220 billion to the deficit and therefore Treasury issuance over two years. That's equivalent to about 2.5% of the size of the government securities markets, a relatively small supply increase. At the current juncture, with all eyes on fiscal conservativism, the markets are extraordinarily sensitive to hints that cam-

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

paign promises won't translate into real spending cuts. Not only is a lack of fiscal conservativism on the tax cut bill adding to 2011 and 2012 supply, but it's convincing the markets that supply will be elevated above expectations for years into the future.

The good news for the rates markets is that demand technicals remain a good bit more stable than supply ones, and not wholly dependent on policy. That isn't to suggest that Fed buying and QE2 isn't playing a major role in the demand side of the equation, rather that once the Fed terminates Treasury note and bond purchases, there's an even greater pool of private capital willing to step in. That's the lesson learned from the March end of the $1.25 trillion MBS purchase program and the fact that mortgage spreads continued to tighten after the Fed's exit. We believe that the Fed is actually providing and will continue to provide the most consistent source of demand for the US rates markets through 2011, creating a stable anchor and preventing the bottom from falling out of demand even as supply risks are on the rise. At this juncture, it's far too early to tell whether the FOMC will extend QE2 purchases beyond the original $600 billion mandate, but given the deflation risk outlook, we suspect an increase is far more likely than a decrease in central bank demand. Overseas interest in the Treasury markets for 2011 will be a province of the dollar's performance, and given our neutral outlook, we believe foreign demand will persist within spitting distance of current level.

On balance, while supply risks represent a potential tipping point for the interest rate markets, the anchors of central bank and organic demand as well as stable price pressures provide for reasonably stable performance in 2011. That said, for the first time in four years, the risks are clearly tilted towards a technical selloff in real yields; making the situation all the more unpredictable is the fact that Congress holds the keys.

Congress' willingness to address the deficit with serious measures remains something of a wildcard for supply and the rates markets.

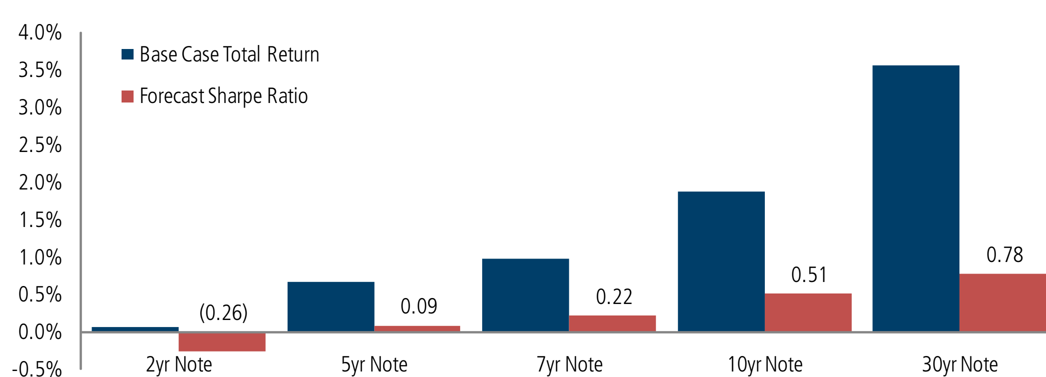
2011 Interest Rate Forecasts

Central Bank Rates	Current	4Q 2010	1Q 2011	2Q 2011	3Q 2011	4Q 2011
Fed Funds O/N	0.13%	0.13%	0.13%	0.13%	0.13%	0.13%

Treasury Curve	Current	4Q 2010	1Q 2011	2Q 2011	3Q 2011	4Q 2011
3m Bill	0.14%	0.14%	0.30%	0.44%	0.61%	0.81%
2yr Note	0.67%	0.64%	0.84%	1.05%	1.27%	1.52%
5yr Note	2.12%	2.00%	2.24%	2.38%	2.61%	2.84%
10yr Note	3.54%	3.39%	3.47%	3.58%	3.69%	3.80%
30yr Bond	4.60%	4.55%	4.54%	4.58%	4.61%	4.65%
2s/10s	287 bps	274 bps	263 bps	254 bps	242 bps	228 bps
10s/30s	106 bps	117 bps	107 bps	99 bps	92 bps	85 bps

All numbers are period end forecasts.

2011 Treasury Total Returns to Vary Sharply by Duration



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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Agencies: Yes Virginia, There Is Such a Thing as an Implicit Guarantee

- We carry an underweight rating on the agency bond sector as a function of absolute investors' propensity to add risk in 2011 and shun lower yielding sectors, though the agency markets should track Treasuries with relative stability.
- Even so, supply technicals look good for the coming year, as a slower pace of mortgage issuance will reduce issuance from Fannie and Freddie and a shrinking balance sheet at the FHLB will do the same for that agency.
- Par and discount priced callables represent the greatest value in the agency markets, as those structures' total return will perform better than either bullets or step ups in our slowly rising rate forecast.
- The future structure of Frannie remains something of a question mark, but we expect no resolution in the coming year and no changes to the credit quality or implied guarantee of outstanding debt when and if resolution arrives.

While agency market technicals look good on reduced supply, the risk-on trade will favor other sectors in 2011.

2011 Agency Outlook

Segment		2011 Performance	Comments
Treasury Spreads	↑	Tighter	Continued yield chasing; spread curve flatter
Swap Spreads	↓	Wider	2yr to have worst risk/return tradeoff on curve
Issuance	↓	$1,030 - $1,070 bln	Shrinking balance sheets mean 11 - 14% decline
Callables	↑	Overweight	Prefer premium callables over bullets

Source: Janney Fixed Income Strategy

As yields have declined from 2008 through the present, the agency debenture market has faded as a mainstay for absolute return investors, a trend we see continuing into the coming year. For 2010, the agency sector underperformed the broader fixed income markets by a wide margin, reflective of flows out of lower risk into higher risk asset classes. Contrary to those flows, however, the agency markets also underperformed lower risk Treasuries—though by a narrower margin—on modest spread widening following the March termination of Fed agency purchases. Total supply for the year is running at a $1.2 trillion gross pace, which while behind 2009's TGLP-driven record issuance, is still much stronger than any prior experience.

Shrinking Agency Balance Sheets Point to Declining 2011 Issuance

Agency	2010 Portfolio	2011 Portfolio (High)	2011 Portfolio (Low)
Fannie Mae	$770 bln	$728 bln	$716 bln
Freddie Mac	$678 bln	$641 bln	$631 bln
FHLB	$896 bln	$847 bln	$833 bln
Total	$2,344 bln	$2,215 bln	$2,180 bln
Funding Needs		-$130 bln	-$165 bln

Source: Janney Fixed Income Strategy

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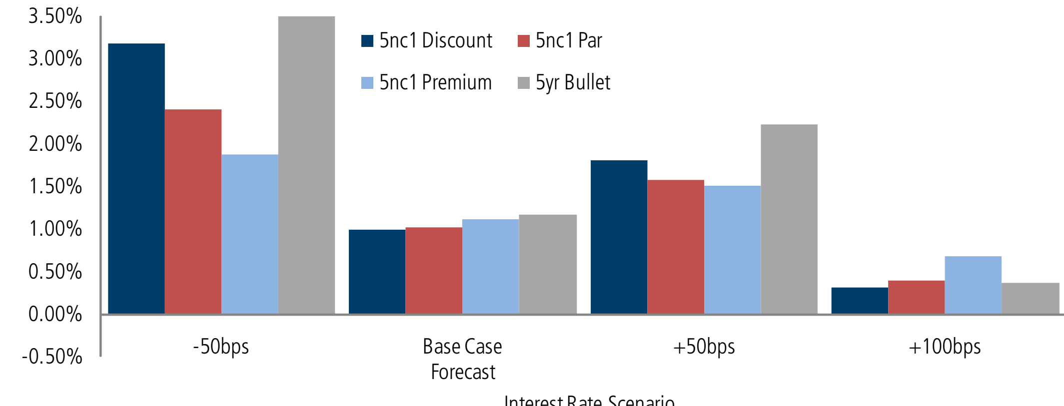
CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

With 2011 to be yet another year of the risk-on trade, we will be maintaining our underweight rating on the sector, with a reevaluation of this position to follow only in the event of a substantial backup in short term interest rates. Agency performance will trend far closer to the Treasury sector than any other major asset class, although decent technicals in agency supply have the potential to create a modest spread tightening as 2011 progresses. With shrinking balance sheets in store at Fannie/Freddie (a sharp reduction in mortgage lending amid higher rates) and the FHLB (reduced bank borrowing demand amid high deposit volumes) comes reduced need for agency issuance. We expect new supply will drop 11 – 14%, or about $130 – $165 billion, which should provide some support for the markets and limit the impact of reduced real money demand. Calls on outstanding agency deals will continue through 1Q, so issuance will be weighted towards the beginning of the year.

Premium Callables Partially Protect Against Price Impact from Rising Rates

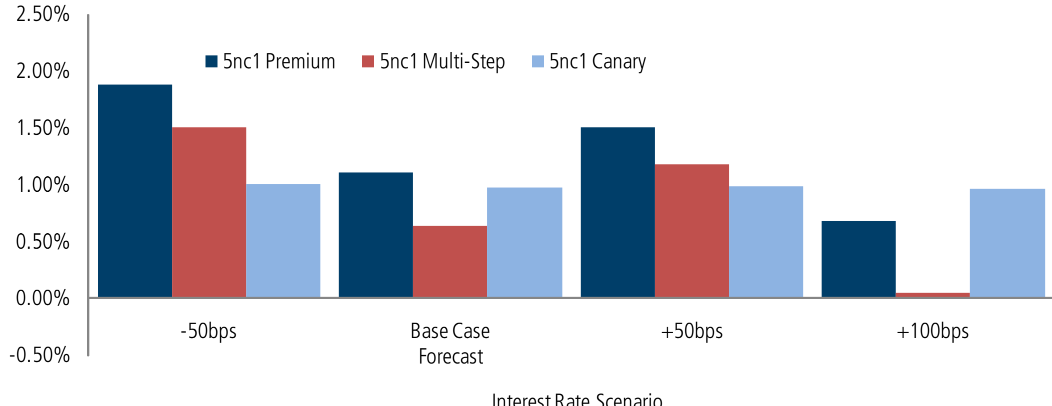


Source: Janney Fixed Income Strategy

We like callables as a source of additional carry but would avoid the alure of multi-cpn step-ups which often underperform in a rising rate environment.

Within the agency market, we hold a preference for par and premium callable paper as a source of additional carry and thereby a slight hedge against rising rates. In the above table, we compare three different 5yr no-call 1yr notes along with one 5yr bullet. In each of the rising rate scenarios considered—including our base case rate forecast—the shorter duration of the premium 5yr no-call 1yr offers a greater degree of protection than lower coupon callables. In the event 2011 rate increases exceed our expectations, the premium 5yr no-call 1yr also outperforms the 5yr bullet. The downside, of course, occurs in the event our primary risk scenario, one of a deflationary spiral, emerges and drives interest rates lower in the front end of the curve. As a practical matter, premium callable structures are challenging to find in this market and, where available, consist of seasoned deals with originally longer lockout (7yr no-call 3yr issued in early 2009, for example).

Multi-Cpn Steps Are Less Efficient in Rising Rate Scenarios than Callables



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AGENCIES
MORTGAGES
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HY CREDIT
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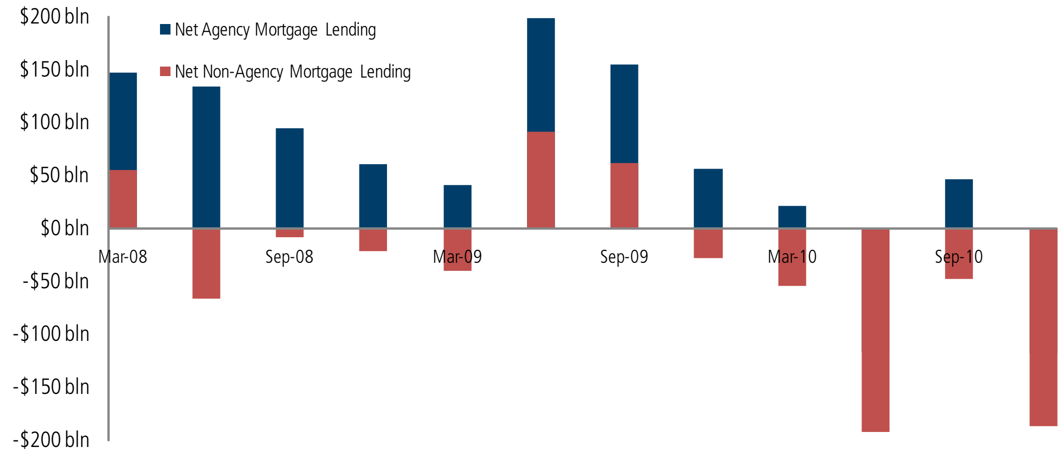
As forecasts of rising rates became increasingly prominent in the early days of 2010, demand for step-ups emerged in force, leading Fannie, Freddie, and particularly the FHLB to issue a greater portion of their funding as steps. Despite the conceptual appeal of step-ups (and especially multi-steps) as hedges to rising rate scenario, the reality is a great deal more nuanced. Typically, steps underperform callables in scenarios in which rates rise more slowly than the coupon of a given issue steps-up. Considering our 2011 outlook calls for a relatively orderly rise in rates, our base case rate scenario has a 5yr no-call 1yr callable easily outperforming a 5yr multi-coupon step-up; that relationship holds even in a +200 basis point scenario. In that sense, traditional multi-coupon steps are decidedly inefficient in protecting against rising rates. The major exception to this step underperformance occurs in the canary (one time step, one time call) structure, which slightly underperforms callables in our base case forecast, but outperforms in more aggressively rising rate scenarios.

Fannie, Freddie, and Ginnie Are the Only Source of Mortgage Originations



Source: Janney Fixed Income Strategy; Mortgage Bankers' Association; Company Reports

The government will likely find it challenging if not impossible to alter the "implied guarantee" structure of presently-outstanding agency debt.

One factor providing a minor overhang above the agency sector for the past two years now has been uncertainty over the future of government-supported Fannie Mae and Freddie Mac ("Frannie"). Thus far, the Treasury has injected $151 billion of capital into the two housing GSEs and intends to issue a comment on agency overhaul in January 2011. Despite this support and the coming report, we see very little risk that any serious proposal will alter the credit risk of outstanding debt, based on four precepts.

- The sponsorship of Frannie agency and MBS/CMO debt by the nation's banking system is such that a default on the part of the GSEs would make the US banking system once again insolvent. Bank of America, as the largest example, carried $160bln of agency obligations as of Sep 30 and $160bln in Tier 1 regulatory capital.
- Foreign central banks and banking institutions first began purchasing agency debt in 2003 – 2007, reportedly with the Treasury Department's explicit blessing. A default by Frannie or even withdraw of support could create a political morass.
- Frannie is essentially the only provider of liquidity to the US mortgage market at this juncture, and, along with Ginnie Mae, accounted for an estimated 90% of $1.4tln in 2010 mortgage originations. Terminating implied support for future issuance would increase mortgage lending costs sharply at a time when the housing markets remain soft.
- Sunk costs are irrelevant to economic decisions, but not to political ones. Politicians are eager to show that bailouts have been cost-neutral or profitable, and based on the subordinated nature of capital injections, allowing for a restructuring of Frannie would deeply impair or wipe out the Treasury's $150bln investment.

While government support over the last several years has included unexpected features, we don't see a good case for pricing additional credit risk into the agency sector for 2011. That approach may change years down the road, but we doubt any changes would affect previously-issued debt.

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Agency Mortgages: The New Bank Fashion

- For 2011, we are entering the year with an overweight rating on the agency mortgage market versus Treasuries and IG credit, driven by growing bank demand and a much slower pace of issuance.
- Market focus will switch from prepayment risk to extension risk once it's clear that the bulk of homeowners eligible for refinancing have already done so, leading to duration extensions on slower prepayment forecasts.
- Within the collateral market, we believe in stepping up in advance of that regime change by buying 15yr over 30yr MBS and looking at higher coupon as well as 2006 – 2007 vintage paper as a way to manage the risk/return tradeoff.
- Typical bank-type CMO structures should also outperform the broader agency mortgage market in an extension-sensitive scenario, particularly full coupon, high cashflow PACs and sequentials on 15yr and 20yr collateral.

We've been here before: the aftermath of 2010's prepay wave should favor the up-in-coupon trade, 15yr over 30yr MBS, and short bank-type Sequentials/PACs.

2011 Agency Mortgage Outlook

Segment		2011 Performance	Comments
Nominal Spreads	↑	Tighter	Benign prepay environment for 2011
OAS	↑	Tighter	Strong bank demand and low issuance support technicals
Durations	↓	Prefer 15yr vs 30yr	Protecting against duration extension to payoff
Coupon	↑	Up-in-coupon	Slowing prepays and extension to benefit premium paper
CMOs	↑	Tighter	Look to short SEQ/PAC structures to capitalize on growing bank demand for agency mortgages

Source: Janney Fixed Income Strategy

Agency mortgages have faced a series of buffeting forces in recent years, starting with default-driven prepays, aggressive Fed buying, and a subsequent voluntary prepayment wave through the summer of 2010. As the calendar approaches year end, however, the pressures affecting the mortgage sector are starting to look mighty familiar: rates moving higher, durations extending, and supply falling. Not to discount the uniquely contemporary problems of falling home prices and still-elevated foreclosures on the MBS and CMO sector, but we've been through the story of 2011 before. The markets prior experience of rising rates in a bear flattener scenario hit in 2004, which was a mixed year for the mortgage basis, with nominal and option adjusted spreads tightening and serving to counteract part of the impact of rising rates. With that experience in mind, it's possible to offer some relatively concrete suggestions as how to handle the typical risks of a bear flattener interest rate scenario—and trust us, it's a weight off to have a relatively clear prepayment and duration outlook for the first time since 2007.

The primary question swirling around the mortgage markets remains whether the tradeoff from wider spreads on cuspy-coupon paper exceeds the extension risk potential from rising rates. As an extension protection play, we generally prefer Fannie/Freddie 15yr over 30yr and premium coupon paper in either term. Our outright pick for 2011 performance is the 15yr 4.5%, which carries a more attractive risk/return combination under our forecast rate scenario of a slow bear flattener and an

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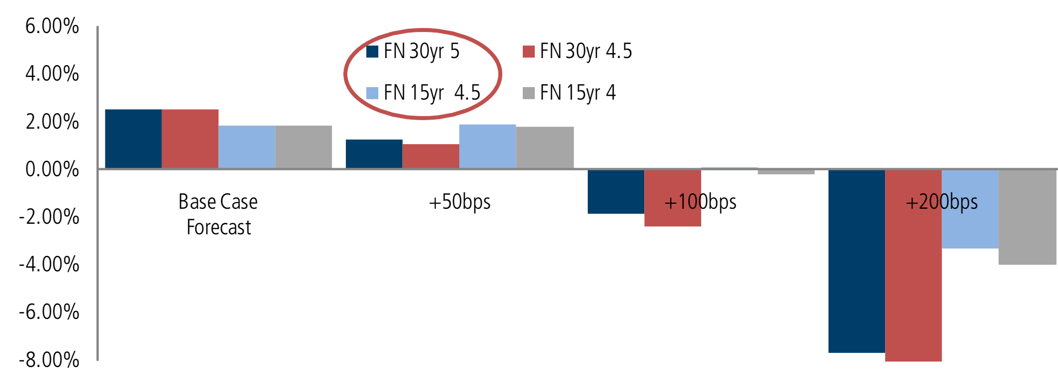
CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

outright more attractive return in scenarios of even more rapidly rising rates. With both the 30yr 5% and 15yr 4.5% still trading at premiums (both 103 handle) in the closing days of December, the primary risk for the up in coupon trade remains a last hurrah from the prepay machine. With the 2010 refi experience largely behind, however, we expect burnout to limit near term prepayment risks and allow premium paper to outperform into the coming year. Although voluntary prepayments are off the table as a major problem, we anticipate foreclosure rates will remain elevated for the coming year, thereby leaving credit risk as a significant factor driving prepays.

Mortgage Total Return Forecasts Favor Up-in-Coupon



Source: Janney Fixed Income Strategy

Declining net supply and low direct bank lending volumes will provide solid technical support for the mortgage markets in the coming year.

As rates rise and kill off prepayment risk into 2011, we expect to see support for the mortgage markets in the form of significantly reduced supply. Gross mortgage originations for the current year are running at a $1.4 trillion pace, but of those originations, roughly 75 – 80% have been refinancing transactions, resulting in a net decline to the size of the agency universe (we estimate agency MBS/CMOs outstanding will hit $6.67tln at year end, down $210bln from 2009). With slower refi volumes on the table for 2011, the current situation points towards a significant decline in new supply. Compounding this supply drop is the macro outlook, which includes a 7 – 10% decline in home prices for the coming year. Such a decline will move a marginal portion of the mortgage universe into a credit-constrained position, further impairing refi opportunities. The situation is particularly acute for 2008 – early 2010 vintage collateral which has yet to experience negative homeowner equity and the uptick in ruthless foreclosures that triggers involuntary prepays on agency collateral. Now that Fannie and Freddie are speeding up the delinquency-to-prepay process by buying out 120 day delinquent loans, prepays will likely be a bit more sensitive to month-to-month delinquency trends.

Mortgage Net Supply Set to Decline in 2011

Category	High Case	Low Case	Comments
+ Home Sales	$185 bln	$120 bln	Existing sales 4.9 - 5.4mm
+ Net Refi Activity	$150 bln	$125 bln	Non-agcy prepays 6.0-7.5%
- Scheduled Payments	$150 bln	$135 bln	
- Involuntary Prepayments	$165 bln	$140 bln	120+ DQ / Buyout rate 2.1% - 2.5%
2011 Net Supply	**$20 bln**	**-$30 bln**	**Zero net 2011 supply**
+ Bank Appetite	$460 bln	$370 bln	Slower 2011 loan growth
+ Life Insurer Appetite	$35 bln	$25 bln	6-9% growth in policies
- Fed Liquidation	$220 bln	$160 bln	Portfolio runoff
2011 Net US Demand	**$240 bln**	**$210 bln**	**Banks trump Fed**

Source: Janney Fixed Income Strategy

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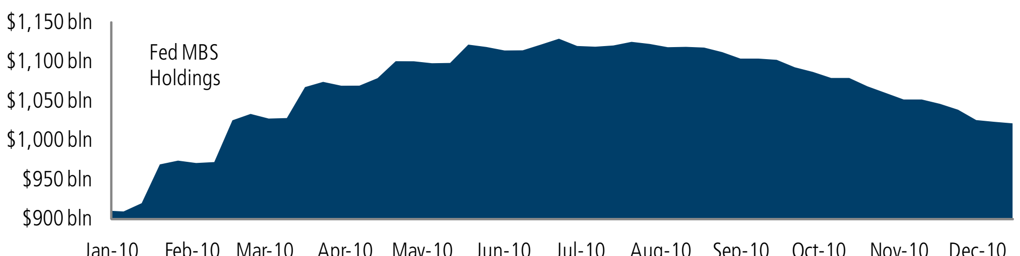
CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

The second source of technical strength we see into 2011 is the bank bid. Lending volumes remain atrocious and financial institutions are still hesitant to commit risk capital to new mortgage originations—hence the high portion of agency production in 2010. Real estate loans on bank balance sheets are down nearly 5% versus last year, even as deposits are up around 3% in (ironically) a liquidity glut that will only deepen as mortgage originations slow. As a result, we see a strong and sustained bank bid for agency mortgage assets in 2011 as financial institutions look to deploy excess deposits in a low loan growth environment. This emergent bank bid should replace the Fed's predominant position in the mortgage markets during the early part of 2010 and, along with slowing supply, provides a strong technical basis for mortgage spreads in the New Year.

Fed Liquidation of MBS Holdings, While Unlikely, Is One 2011 Risk Factor



Source: Janney Fixed Income Strategy

The wildcard in this supply/demand equation remains the Fed's ability to control the markets by announcing an MBS sale program, but we find such a monetary tightening unlikely, and an extraordinarily unlikely prospect while the Central Bank is still buying Treasuries. Even without such sales, prepayments on the Fed's $1.25tln mortgage book are running at a $160 – $220 billion pace for the coming year, and the banking sector would need to expand mortgage sponsorship by approximately 16% to counter these paydowns, but that figure is easily achievable considering our expectations of slower originations and excess bank liquidity. Foreign demand remains somewhat unpredictable in the midst of a volatile dollar, but we anticipate strong sponsorship from core US buyers in 2011.

While the Fed has the potential to drive a spike into the markets by announcing liquidations in its MBS portfolio, we view that risk as limited.

The CMO engine proved powerful this past year, as a steep curve enhanced arbitrage opportunities and allowed dealers to create a net $43 billion in new deals against shrinking overall markets. Bank balance sheets were the primary purchasers in the CMO markets, and the lack of interest for longer sequentials from traditional buyers in that segment (life insurers, etc) has created a rather steep CMO curve. This CMO demand dislocation has created a temporary vortex of value in longer 7-11yr sequentials and PACs—great for the unrestricted real money or insurer investor base—but this dislocation will likely close rapidly in early 2011. For the full year, we expect CMO issuance will remain robust, though concentrated in 1Q and 2Q, as a steep yield curve continues to support arbitrage. This CMO supply will serve well to supply the aggressive bank bid, which we expect will continue even as a flattening curve in the back half of 2011 starts to reduce issuance. As with the collateral markets, we expect the traditional short bank-type sequential and PAC structures, and particularly the premium coupon issues, to be a bright spot in the fixed income markets for the coming year.

For Premium-Averse Investors, Short Bank SEQs and PACs Limit Extension Risk

4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
-8.00%
FN 30yr 5 | FN 15yr 4.5 | 4yr SEQ | 4yr PAC
Base Case Forecast
+50bps
+100bps
+200bps
Interest Rate Scenario

Source: Janney Fixed Income Strategy

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Investment Grade Credit: Sun Setting on a Strong Day

- We are heading into 2011 with a marketweight position on the investment grade credit sector, as we anticipate spreads will remain largely unchanged and IG will follow the course of the Treasury markets indicating total returns of 2 – 3%.
- While economic conditions are supportive of corporate profits, credit fundamentals in the IG universe are trending slightly weaker as firms pursue shareholders returns to the detriment of credit quality via re-leveraging transactions.
- Investment grade issuance will likely decline 4 – 7% to around $710 billion, based on reduced funding needs in the financial sector, a 10% increase in M&A volumes and an uptick in re-leveraging transactions.
- Strong demand particularly from the pension investor base should nonetheless help to support the IG credit markets against a backdrop of these slightly weakening credit trends.
- Major risks to our expectations for IG credit stem from the economic and interest rate environment, as our primary downside risk (a deflationary spiral) would drive spreads wider and simultaneously elevate re-leveraging/refinancing issuance.

The IG credit sector should track the broader interest rate markets in 2011 as mixed pressures keep spreads relatively unchanged.

2011 Investment Grade Credit Outlook

Segment	2011 Performance	Comments
Spreads	Neutral	Returns to track interest rate markets
Credit Quality	Weaker	IG companies re-leveraging
Issuance	Lower	$710bln is 4-7% decline vs 2010 levels
Demand	Stronger	Pension bid for duration assets growing along with aging plan participants

Source: Janney Fixed Income Strategy

The era of credit improvement persisted from mid-2009 through late-2010, with risk-adjusted performance in the investment grade markets reaching towards the strongest levels in memory. Through mid-December, the US IG credit markets have registered a 6.9% total return, driven by a modest drop in spreads year-over-year, but more importantly a tide of stronger rates markets that has lifted all boats. At this juncture, credit spreads have built in expectations of continued liquid markets, limited credit risk, moderating issuance volumes, and ongoing strong demand from a cash-rich investor base. Considering our 2011 economic expectations also lend themselves to these four factors, we expect IG credit spreads will trend largely sideways for the coming year. As a result, the IG markets will track the performance of the interest rate sector; with our base case forecast of gradually rising rates, this outlook implies a 2 – 3% total return within the investment credit markets for 2011.

Credit quality among IG issuers is facing a set of mixed pressures. On the positive side, our economic outlook for continued stable growth and a steady state of consumer spending bodes well for corporate EBITDA, which we estimate will expand at a 4.5 – 5.0% rate economy-wide in the coming year. EBITDA expansion without any corresponding increase in debt load is essentially a free lunch for credit metrics, and our estimates, absent any increase in debt, would represent an estimated 0.4x decline in debt/EBIT ratios among IG corporations. On the negative side in terms of credit pressures is the tendency for firms to re-leverage balance sheets now that the worst of the crisis is behind.

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

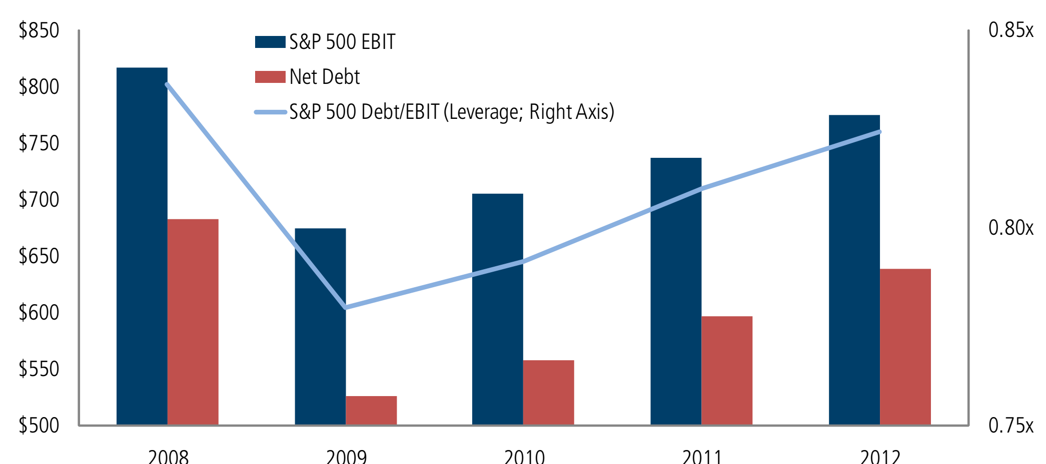
IG Credit Spreads Have Been Retreating Since Late June...

Source: Janney Fixed Income Strategy; MarkIt

Investment grade issuers are beginning to re-leverage their balance sheets after cutting debt in 2008 through early 2010.

We've seen a number of transactions over the past several months which accomplish this re-leveraging, from M&A deals to the most classic of wealth transfers, the debt-funded share buyback. On the latter count, firms have frequently found themselves over the last six months with fewer opportunities for investment in core business activities. With interest rates and funding costs at or around record lows and limited business investment, a number of firms have looked to issue debt and use the proceeds to buy back stock, thereby increasing leverage and benefiting shareholders at the expense of credit quality. With issuance costs still relatively cheap in 2011 and the chance that the recent equity rally turns to correction mode, we see these sorts of credit-unfriendly capital structure transactions as remaining prominent in the coming year. On balance, we expect re-leveraging transactions will offset organic improvement in credit from better profitability, resulting in a modest increase in leverage ratios and a slightly weakening in overall credit quality among investment grade issuers.

...Even as We Forecast IG Issuers to Continue Re-Leveraging



Source: Janney Fixed Income Strategy; S&P

Credit markets supply over the last three years has been a story that reads much like the Three Gorges Dam project: supply was so heavily constrained in 2008 – mid 2009 that late 2009 into 2010 have seen an absolute flood. Those floodwaters should ebb in 2011 as a slow rise in interest rates discourages refinancing transactions, though M&A volumes, FDIC refinancing needs, and the aforementioned re-leveraging transactions are still creating a need for IG issuance. We are presently

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

looking for a decrease in new issuance to between $695 and $720 billion for 2011, which would represent a 4 – 7% decline versus 2010 levels. The midpoint of this forecast ($710 billion) includes:

- 10% increase in M&A volumes for the coming year with a similar cash/stock mix and funding ratios as 2010
- Refinancing two-thirds of scheduled USD maturities issued during the financial crisis under the FDIC's Term Liquidity Guarantee Program
- Re-leveraging transactions which total $75 billion and IG capital structure refinancings totaling $30 billion
- Decline in financial debt outstanding of $40 billion over and above partial TLGP refinancings

IG Issuance Will Likely Decline 4-7% for 2011

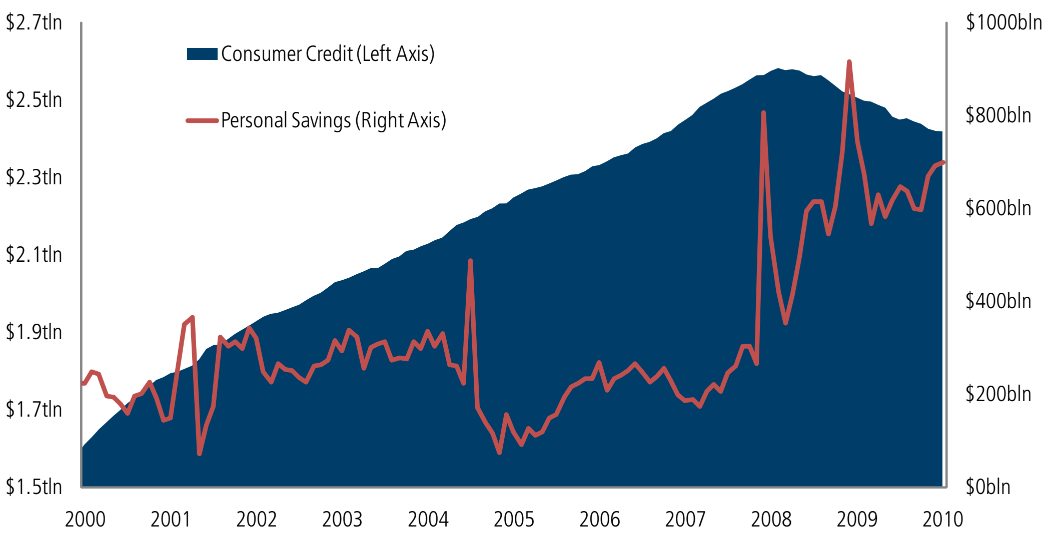
Source	High Case	Low Case	Comments
Maturity Refinancing	$375 bln	$378 bln	Financials cutting debt ~$40bln
FDIC Refinancings	$65 bln	$60 bln	60-70% TLGP refinancing
M&A Funding	$171 bln	$159 bln	Looking for 10% increase in M&A
Re-leveraging Transactions	$110 bln	$100 bln	Re-leveraging transactions remain prominent
Total	**$720 bln**	**$695 bln**	**4-7% Decline**

Source: Janney Fixed Income Strategy

Although IG issuance will be lower in 2011 than in 2010, a greater portion of that issuance will be used for re-leveraging transactions.

Our 2011 issuance forecast does not include Build America Bonds, which, while a form of municipal and not corporate obligations, are a significant portion of the broader IG credit sector. Potential BABs issuance ranges from $75 – $90 billion, contingent upon Congress reauthorizing the on-again, off-again program and also upon the issuer subsidy level. Incoming Transportation Committee Chair John Mica has most recently indicated that he will work to extend BABs issuance. As the BABs investor base seems somewhat segregated from the traditional corporate credit investor base, we suspect additional BABs supply will not have a meaningful impact on technical dynamics in the corporate markets.

Personal Savings Are a Major Source of Demand for IG Markets



Source: Janney Fixed Income Strategy; Federal Reserve; Commerce Dept

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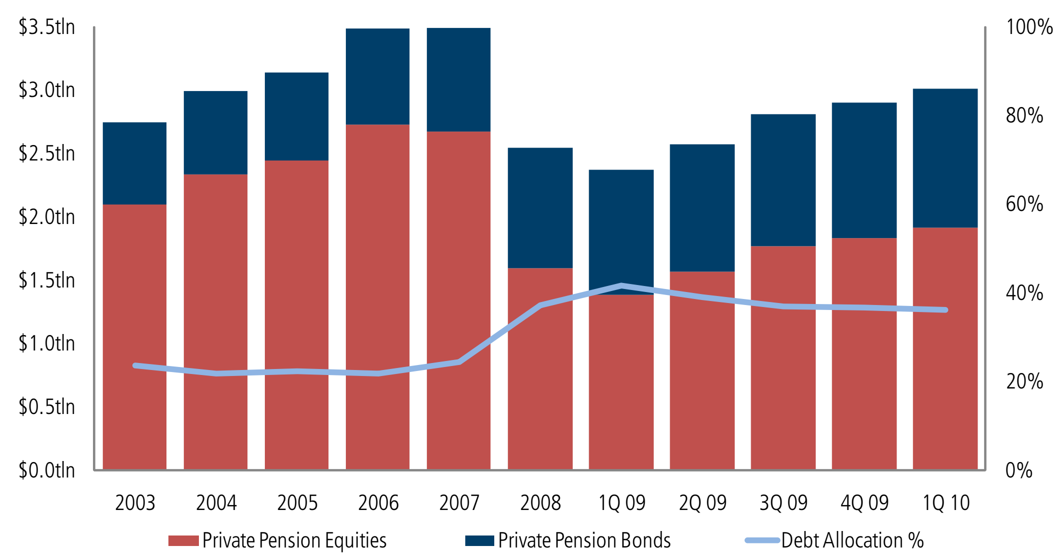
CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Speaking of investor base, we anticipate that the demand side of the equation will continue to be a strong driver for the credit markets in 2011 and readily sop up new issue supply, even as some existing investors get disillusioned with re-leveraging transactions. While real money money managers were some of the biggest sources of demand within the credit markets for the past year, we expect pension investors to take over as the primary source of cash going forward. This trend is not just a 2011 phenomenon, but likely a years-long process as the average age of pension plan participants rises along with broader demographic trends. Based on our midyear pension analysis, the average corporate pension holds just 36% of their portfolio in debt instruments, an allocation that will necessarily rise as funds move increasingly from capital appreciation into retiree payout mode. In addition, an IASB accounting proposal (possibly to be followed by a US FASB proposal), if adopted for 2012, would increase firms' incentive to match plan assets' risk profile to participant characteristics, thereby accelerating the pension transition out of equities and into fixed income investments. Corporate credit, both IG and sub-IG, as the highest yielding stable duration asset class should absorb a substantial portion of the pro-debt pension allocation changes.

Pension reallocation out of equity and towards debt provides long term demand for the IG credit sector.

Pensions Account for 25% of US Investments and are Re-allocating to Credit



Source: Janney Fixed Income Strategy; Federal Reserve

On balance, our outlook for the US investment credit markets is neutral, as subtly weakening credit fundamentals should be offset by a reduction in supply and continued strong investor demand for the sector. That leaves IG subject to the whims of the rates markets, and given expectations for a gradual rise in rates, this assessment translates into a good but not great total return. The primary risk factor we see for the IG markets is driven by the potential for a deflationary spiral to emerge, as detailed in the economic comments at the beginning of this outlook. Not only would the deflative environment imply an extended soft patch for aggregate demand and therefore profitability, but it would also incent issuers to increase re-leveraging transactions as a result of cheap funding costs and weakening equity markets. Additional supply at a time of significantly weakening fundamentals introduces the potential for a substantial widening in credit spreads—though, again, this deflationary spiral remains an unlikely scenario.

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

HIGH YIELD CREDIT: ANOTHER YEAR OF RELIEF

- High yield credit is set to once again be the star performer in the fixed income markets for 2011 and our rating on the sector stands at an overweight.
- Continued improvement in the credit cycle should push US speculative grade defaults south of the 2% mark, which is below Moody's 2.5% forecast.
- In contrast to IG issuers, HY issuers are not, as a rule, re-leveraging, but rather entering into transactions which improve credit quality and especially liquidity via better maturity schedules.
- Issuers have eaten away at the once $1 trillion high yield maturity wave via exchanges, refinancings, and good ol' Chapter 11, thereby pushing out the major risk of higher defaults to 2013 and beyond.
- Demand from yield-hungry investors should continue to compress spreads relative to both Treasuries and IG credit and permit issuers largely unfettered access to primary market issuance.
- A word of caution: decisions made today can affect performance in the next credit downturn years down the road and legal protections are eroding on new issues.

Yield hungry investors will drive the down-in-credit trade for 2011 as the default rate continues to ease.

2011 High Yield Credit Outlook

Segment		2011 Performance	Comments
Spreads	↑	Tighter	Fundamental improvements along with yield chasing behavior are big positives
Credit Quality	↑	Stronger	Issuers revamping maturity schedules successfully; prefer Ba3 and B1 area of credit spectrum
Default Rate	↓	Lower	Forecast decline to mid-1% range
Issuance	↑	Higher	Liquid markets and investor demand indicate higher issuance, but hard to peg
Demand	↑	Stronger	Real money investors chasing yields down rating range

Source: Janney Fixed Income Strategy

Easy money and roughly fifteen months of hungry investor risk appetite has driven two years of tremendous performance for the high yield markets, with the sector registering a total return of 14.76% for 2010 thus far. While it's naive to expect yet a third year of double-digit returns for the high yield credit sector, we are calling for the risk-on trade to continue and spreads in high yield to compress relative to both Treasuries and investment grade credit for both fundamental and technical reasons. At the core of our expectations for high yield, however, is the fact that corporate profitability and the credit cycle continues to turn.

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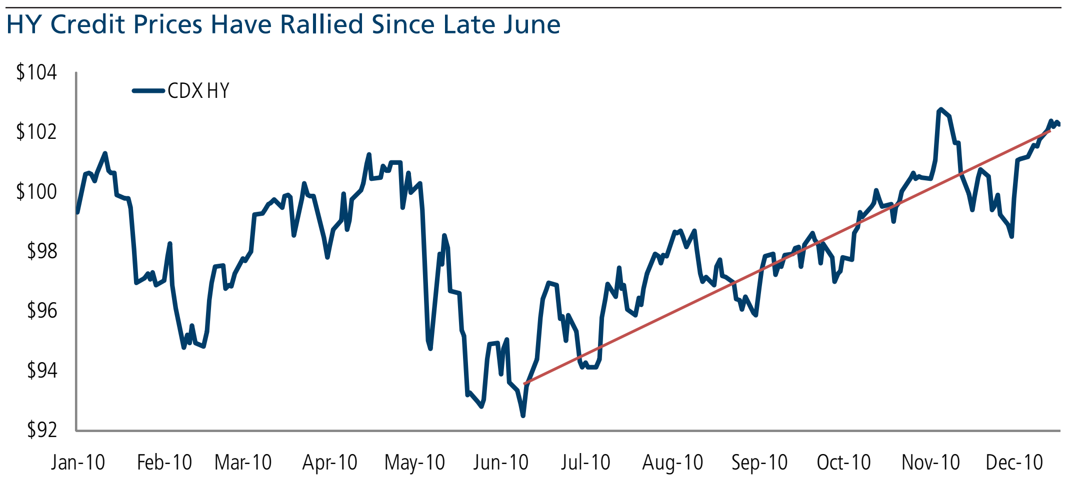
CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

HY Credit Prices Have Rallied Since Late June

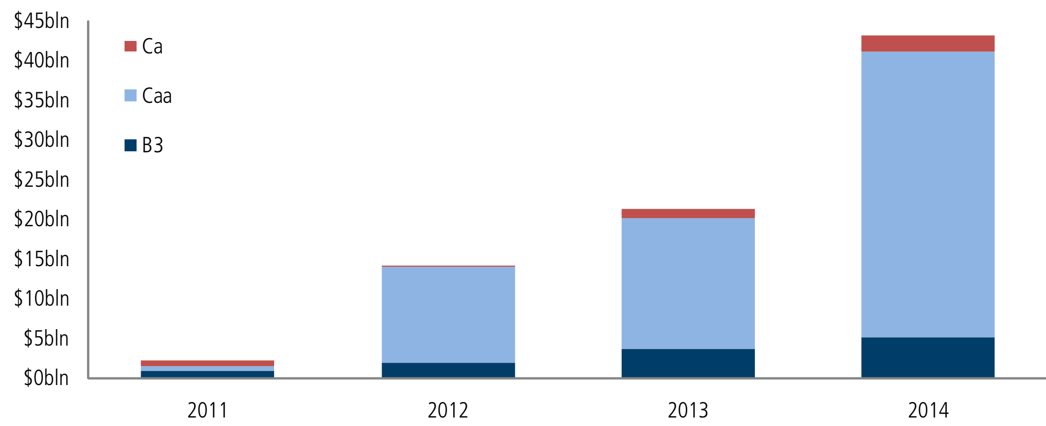


Source: Janney Fixed Income Strategy; MarkIt

The higher risk (i.e., lower rated within the HY sector) volume of debt slated to mature in 2011 measures just slightly above $2 billion. That figure, which covers maturities from issuers rated B3 or below by Moody's with negative outlook, represents just 17 basis points of the broader high yield index, the lowest portion we've seen since 2007. Given limited liquidity needs among this highest risk element of the high yield sector, we anticipate a further decline in the speculative grade default rate to between 1.5 – 1.7% for 2011 (issuer weighted). That level compares quite favorably to the November 2010 trailing twelve month US default rate of 3.5%, the November 2009 level of 20.1%, and even Moody's 2011 forecast of a 2.5% issuer default rate.

The low level of distressed issuer debt maturities in 2011 offers a strong basis for a declining speculative grade default rate.

2011 Maturities from Lowest-Rated Neg. Outlook Issuers Are Minimal



Source: Janney Fixed Income Strategy; Moody's

We see several major factors as driving this trend towards stronger fundamental credit quality and lower default rates within the high yield markets. One natural outgrowth of a major economic and financial downturn is that it effectively "shakes out" the weaker credits from the high yield universe via involuntary defaults and restructurings. As a result, the current composition of the high yield sector, all else held equal, is somewhat stronger than immediately prior to the last default wave. Factor number two is economic, as a normalization of consumer and business spending is aiding revenues, improving cashflow, and reducing debt/EBIT leverage ratios. Unlike for IG issuers, the revenue im-

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CONTENTS

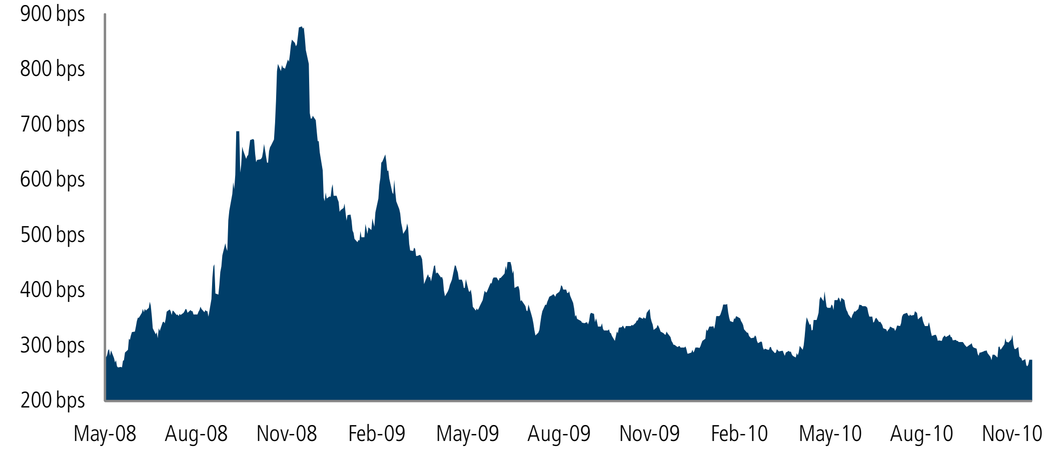
ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

provements are generally occurring at a faster pace than debt issuance. The final major factor on the list has been improved liquidity—both external and internal—as the markets have come alive to accept new deals and issuers have used the opportunity to reduce upcoming debt maturities.

One secular outgrowth of the 2008 – 2009 financial crisis is a greater investor focus and therefore higher pricing on liquidity risk. The markets rediscovered that, while net losses hurt and weak balance sheets maim, liquidity kills, and the long term outgrowth is a severe penalty towards entities which carry a high degree of liquidity risk. By corollary, we've seen a strong response to that risk among high yield issuers now that the debt issuance door is wide open. IG firms have looked to re-lever with debt funded share buybacks which enhance equity returns at the expense of credit quality at a time when the markets are comfortable with leverage risk. Now, high yield firms are looking to adjust maturity schedules at the expense of income at a time when the markets are uncomfortable with liquidity risk. In comparing IG and HY trends, it appears that while IG issuers are on average adding risk via leverage transactions, HY issuers are generally cutting risk by improving maturity profiles. The rising tide of an improving credit cycle lifts all issuer boats, but these trends imply a further tightening in spreads between IG and HY issuers.

IG issuers are using new issue deals to re-leverage while HY issuers are using new issue deals to improve maturity profiles.

Ba/B Spread Compression to Persist into 2011



Source: Janney Fixed Income Strategy; Barclays

One of the biggest long term problems facing our outlook on the high yield sector in 2009 – early 2010 was the fact that nearly $1 trillion of bonds and loans originated during the heyday of the credit boom were slated to mature between 2011 and 2015. Since that wall was built, a remarkable set of circumstances has emerged, leading to an unprecedented number of restructurings that have, in turn, chipped away at this high yield maturity wall. The bulk of these restructurings fall into one of four categories: issuance of long and subsequent repurchase of short debt, amend-to-extend loan deals which push out maturities, coercive transactions, and the old standby, Chapter 11 bankruptcy. In total, we estimate high yield issuers have cut down on the debt maturity wall by about 12%, leaving 2011 – 2015 maturities now at $878 billion. Much of the progress made has been in nearer dated obligations, notably 2012 and 2013 maturities, which is to be expected, as these short maturities present the best opportunities for coercive restructurings.

Yet the debt reduction in that period is offset by a commensurate increase in 2015 – 2016 maturities, leaving the total size of the debt maturity wall at still-daunting levels and looking increasingly back-weighted. At the very least, however, the improving maturity profile of the high yield markets leaves us no longer concerned about market liquidity until 2013. In some sense, this assessment amounts to kicking the can down the road—but then again, that's precisely what issuers have done by extending maturities.

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Chief Fixed Income Strategist

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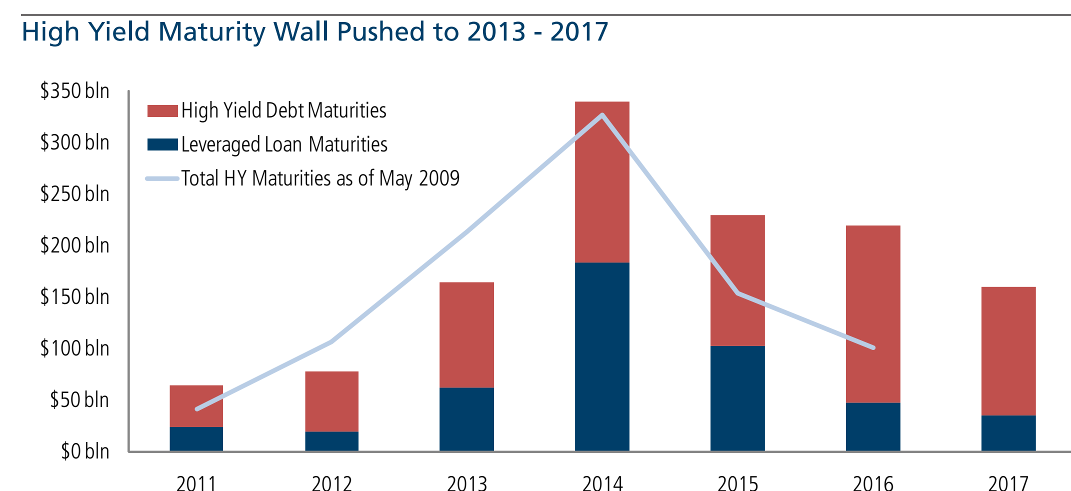
CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

High Yield Maturity Wall Pushed to 2013 - 2017



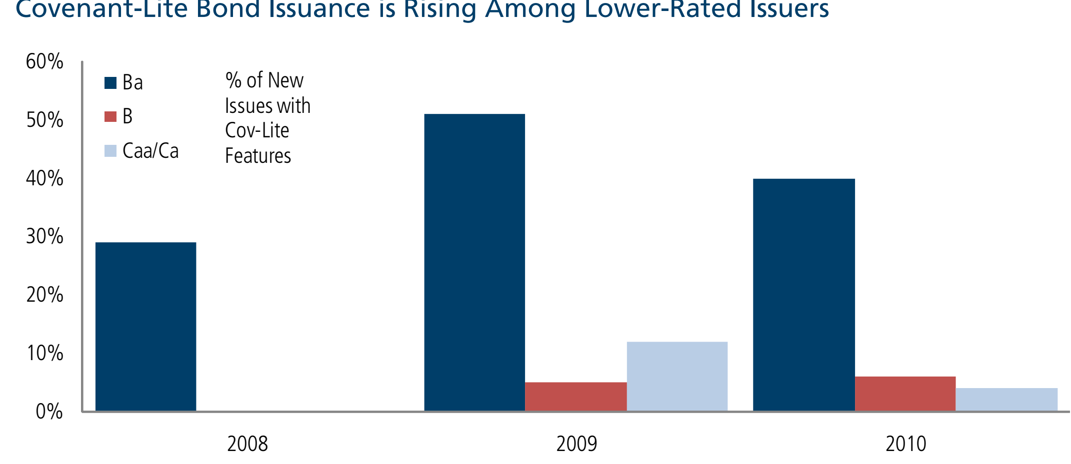
Source: Janney Fixed Income Strategy; S&P/LSTA; BAML

A declining default rate and improving fundamental conditions among high yield issuers are supportive, but ultimately increasing demand from yield-hungry investors is what's set to drive strong HY performance in 2011. With banks and CLOs both no longer providing capital to the HY sector via leveraged loans, the bond markets have become a region of greater focus. Moreover, as absolute yields trend at disappointingly low levels for many investors, there's an increasing migration down in credit quality that should permit traditionally investment grade debt buyers to stray into high yield space. That trend is already firmly in place, as evidenced by asset managers' (and our) increasing preference for the double B area of the credit spectrum, particularly as compared to low IG-rated debt. In addition, bank lending volumes continue to evaporate, and institutions in many instances are hard-pressed to lend out cheap deposit dollars for lack of borrower demand. So long as interest rates remain relatively low (and based on our forecasts, they will through mid-2012), we see strong demand for high yield assets continuing and thereby compressing spreads in the high yield sector.

Decisions made today will affect default performance in the next credit cycle.

Not to sober our positive outlook on the sector for 2011, but there's a crucial and oft-overlooked aspect of the high yield markets worth mention. Over the past several months, elevated investor demand for high yield has allowed issuers to relax legal protections on new deals, with even a handful of Caa rated firms bringing covenant-lite sales to market. Those reduced lending standards pose little problem when the default cycle is improving as it is today, but they can make all the difference in the world if and when conditions begin to worsen. In that sense, bond lending decisions made today will be the ones that determine performance down the road in the next default cycle. Beware of covenant-lite and the lax lending conditions it represents.

Covenant-Lite Bond Issuance is Rising Among Lower-Rated Issuers



Source: Janney Fixed Income Strategy; Moody's

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Municipal Strategy: Contents May Not Explode Under Pressure

- We carry an overweight rating on the municipal sector, as bad news is more than priced into the markets, and current trading levels offer attractive carry relative to other fixed income sectors.
- The BABs program will hold a great deal of sway over municipal/Treasury ratios on the long end of the curve, as whether and at what subsidy the program is extended will determine long maturity tax-exempt issuance.
- Extended or not, BABs trade at wide spreads to like-rated corporate debt, despite municipalities' lower long term default experience, and we continue to see value in the sector.
- Credit pressures are substantial, but several examples of cutbacks prove that issuers don't need to succumb to downgrades as tax revenues decline.

2011 Muni Market Outlook

Sector		2011 Outlook	Comments
M/T Ratios	–	Neutral	Returns to beat out Treasuries on tax-free carry
Credit Quality	↓	Weaker	Issuers are dealing with credit issues, but underlying trends are negative
Issuance	–	Contingent	No-BABs extension $370 - 390 bln; With BABs extension, $280 - $300 bln
Demand	↓	Weaker	Credit headlines problematic for retail bid
BABs Spreads	↑	Tighter	Extension or not, BABs trade too cheap to corporates and are one of our favorite sectors

Source: Janney Fixed Income Strategy

While we expect M/T ratios to remain relatively stable for 2011, higher carry on tax exempt munis should help the sector outperform.

Tax free yields have moved higher post election, primarily responding to weak Treasury markets. Treasury yields in turn have increased in response initially to the uncertainty about the status of Bush era tax cuts and subsequently to concern about the tax cut compromise reached by the Obama administration and Congress, which will extend cuts for two years, add to the deficit and necessitate increased Treasury issuance. Although there may be continued volatility as we enter the new year, we expect long term tax free yields to remain near current levels. Inflationary expectations are muted, and reading between the lines of recent Fed pronouncements it seems that deflation may be as much of a concern as inflation.

A second pressure on long term tax free bonds is the volume shift expected as a result of Congress' failure to extend the Build America Bond program beyond its scheduled December 31 sunset. New issue volume for the year is shaping up to be about $415 billion, roughly $117 billion of which will be BABs, mostly longer maturity issues. Assuming BABs are finished, this means an increase in supply of tax free bonds by as much as 35%. The incoming Chair of the House Transportation and Infrastructure Committee, breathed life into potential for BABs redux in 2011, stating he plans to introduce a "reincarnation" of the Build America Bond program, but we place the odds of BABs return as below 50%. The cost to the federal government has been estimated to be about $3 billion annually, but this amount grows with each new issue. Since the subsidies will last until bonds mature, in many cases thirty years or beyond, the prospects for continuation of this "stimulus spending" are mixed.

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

BABs Spreads Are Cheap to Corporates

75 bps
65 bps
55 bps
45 bps
35 bps
25 bps
15 bps
Oct-09 Dec-09 Feb-10 Apr-10 Jun-10 Aug-10 Oct-10 Dec-10

Source: Janney Fixed Income Strategy; Barclays

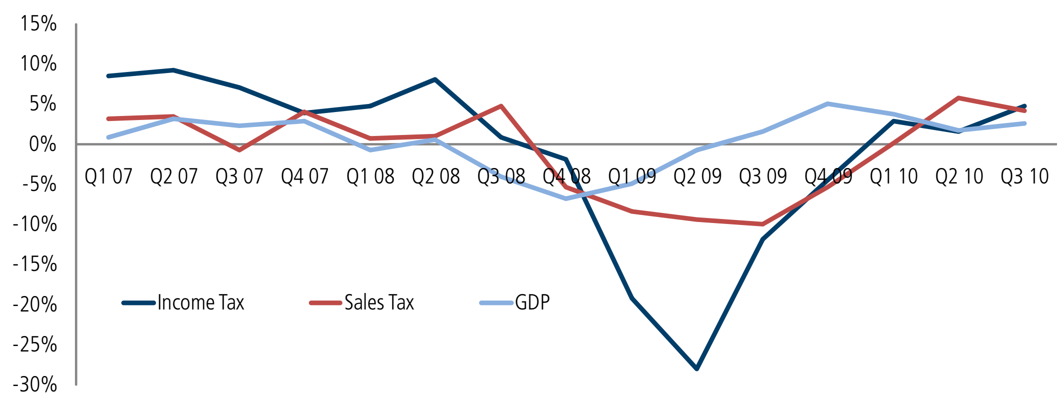
The December report from the National Commission on Fiscal Responsibility and Reform, titled the Moment of Truth, failed to garner necessary votes for submission to Congress, but in the context of tax simplification and deficit reduction, we may see many parts resurface. A proposal to eliminate the tax free feature of future municipal bond issues was part of the package, and the possibility flowed through press accounts, before the excitement subsided. Longer term there is a likelihood that this dramatic change will be revisited, and ironically the success of the short lived BABs program provided fodder. BABs showed that there is demand for taxable munis. Eliminating tax free munis would certainly raise interest costs for municipal issuers, but an interest subsidy program, similar to that of BABs, could ease the pain and be phased out over time. In the meantime BABs offer opportunity to investors. The heavy supply of issues squeezed into year end have pushed spreads (yield differential) between BABs and corporate bonds to the highest levels in more than a year. Faced with a decision whether to invest in corporate bonds or like rated taxable municipal bonds, fifty basis points or more of additional yield adds a compelling argument, along with the diversification BABs offer to tax advantaged portfolios such as IRAs. We expect the yield gap between corporate and BABs to narrow as the prospects of future BABs issuance dims.

BABs extension has been an uncertainty hanging over both the BABs and tax-exempt markets for nearly three months now.

Are Credit Pressures Really That Explosive?

Throughout 2010, media reports dripped on the market with messages ranging from states and municipalities facing tough fiscal times to dire predictions of sharp upticks in default rates. As we go to press, the talk is of a Sixty Minutes segment featuring New Jersey Governor Chris Christie and analyst Meredith Whitney. As noted elsewhere in this publication, we maintain our stable outlook for the state sector and our cautious outlook for local government, but we do not see an impending disaster or sharp increase in default rates. Default rates in 2010 have actually run below longer term averages, and while we expect some increase in 2011, the pace will continue to be moderate.

YoY Government Tax Revenues are Trending Back in the Black



Source: Janney Fixed Income Strategy; Rockefeller Institute of Government

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CONTENTS

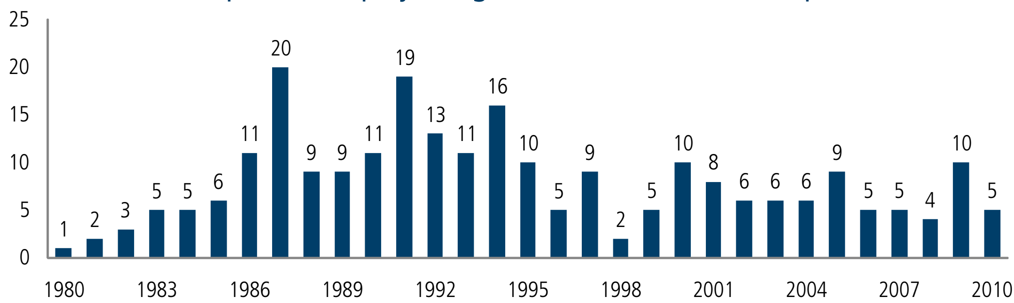
ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

New Jersey offers a relevant example of the financial challenge and process facing state and local government. Although the Great Recession ended six quarters ago, the impact on state and local government has lagged. Unemployment remains elevated, and this translates into lower income and sales taxes, primary revenue sources for states. NJ Governor Christie hit the ground in 2010 and immediately began to cut spending, while sticking to a no tax increase pledge. One of the largest spending reductions was state aid to local communities, in effect downstreaming the state's problems to local issuers, resulting in at least 23 NJ municipality downgrades from Moody's, twice as many as the next highest state, New York. Additional pressure comes in the form of a 2% cap on property tax increases implemented by Christie. Property taxes are already under pressure given the difficult housing market, with many homeowners seeking reassessment.

Although these spending cutbacks can be painful, they are a necessary evil. California's new governor, Jerry Brown, is promising significant cuts and as the political process continues to play out we expect other states to follow in New Jersey's footsteps, making tough spending decisions. State revenues have turned a corner, with more than 30 states reporting increased tax revenue in the third quarter 2010, but there are still lean years ahead. After the 2009 - 2010 flow of stimulus transfers from federal to state and local government, the tap is closing.

Despite evident credit pressures, only 5 municipalities have filed for Chapter 9 bankruptcy in 2010.

Number of Municipal Bankruptcy Filings Remains Quite Low, Despite Pressures

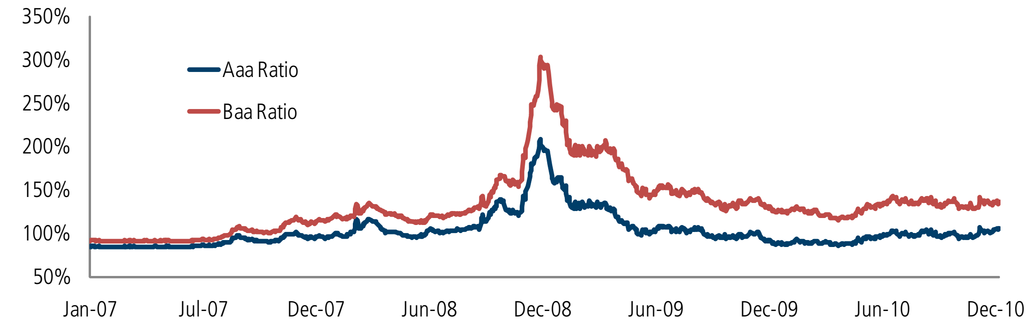


Source: Janney Fixed Income Strategy; Chapman & Cutler

The good news in all this is that state and local issuers are beginning to make the necessary adjustments. We will see more downgrades (and upgrades), and the rate of defaults may rise from the five experienced in 2010, but there is no municipal disaster on the horizon. We expect to see continuing alarm conveyed to investors through media outlets, and since perception can overtake reality, lower quality issuers will be disproportionately impacted. A measure of relative value of tax free municipals is the ratio of a tax free yield to a like maturity Treasury yield. The gap between Aaa ratios and Baa ratios has remained wide since the liquidity crunch of late 2008, and we expect this gap to continue or even widen as 2011 progresses. As states follow the Jersey model, we can expect some downgrades, with investors demanding more yield to offset downgrade risk.

Overall, however, the municipal sector remains sound. We continue to emphasize the importance of diversification across geographic areas, sectors and maturities, with a laddered portfolio being our preferred approach to portfolio construction.

Baa vs Aaa Credit Spreads Have Retreated Sharply Since 2008



Source: Janney Fixed Income Strategy; MMD

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

MUNICIPAL CREDIT: 2010 REVIEW AND 2011 PREVIEW

- Credit deterioration is a fact of municipal issuers' lagged and incomplete responses to the economic downturn, but defaults among traditional GO and essential purpose revenue issuers will remain few and far between for 2011.
- State governments are cutting support of their smaller local government constituencies, which is creating divergent credit pressures on the two sectors, though school districts remain funded.
- Among the more volatile sectors, we hold cautious outlooks on airport, higher education, hospital, and tobacco bond issuers' credit profiles.
- We hold stable credit outlooks on more traditional essential purpose revenue sectors including single family housing, public power utilities, mainstream toll road facilities, and water and sewer authorities.

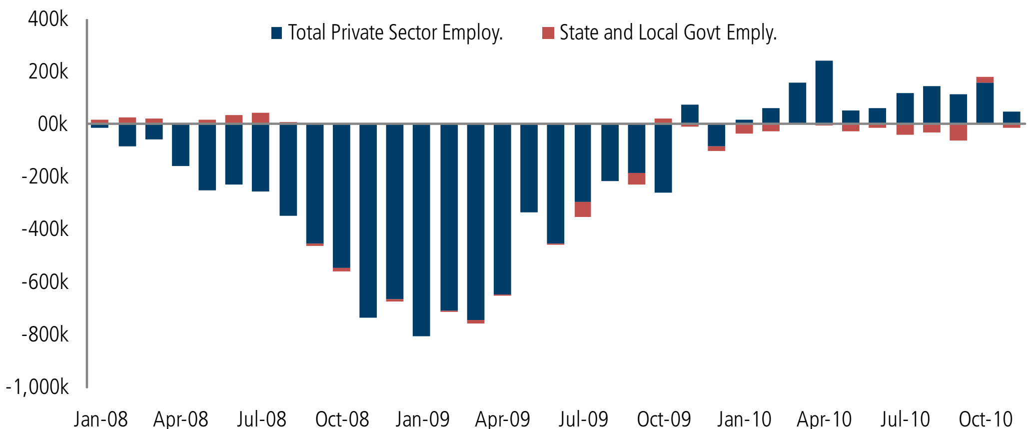
Suggestions of factors stressing the municipal market were excessively overblown throughout 2010 and we expect exaggerations to worsen in 2011. Concern about municipal market credit risk will be heavily mixed with headlines of imminent danger stemming from political posturing during state and local government budget negotiations. Factions will battle over wages, program cuts, and general spending. You name it and it will likely be fought over. Increased "threats" of Chapter 9 municipal bankruptcy will also become more prominent. That being said, investors should not buy into artificial intimidation tactics but ought to be mindful of the effect of the current economic environment on municipal holdings.

Municipal credit fears have proven overblown through this point in the credit cycle.

Municipal market defaults and bankruptcies remained low during 2010, despite negative fanfare. Annual Chapter 9 filings were limited to five, versus ten in 2009 and they were restricted mainly to situations with extenuating circumstances. Defaults were also minimal. Since the middle of 2009 only three municipal issues in the "safe" sectors, which are characterized as general obligation, tax backed and essential services, defaulted, according to Municipal Market Advisor's data. There were several defaults for issues in riskier sectors such as stand-alone multi-family housing (49), hospitals (31), or retirement facilities (30) but these are all sectors at the far end of the municipal market risk spectrum. Even though there has been a question of confidence about the municipal bond market we still embrace the premise that there will not be a "Municipal Meltdown," or a significant increase in the number of municipal defaults or bankruptcies versus historical experience in the near term.

Governments' Lagged Response to Downturn Will be Key in 2011

State & Local Government Response to Downturn Lagging Private Sector



Source: Janney Fixed Income Strategy; Labor Dept

If we refute basis for fear-mongers' warnings in 2010, what is it that investors should be thinking about for 2011? A key factor we will be watching is the lagged response governments, especially local governments, are having in response to the economic downturn. This is partially because stimulus funds from 2009 - 2010 are no longer available. Using employment as example we saw the

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CONTENTS

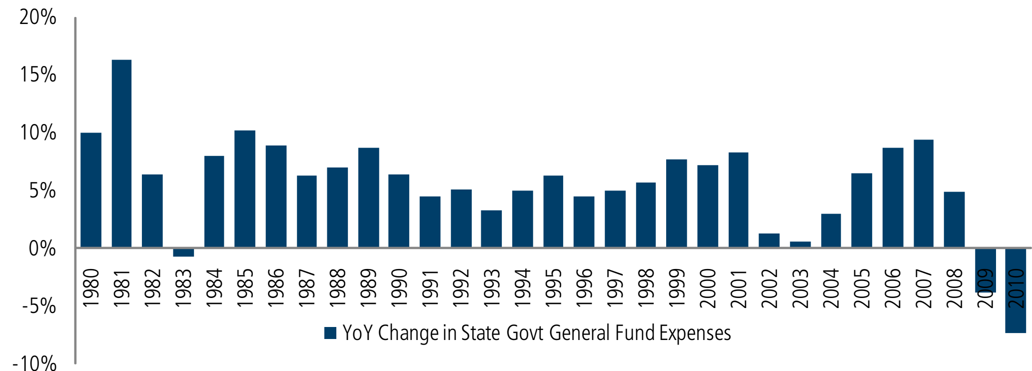
ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

private sector cut just over 7% of employment in 2008 and 2009 while state and local government did not begin making notable employee reductions until the beginning of 2010. State and local governments cut just under 2% of its workforce from the beginning of 2009 through November 2010. Traditionally, public sector positions are more stable during economic downturns, but we expect that will not be the case this time around. We are anticipating further government employment trimming throughout 2011 and 2012.

Although state and local government employment cutbacks have lagged the private sector, we are seeing state governments generally willing to manage general fund spending. General fund spending was down in 2009 and 2010 for the first time in over 25 years. Fueled by the November elections and a more fiscally conservative mind-set this could be set to continue in the near future. Overall decreased state spending is flowing down to and affecting the credit profiles of other municipal market issuers. Please see the below sector by sector reviews for more detail about the effects of lower state aid payments.

States have begun the painful process of adjusting spending to a lower absolute level of tax receipts.

States Have Reduced General Fund Spending Post-Recession



Source: Janney Fixed Income Strategy; Nat'l Assn of State Budget Officers

Janney Municipal Market Sector Outlook and Review

Every month we include this table which contains a sector by sector review of Janney's near term municipal credit outlook, Barclay's 12 month sector total returns and key sector trends. This month we revised up our outlook to "Cautious" from "Negative" on the tobacco sector, despite rating agency downgrades and market pessimism toward the municipal tobacco sector. The Tobacco Sector review below includes more background supporting our view.

Municipal Sector Credit Outlooks

Sector	Janney Outlook	Last Month Change	12 Month Return (Nov 30)	Key Sector Trends	Recent Janney Sector Review
State Government	Stable	Same	5.00%	Taxing power = more security	Sept MBMM
Local Government	Cautious	Same	4.27%	Less revenue, look for over-leverage	Nov MBMM
School Districts	Stable	Same	-	State programs offer more security	Aug 30 FIW
Airports	Cautious	Same	5.34%	Enplanements slightly higher in 2010	Feb 8 FIW
Higher Education	Cautious	Same	4.70%	Publics get less $, privates face pressure	Jan 25 FIW
Health Care	Cautious	Same	6.84%	Ratios are improving	Oct 25 FIW
Housing	Stable	Same	6.09%	Single family is stronger than multi	Aug 23 FIW
Public Power (Elec.)	Stable	Same	4.94%	Essential purpose, but volatile	Jun 21 FIW
Tobacco	Cautious	Higher	4.36%	Favorable risk/return tradeoff	Dec 6 Note
Toll Facilities	Stable	Same	5.34%	Traffic rising, DS cov. strong	March MBMM
Water and Sewer	Stable	Same	4.79%	Essential purpose, scarcity in south	Apr 19 FIW

Source: Janney Fixed Income Strategy; Nat'l Assn of State Budget Officers

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

State Government Revenues are Higher (Stable)

Although the U.S. employment picture remains troubling and the financial implications of state aid cuts to local governments and other municipal issuers will be deep and painful our outlook for state governments in 2011 is generally strengthening. Falling credit ratings may not be completely behind but, 2011 will not see the same concentration experienced in 2010. The financial and political dynamics in California and Illinois are worth keeping an eye on, even though California just reported November tax receipts that were almost 20% higher than expectations. Pensions and other health care expenses are finally being taken seriously and many are addressing bulging funding requirements by reforming programs. State tax revenues have trended higher and state credit spreads have generally tightened. Nearly 90% of reporting states experienced rising tax revenues as state tax receipts were higher for the third consecutive quarter, according to data from a Nov 30 Nelson Rockefeller Institute of Government report. Now three quarters into a positive trend, the recent upticks officially fall into the "encouraging" category. The results should aid governments especially at a time when federal support is trailing off, though we remain mindful that state and local government have their work cut out for them in 2011 and 2012. Municipal market observers should prepare for tense budget negotiations at every level of government especially as politicians posture themselves for 2012 elections.

3Qs in the Black: YoY Change in Tax Revenues

Quarter	Pers Inc Tax	Corp Inc Tax	Sales Tax	Total
1Q2007	8.5	14.8	3.1	5.2
2Q2007	9.2	1.7	3.5	5.5
3Q2007	7.0	(4.3)	(0.7)	3.1
4Q2007	3.8	(14.5)	4.0	3.6
1Q2008	4.8	(1.4)	0.7	2.6
2Q2008	8.1	(7.0)	1.0	5.4
3Q2008	1.2	(12.9)	4.7	2.7
4Q2008	(1.2)	(16.8)	(6.4)	(4.6)
1Q2009	(17.4)	(20.1)	(8.3)	(11.6)
2Q2009	(27.2)	1.6	(9.3)	(16.5)
3Q2009	(11.8)	(22.1)	(10.0)	(11.4)
4Q2009	(4.3)	(0.5)	(5.3)	(4.0)
1Q2010	2.5	0.6	0.4	2.5
2Q2010	1.6	(18.3)	5.7	2.3
Prelim 3Q2010	4.7	(2.5)	4.1	3.9

Source: Janney Fixed Income Strategy; Rockefeller Inst. of Gov't

Local governments will see growing challenges as states reduce aid to their "downstream" entities.

Local Government Credits Will Remain Strained Through 2011 (Cautious)

Local Govt's Derive Revenues from State Aid

Source: Janney Fixed Income Strategy; CBO, Commerce & Census

Although State government revenues have trended higher we have not seen or expect to see similar positive signs for the local government sector. State governments have been and will continue to reduce state aid to local governments in 2011 and 2012. We lowered our Local Government sector outlook to "Cautious" from "Stable" in the middle of 2009 mainly because of anticipated lower funding levels from states. 2011 will be the first year where State funding of local governments will be drastically lower in the near term. The question for local government is how much lower? This is where the above mentioned lagged reaction by government comes into play. We anticipate changes to local government budgets prove drastic by

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

any historical standard. Some municipalities operate almost as subsidiaries of the state, receiving a considerable amount of revenue from their respective state treasuries. The range of funds local governments receive from the states varies significantly. So, some local governments will be forced to adjust budgets more than others. Falling property tax valuations may also linger for a two to three year period or even longer. This uncertainty furthers the difficulty local governments will have projecting and meeting budgets near term. There are other historically abnormal stresses, such as the limited availability and rising cost of bank support agreements for variable rate debt, and rising termination payments for swap contract cancellations which have become all too common. In order to best avoid the pitfalls that might accompany investing in local governments investors should focus on buying high quality local governments which have minimized their exposure to the mentioned negative credit factors and have released current financial information.

Less Money for School Districts but State Programs Provide Stability (Stable)

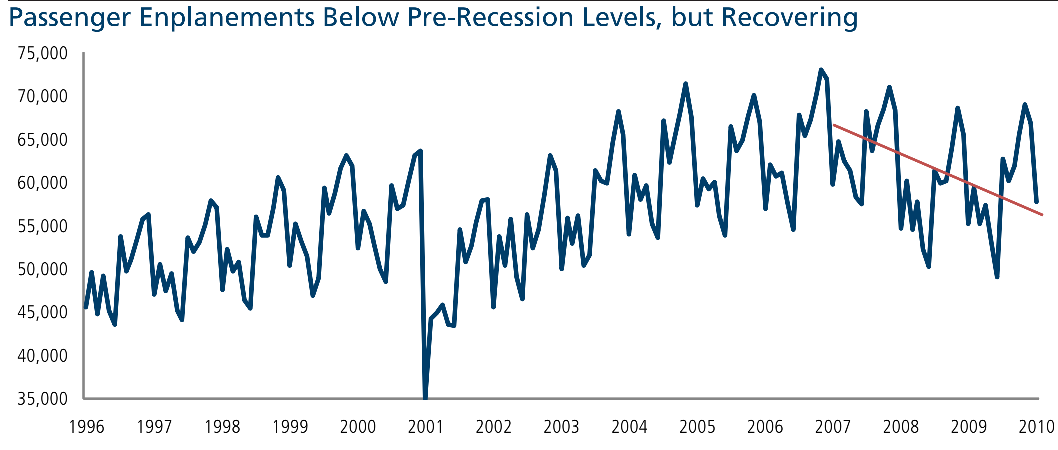
School districts should remain stable despite decreasing revenues partially as a result of state aid intercept program backing. State aid intercept programs are mechanisms whereby states, after a school district has defaulted on a debt payment, will the make school districts' debt service payment using funds scheduled to be paid to the school. School district revenues will be lower in 2011 because state aid is decreasing compared to the pre-recession years and most stimulus funds are spent. Although it looks like property values have found a bottom falling property tax revenue will likely continue for years to come until the housing market fully recovers and property values pick up again. We expect school districts will come under increasing pressure to cut spending and services in some cases because of their narrowing revenue sources namely property taxes and state aid but they should generally remain stable because of the state payment/oversight mechanisms.

Airport enplanements are on the rise, but airlines are hesitant to add to their cost structure with addtional flights and landing slots.

Activity is Starting to Fly Again at U.S. Airports (Cautious)

Many U.S. airports and airlines saw activity drop off but the economic recovery, albeit slow, seems to be helping to firm airport performance. Airport industry trends stabilized and enplanements (passengers boarding planes) in 2010 over 2009 were slightly positive, breaking the negative change from 2007 to 2009. The majority of airports were on solid financial ground going into the economic crisis and are continuing to weather the storm as we had anticipated. Some downside risks remain a cause for concern, however. Airports remain exposed to high-fixed costs, a challengs for managements trying to control spending. Jet fuel prices, which peaked in summer 2008 and bottomed in 2009 have remained volatile. Regulatory risks, especially those concerning environmental and emission controls, remain. Event risk for this sector is higher than that of other sectors. A prolonged "Severe" Homeland Security warning or some type of security incident that lowers travel at a holiday or otherwise busy travel period could quickly lower airport usage.

Passenger Enplanements Below Pre-Recession Levels, but Recovering



Source: Janney Fixed Income Strategy; Bureau of Transportation Statistics

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CONTENTS

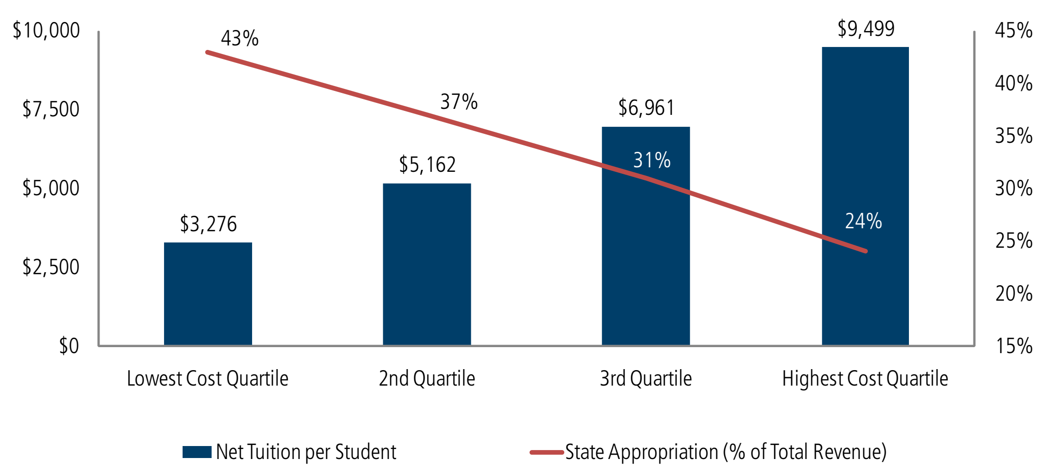
ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

We are Still Learning About the Higher Education Sector (Cautious)

The higher education sector could remain under pressure in 2011. Lagging results from the slowly recovering economy, smaller allocations of state aid, volatile endowment values and tuition hikes for both public and private schools will continue in the coming year. Public sector universities have been and will continue to be direct recipients of state budget cuts through 2011. This is another sector where the lagged response of governments to the economic downturn will be prevalent. Recently most schools have had to reduce programs and/or raise tuition. We expect those strategies will continue. Many public schools' tuition rates have generally been at the lower end of the cost spectrum and more pricing power is available for them to utilize through 2011 and 2012. The question is will they be able to adjust in time and at the correct magnitude in order to make up for the declines in state appropriations without negatively affecting their educational reputations and future enrollment? Public universities in states with the more difficult budget situations such as California, New Jersey and Illinois will likely continue to see higher than average aid reductions because of the lack of available funds.

State funding is a particular issue for public universities, most of which rely on state aid for between one quarter and one half of all revenues.

Lower Cost Public Universities are More Reliant on State Funding



Source: Janney Fixed Income Strategy; Moody's

Private institutions will continue to face difficulty while trying to meet enrollment targets. The battle these schools face is to offer sufficient tuition incentives while keeping enrollment strong. Working against them will be students who are seeking lower cost public institutions as alternatives to the higher priced private schools. On the positive side we are seeing private schools lower operating expenditures and cut spending from their endowments. These adjustments along with other strategies are partially a result of broad strength from management and board oversight in the sector. Student affordability remains a challenge for many private schools and some responded in 2009 and 2010 with increases in financial aid packages to satisfy enrollments. This will continue in 2011 but at this point there is probably little realistic chance that enrollment levels will fall too far, especially as public schools raise tuition rates. Additional help has been provided by a small recovery equity markets and other investments. Endowment values have recovered somewhat through 2010, helping fund some operating needs as necessary. We remain most concerned for lower rated smaller private institutions. Larger well known private schools with strong alumni networks typically have well-funded endowments or other resources to draw upon. It is generally the lower rated, lesser known, and smaller private schools which possess smaller or no endowments and will face the strongest roadblocks to maintain enrollments and keep spending manageable.

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CONTENTS

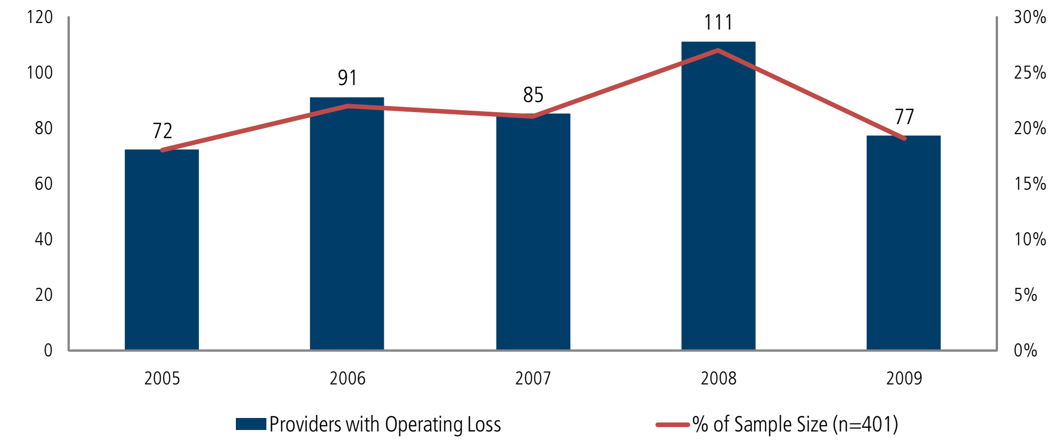
ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Mixed Prognosis from the Health Care Sector (Cautious)

We continue to expect varied results from the recent universal health-care legislation although it is still tricky to forecast what changes will have the deepest impact because most modifications do not become effective until 2014. Uncompensated care expenses will likely decrease and hospitals should serve more paying customers as the insured patient pool is set to increase through insurance exchanges and the expansion of Medicaid. This is likely to result in more patients and revenue. Increased Medicaid eligibility is expected to make up about 16 million of the newly insured and since hospitals are not typically reimbursed the entire amount for Medicaid insured procedures, it is possible that the increased number of Medicaid cases will dilute the benefit of the increase in the number of insured. Under the new plan decreased funding for Medicare in the amount of $150 billion over 10 years is also a negative factor. Hospitals will need to operate more efficiently and it is often challenging for smaller hospitals to create operating efficiencies and raise capital for new facilities and equipment in order to compete. This competitive disadvantage can make smaller health systems attractive acquisition targets for larger, more diverse systems. We continue to expect hospital merger and acquisition activity to pick up. Operating performance has generally strengthened but we will be on the lookout for continuation into 2011. Pressure could come from lower governmental support and rising uncompensated care increases in the near term.

Credit metrics among hospital issuers are improving in the wake of the recession, though efficiency gains aren't fast enough in coming.

Portion of Hospitals Recording Losses is on the Decline



Source: Janney Fixed Income Strategy; Moody's

A credit concern to keep in mind over the next few years surrounds how financial requirements from the new legislation will affect state governments. Increased Medicaid costs are going to hit state budgets just as lawmakers are hoping to get relief from increasing tax receipts courtesy of a recovering economy. The new law will increase the number of people who qualify for Medicaid. Barring federal help, states will need to fund this expansion, possibly a difficult task if state revenues do not continue to rebound.

Single Family Housing is Underrated (Stable)

The U.S. housing market remain challenged, and although many State HFA single family (SF) housing programs have experienced better delinquency and foreclosure results than statewide averages the uncertainty of the general housing market performance remains an issue. We still believe most SF programs are underrated and their overall credit profiles should remain stable, despite this warning. Most enjoy programs with solid financial positions and strong excess collateral. The programs' mortgage portfolios do not contain sub-prime loans. The majority of loans are 30 year fixed rate first mortgages liens, from borrowers with above average credit scores. Most State HFA's have experienced management teams with several years of industry experience. The management teams are usually very willing to utilize resources, usually in the form of available agency funds, to support

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

single family housing program's ratings. If the rating agencies threaten a downgrade because of a cash-flow issue, for example, managements have been known to transfer funds if necessary. In 2012 we could see some pressure mostly from exposure to private mortgage insurers, guaranteed investment contracts, and swap and liquidity providers. We are also very cautious on anything in the multi-family side that is not part of a larger multi-family program. Undiversified stand alone multi-family projects will continue to suffer in this economic environment.

Select Single Family Housing Program Statistics

Issuer	Program/Resolution	Ratings	Assets to Debt	Out. Debt (bln)	% of HFA Loans Delinquent	% of Loans in State Delinquent
CT HFA	Housing Mortgage Finance Program Bonds	Aaa/AAA	1.21%	$3.8	8.6%	9.2%
FL HFC	Homeowner Mortgage Revenue Bonds	Aa1/AA+	1.04%	$1.7	11.0%	17.0%
NJHMFA	Housing Revenue Bonds	Aa2/AA	1.07%	$1.3	9.8%	12.4%
PA HFA	Single Famliy Mortgage Revenue Bonds	Aa2/AA+	1.06%	$4.8	4.3%	6.7%

Source: Janney Fixed Income Strategy; Moody's; S&P

Public power utilities have proven stable throughout the recession and remain so as revenues in other areas recover.

Public Power Utilities are Running Solidly (Stable)

The public power utility sector has been one of the more stable municipal sectors throughout the recession. Utilities in the sector continue to benefit from monopolies and stable ratings. The greatest short term issue facing utility credit quality is the political pressure to keep rates low because the recession slowed overall economic demand and power sales declined. Overall, the Energy Information Administration reported total U.S. electricity demand was down in 2008 and 2009 due to the economic contraction but the EIA raised its forecast for 2010 to an expected 4.7% increase for total electricity usage. This increase was partially due to the extremely hot summer. Improved economic conditions should help keep demand strong in 2011 too. The costs of meeting new emissions standards is a factor expected to provide credit pressure in the public power sector. We had expected environmental standards passed by Congress would be less onerous considering the current economic environment. However, momentum surrounding future efforts to implement greenhouse gas regulations and the development of renewable energy sources is likely to swell. Increased regulation could add to costs and would need to be recovered in rate increases. In the medium term we believe water availability risk could stress the southwest and southern U.S. issuers. A significant amount of water is used during electricity generation. The Hoover Dam, which provides hydropower to cities in CA, AZ and NV, may have problems with electricity production if water levels in Lake Mead do not rise. Despite these pressures we believe credit quality in the sector will remain stable in the near term because of the sector's monopolistic nature, delivery of an essential service, and conservative financial management.

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

Tobacco bond credit quality is problematic amidst cigarette consumption declines, but bond pricing largely reflects our outlook.

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Tobacco Bond Price Declines Enhance Risk/Return Tradeoff (Cautious)

Light at the End of a Long Tunnel? We are raising our outlook on the Tobacco sector from negative to cautious, primarily based on valuation changes, with prices on many issues falling sharply due to downgrades of some issues and tranches by S&P and Fitch, a consumption decline 2009 vs 2008 of 10% and a drop in MSA payments for 2010 by 16%. For example Buckeye (Ohio) Tobacco Settlement Financing Authority 5.875% due 6-1-47 (Baa3/BB-/BBB-), which were downgraded to a junk BB- rating by S&P in November, had trading yields adjust 75 to 125 basis points higher after the November 11 downgrade.

Buckeye Tobacco 5.875% 2047 Trading

Period	Daily Average Low	Daily Average High
August	8.14%	8.37%
September	7.93%	8.44%
October	7.76%	8.14%
November 1 to 10	7.70%	7.91%
November 11 to 30	8.51%	9.39%
December 1 to 15	8.59%	9.40%

Source: Janney Fixed Income Strategy; MSRB

The year past was perhaps a watershed year for bonds secured by the 1998 Master Settlement Agreement. Our November 6, 2010 report titled Tobacco Bonds explores and explains the workings of these issues. On the negative side of the scales, the impact of excise tax increases, smoking bans and anti-smoking education efforts came home to roost in the form of record drops in US cigarette shipments and MSA payments. This led to rating downgrades. We believe the year ahead will be more favorable. According to the Department of Treasury's Alcohol and Tobacco Tax Trade Bureau, shipments of cigarettes through September are down about 5% compared to last year, a significant improvement over the 10% decline of 2009, but still problematic for the structuring assumptions of many issues. The relatively high yields available on some of the more stressed issues such as Buckeye, New Jersey and Virginia 2007 issues, offer an attractive risk return proposition for investors who understand the underpinnings of tobacco bonds and the associated risks, which are many.

The recent Railsplitter issue from Illinois, established a potential template for future issues. Based on relatively conservative structuring assumptions, the issue garnered A and A- ratings (depending on maturity) from S&P, the first A category rating the agency has given a tobacco settlement backed issue since 2001's Alabama 21st Century deal. The longest maturity, 2028, continues to trade around the original offering yield of 6.10%. With states facing ongoing financial pressures associated with the Great Recession, we would not be surprised to see others states, from among the thirty plus which did not securitize payments, to issue bonds modeled after the Railsplitters.

Alan Schankel

Life is a Highway for Toll Facilities (Stable)

Vehicle Miles Driven is on the Rebound

Source: Janney Fixed Income Strategy; Moody's

CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

The economic recovery, albeit slow, is helping to strengthen this sector's results. We believe the worst is over for toll facilities throughout the US and defaults (only 3 for 2010) and bankruptcies will remain the exceptions. Traffic volume declined starting in 2008 as a response to lower business activity and rising oil prices, but has since stabilized and is steadily rising. The pace of the economic recovery remains slow but we expect momentum to grow in 2011 and traffic volume to follow. Vehicle miles traveled are currently at 2005 levels, so a full rebound remains several years away. The credit profiles of the more established issuers within this sector remain stable and the majority still possess medium to high ratings.

Water is Essential and Available...For Now (Stable)

We expect municipal water and sewer credit quality to remain stable in 2011 despite continuing post-recessionary pressures and worrying weather conditions. Water is an essential product consumers cannot do without and providers benefit from low levels of payment delinquency. This stable collection ability and our expectation that demand will remain constant even as prices increase are also positives for the sector. We expect future debt levels to rise to meet infrastructure demands but ratios should remain at positive levels in the near term.

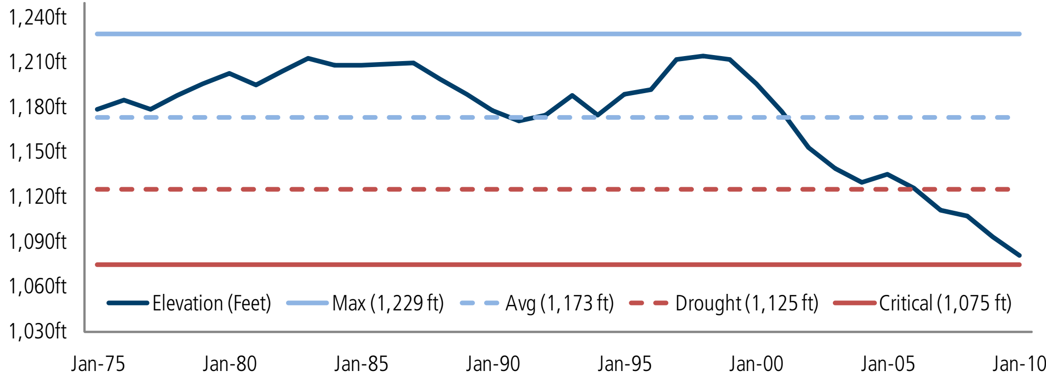
A longer term concern gaining traction revolves around providers' vulnerability to supply. Water stress or situations where there is not enough water for business or personal use is an issue of concern on the horizon, but currently limited geographically. The process of population growth straining water resources is highest in the south, west and southwest U.S. This risk was highlighted in a October 2010 report released by Ceres, a national coalition of market participants, highlighting susceptibility to the lack of water availability. Several immediate threats identified included:

- LA Department of Water and Power (Aa2/NRAA+)- received the highest level of risk.
- The Atlanta Water and Sewer System (A1/NR/A)- supply could be cut by 40% by federal judge.
- Phoenix (NR/AAA/NR) and Glendale (NR/AA/NR), AZ rely on imports from the Colorado River.

Water and sewer authorities are the most essential of essential revenue bonds, and we expect strong credit quality for the coming year.

Lake Mead is a major reservoir of Colorado River used by AZ, CA, and NV among others and its water level has fallen close to post-damming lows. In 2008, Tim Barnett, a scientist at the Scripps Institution of Oceanography and Lake Mead expert warned that the reservoir had a 50% chance of reaching a critical shortage level and might even run dry by 2021.

Lake Mead Water Elevation Exemplifies Long Term Risks



Source: Janney Fixed Income Strategy; Dept of Interior

In addition, droughts can cause severe unexpected stress and drought conditions are not necessarily limited geographically. But there are currently "Severe" drought conditions in CO, TX, AK, LA, MS, TN, FL, AL, and GA. Droughts limit water supply and often cause lawmakers to limit water use. Despite water supply and weather related concerns we remain positive on municipal water and sewer sector, but are on the lookout to make sure that availability risk is factored into credit assessments and ratings reflect regional factors. Water demand will remain stable, allowing issuers to maintain financial ratios, and will be able to make adjustment to climate change scenarios in time.

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

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CONTENTS

ECONOMICS / MACRO
INTEREST RATES
AGENCIES
MORTGAGES
IG CREDIT
HY CREDIT
MUNI STRATEGY
MUNI CREDIT
INFORMATION & DISCLAIMERS

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Positive: Janney FIS believes there are apparent factors which point towards improving issuer or sector credit quality which may result in potential credit ratings upgrades

Stable: Janney FIS believes there are factors which point towards stable issuer or sector credit quality which are unlikely to result in either potential credit ratings upgrades or downgrades.

Cautious: Janney FIS believes there are factors which introduce the potential for declines in issuer or sector credit quality that may result in potential credit ratings downgrades.

Negative: Janney FIS believes there are factors which point towards weakening in issuer credit quality that will likely result in credit ratings downgrades.

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