

TOP 11 SURPRISES FOR '11

JANNEY FIXED INCOME STRATEGY

JANUARY 3, 2011



We go the extra inch and offer up our top eleven surprises--not ten--for 2011, covering macro, financial, and commodities markets.

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SURPRISES

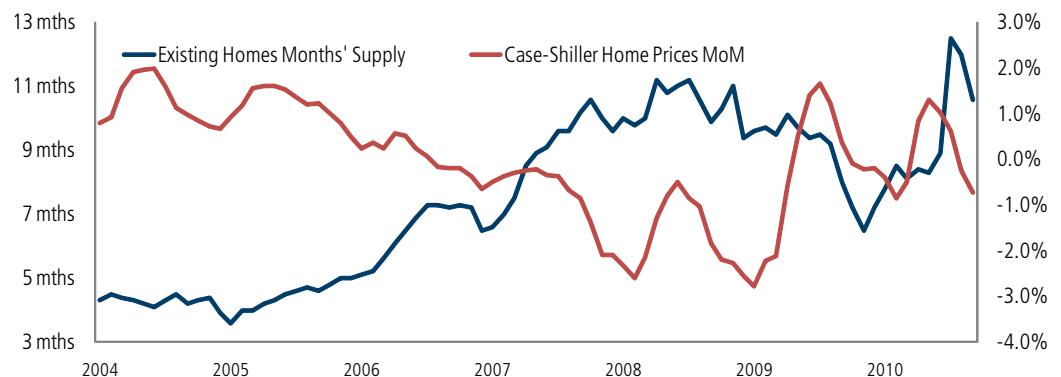
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Each January, we produce a list of our Top Surprises—events which we believe have a reasonable chance of occurring, but which the markets are not pricing in—for the New Year. For 2010, six of our top ten surprises came to fruition, ranging from the probability that commercial real estate defaults would remain limited to the likelihood that the EU would step forward and bail out a peripheral member country (the latter surprise being a reality twice over). At this point, 2010 is in the history books, and the focus is turning to the coming year. On balance, economic growth should resume at a slow though positive pace and financial market conditions should avoid any of the distresses that plagued the final years of the last decade. We do see a range of unexpected risks emerging, though for the most part, these risks are less problematic than the ones present in recent years.

US MACRO

- Home prices experience another 10% or greater nationwide decline in 2011, resulting in an extended construction industry slump and an increase in mortgage defaults.
 - ▶ High probability, moderate impact.

Oversupply Setting Up for Falling Home Prices



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

- After two years of elevated unemployment, productivity gains slow, causing wages to become unstuck and drop, thereby triggering the early stages of a deflationary spiral.
 - ▶ Low probability, high impact.
- The Federal Reserve, seeing an increasing risk of deflationary spiral, expands the QE2 asset purchase program to \$1.0 trillion, creating greater political debate as to the Fed's role.
 - ▶ Moderate probability, moderate impact.
- Congressional spending cuts fail to live up to election hopes, leading to Treasury supply concerns and causing real yields to continue to rise despite constrained inflation outlook.
 - ▶ High probability, high impact.

GUY LEBAS
Chief Fixed Income Strategist
215 665 6034
glebas@janney.com

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A war of words over currency manipulation could easily turn into a real problem affecting global capital flows.

GLOBAL MACRO

- A bailed-out Eurozone nation goes back to the trough for a second round of aid; Germany responds by demanding bondholders take haircuts as a condition of that additional aid. The Euro falls back past the \$1.10 mark.
 - ▶ Moderate probability, high impact.

Euro Will Be Highly Sensitive to a Re-Bailout



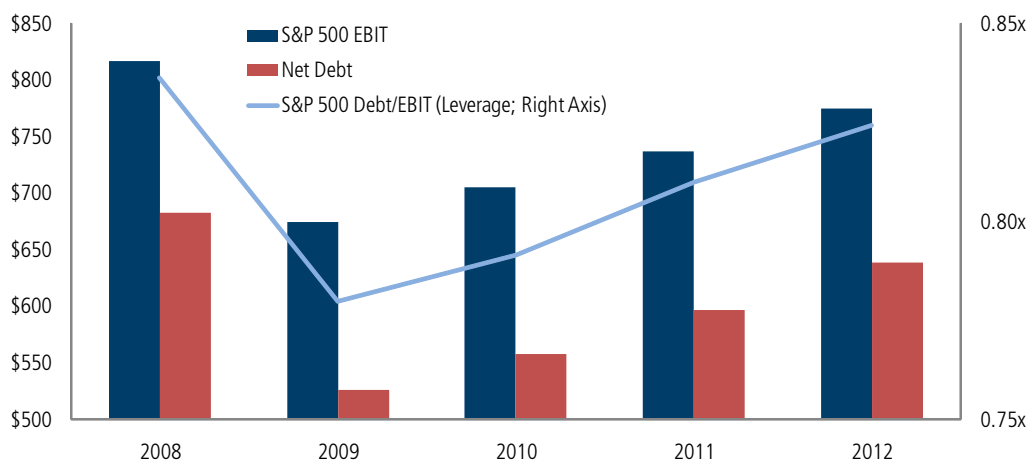
Source: Janney Fixed Income Strategy

- Talk of currency manipulation including from the Fed and QE2 triggers an international rhetoric war which leads to problematic capital controls and/or foreign investment taxation.
 - ▶ Low probability, high impact.

CORPORATE

- Corporate re-leveraging transactions among investment grade rated firms boost the equity markets at the expense of credit quality by driving EPS higher even as P/E ratios decline on weaker quality of earnings.
 - ▶ High probability, moderate impact.

Leverage Among S&P 500 Companies Will Likely Increase in 2011



Source: Janney Fixed Income Strategy; S&P

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China is playing an increasing role in our 2011 Surprises, as the country's industrialization and growing private sector exert more control over the global markets.

- Falling home prices trigger an increase in ruthless mortgage foreclosures, causing 2007 – 2009 originated mortgages to default at a higher rate and impairing bank profitability through 2013.
 - ▶ High probability, moderate impact.

- A government-involved Chinese company (non-financial such as Sinopec) looks to acquire a major US firm, generating debate about the risks and appropriateness of foreign ownership of US businesses.
 - ▶ Low probability, moderate impact.

Largest Chinese Firms Eclipse Comparable US Firms in Market Cap

Chinese Firm	Market Cap	Comparable US Firm	Market Cap
PetroChina	\$303.4 bln	ExxonMobil	\$374.5 bln
Ind. & Comm. Bank of China	\$233.8 bln	JP Morgan	\$170.1 bln
China Construction Bank	\$225.4 bln	Wells Fargo	\$165.3 bln
China Mobile	\$200.7 bln	AT&T	\$174.6 bln
Bank of China	\$140.4 bln	Bank of America	\$140.7 bln

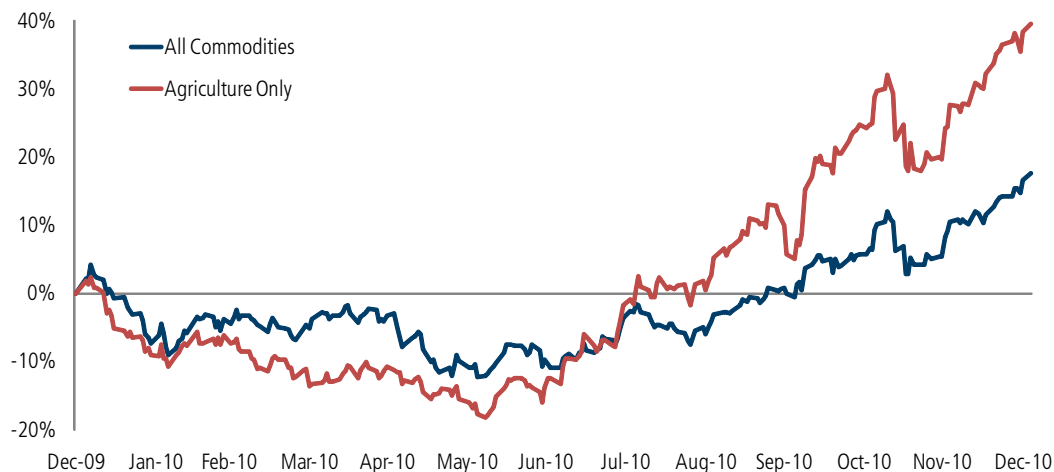
Source: Janney Fixed Income Strategy; S&P; CITIC

COMMODITIES

- Coal prices soar to \$100 per ton (+25%) on a sudden uptick in Chinese imports as the country's power and steel needs pass the levels that can be covered with domestic coal.
 - ▶ High probability, low impact.

- Agricultural commodities prices retreat by spring on a strong supply outlook led by grains, with the DJ-UBS Agriculture index falling back to the low 70s level (-20%).
 - ▶ Moderate probability, low impact.

Agricultural Commodities Outperformed On 2010 Supply Shocks



Source: Janney Fixed Income Strategy; DJ-UBS

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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.

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Agencies: Janney FIS ratings employ the "Barclay's U.S. Agency Index" as a benchmark.

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