

TOBACCO SECTOR UPGRADE

JANNEY FIXED INCOME STRATEGY

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We are raising our outlook on the municipal tobacco sector to cautious from negative based on adjustments to valuations.

Our December 6 report titled Tobacco Bonds explores and explains the workings of these issues.

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TOBACCO BONDS — LIGHT IN THE MIDDLE A LONG TUNNEL?

We are raising our outlook on the municipal tobacco sector from negative to cautious, primarily based on recent 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.

The year past was perhaps a watershed year for bonds secured by the 1998 Master Settlement Agreement. Our December 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. Particularly impactful was an April 2009 increase in the federal excise tax on cigarettes from 40 cents to a dollar per pack.

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 likelihood of adverse legal results from challenges to the 1998 Master Settlement Agreement recedes as time passes. Relatively high yields available on some of the more stressed bonds such as longer maturities from 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. Fitch rated the entire issue BBB+. The longest maturity, 2028, continues to trade at yields close to the original offering yield of 6.10%. Illinois, with its troubled finances, used the proceeds to partially plug a budget gap. With the ongoing financial pressures associated with the aftermath of the Great Recession continuing, we would not be surprised to see other states, from among the thirty plus which did not securitize payments, issue bonds modeled after the Railsplitters.

Given the many variables, legal and structural, which can impact payment streams underlying bonds in this sector, investors need to understand the inherent risks of tobacco bond investments. Many factors could change investment prospects, particularly for longer maturities, but we believe yields available today provide a level of income consistent with the risks of the sector.

Yields are Higher Post Downgrade

Buckeyes (Ohio)	Daily Average	
	Low	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 FIS, MSRB

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