

# 2009 YEAR IN REVIEW

JANNEY FIXED INCOME STRATEGY

DEC 2009

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### ■ Economics

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*Any way you cut it, 2009 was a remarkable year for the interest rate, credit, and municipal markets. The domestic economy swung from deep recession to questionable recovery just as market sentiment swung from depression to outright optimism.*

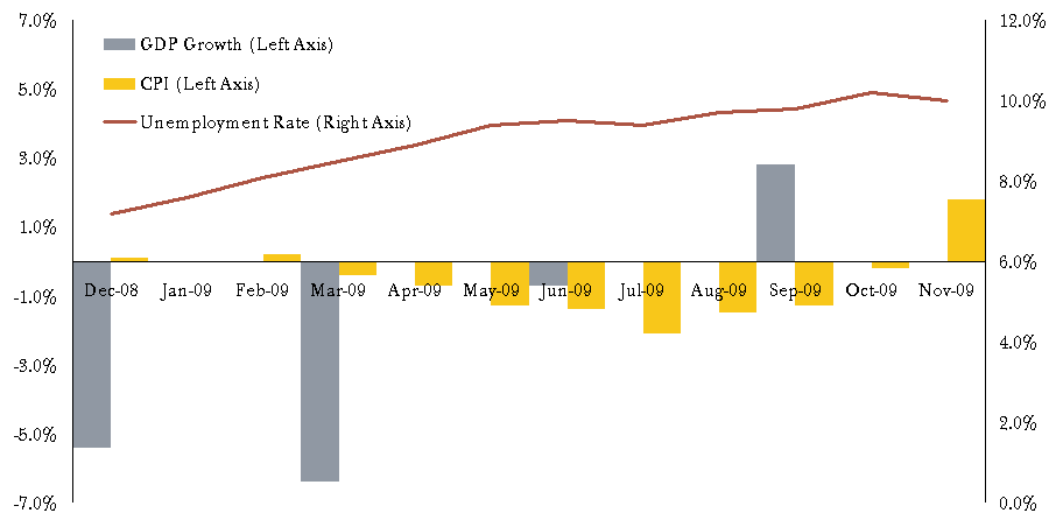
## ECONOMICS

- The Great Recession reached a low point and subsequently eased in 2009, marking the culmination of credit pressures and consumer balance sheet weakness that was building for years.
- Real and financial economies became all the more linked in 2009, as organic feedback mechanisms grew in complexity and government support took on a bigger role.
- Despite seeming structural changes, economic performance reaffirmed basic conceptions of demand-pull inflation (or in this case, no inflation).

Domestic economic performance cut a wide swathe across a range of possibilities, from panicked contraction to solid expansion in what was arguably the most volatile year for economic growth in the last quarter century. The U.S. faced the realization of credit-driven pressures on consumer balance sheets, which we first began to recognize in mid-2007, as subprime troubles began. Gross domestic product growth, considered the ultimate academic definition of concurrent economic performance, sunk to a -6.4% annualized rate in the first quarter, tying for the lowest level since 1982, before rebounding with remarkable rapidity to +2.8% in the third quarter. We estimate GDP is now tracking at a 3.8% - 4.0% rate for the fourth quarter. So even as unemployment remains elevated, academic definitions at least suggest that the Great Recession ended in the second quarter of 2009.

As those initial consumer concerns spiraled into capital markets illiquidity, the pressures that were once a long-term consumer phenomenon melded into a more acute form of crisis, evident in the uptick in small, midsize, and large corporate bankruptcies in late 2008 – early 2009. The crunch behind these bankruptcies provides strong evidence that the relationship between the financial economy and the real economy has grown in complexity in recent years. The details and degree of the financial markets' contribution to the recession in progress are arguable, but the fact that credit conditions and liquidity problems have triggered, or at the very least added to, declines in consumer and corporate spending throughout late 2008 into 2009 is not.

## Economic Performance: Growth, Jobs, and Inflation



Source: Janney FI Strategy; Commerce Dept; Labor Dept

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*> In addition to notably weaker income prospects, consumers also faced unprecedented wealth destruction in 2009.*

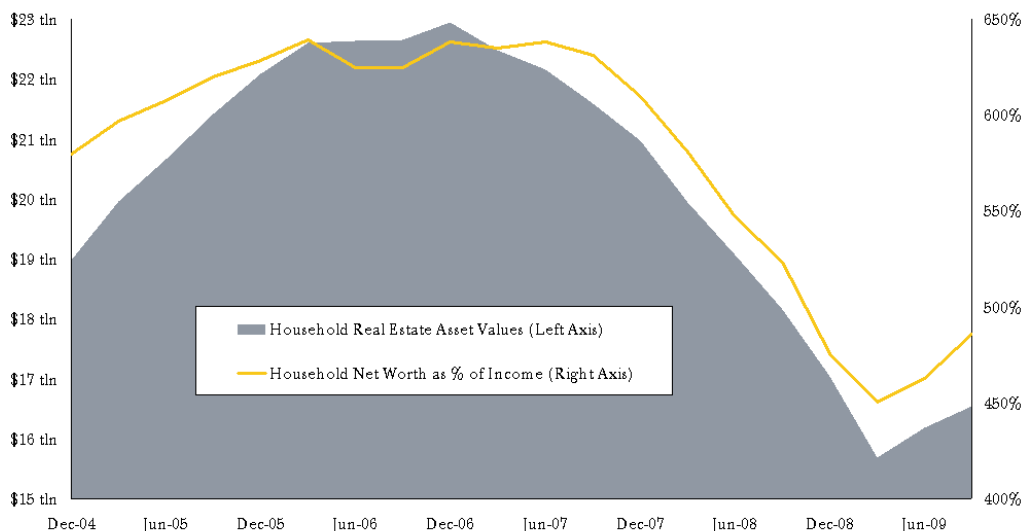
This relationship between the financial markets and spending is most evident in bankruptcy trends over the course of the last several years. Approximately three months after liquidity conditions, as measured by the LIBOR – OIS spread, began tightening in July 2007, business bankruptcies began ticking higher; the same happened in early 2009 after a three month lag following the deepening in liquidity pressures. To a lesser degree, consumer bankruptcies also began rising in the wake of tightening liquidity conditions, though seeing as consumers tend to rely less on borrowing to fund short term needs, that relationship is less concrete.

Government support of the real and financial economies reached new heights in 2009, thanks to the Federal Reserve’s zero interest rate policy and the various fiscal stimulus measures. Stimulus took on a new meaning with the \$787 billion ARARA package passed in February. While the bill promised to provide the same support to Main Street that had been afforded to Wall Street with 2008’s TARP, it’s hard to shake a sensation that the most touted components of the bill (infrastructure spending) proved impotent in restoring growth and creating new jobs. To date, the greatest effects of ARARA lay in support of state budgets, the late summer cash for clunkers program, and the launch of the Build America Bonds municipal funding mechanism. Yet despite the disappointing aspects of the package, it did send a signal to corporations in particular that Congress was committed to providing economic support in times of distress.

**Unlike the ARARA, the Fed’s zero interest rate and quantitative easing policies do appear to have had an effect in improving activity through freeing up credit availability.** At the same time, the extraordinarily accommodative monetary regime raised the specter of risky inflation down the road, at least in terms of rhetoric. In reality, so long as these accommodative policies are removed with appropriate haste when necessary, there’s no reason that they should prove inflationary. While that concept flies in the face of monetarists’ thinking, there’s a clear reason, in this case, why short term inflation can’t emerge: aggregate demand—or rather, lack thereof. As we’ve noted on numerous occasions, producers can’t raise prices when nobody’s buying, and despite substantial improvements in output growth, demand remains relatively anemic. In that sense, we continue to see limited inflationary pressures, despite the extraordinary monetary policies put in place to date.

The final piece of the economic puzzle for 2009—and perhaps the most problematic—has been the employment picture. During the year, the official unemployment rate rose from a high 7.2% to an astronomical 10.2% in October, but our estimate of the underemployment rate, including jobless and forced part-timers, is closer to 17%, or about one in six individuals. In post-war recessions, the unemployment rate has typically peaked 6-9 months after the trough in economic output, but in post-war recessions, the jobless rate hasn’t risen as fast, as far. The vehemence of this increase in un and underemployment is by a long shot the most substantial risk facing the domestic economy in 2010. If rising joblessness feeds back into another leg down in aggregate demand, there’s potential for a severe double-dip recession. While we tend to believe this is an outside prospect, it’s nonetheless one worth more than a sideways glance.

**Household Wealth**



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> *The biggest change in the yield curve for 2009 was a steepening triggered by a Fed commitment to low rates and concerns about long term inflation.*

**TREASURIES**

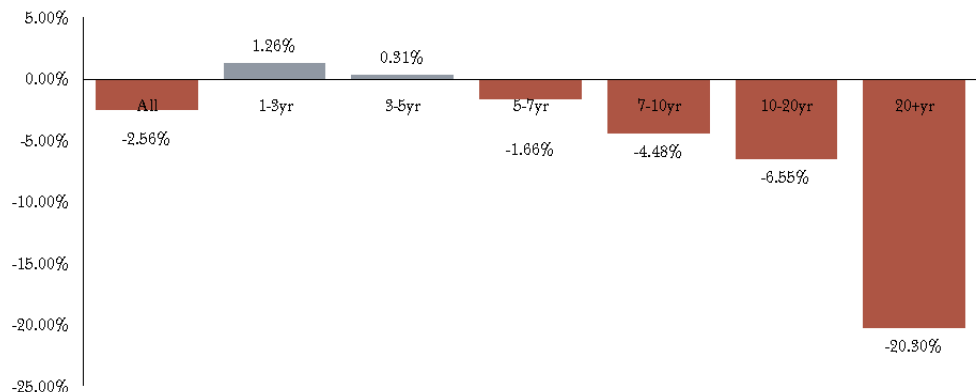
- In our 2009 Fixed Income Outlook, we indicated an “underweight” recommendation for the fixed rate Treasury markets.
- The risk reduction trade reversed in the early months of 2009, leading to a significant underperformance in the fixed rate Treasury markets.
- Interest rate markets have begun pricing in growing uncertainty about conditions much further out than five years down the road.
- Growing Treasury supply has yet to pressure the interest rate markets and auctions remained well-bid throughout the year.

As 2009 opened, the bid for safety in the fixed income markets remained quite strong, thanks to the fresh memories of a liquidity crisis that nearly took down the world financial system. That bid for safety pushed interest rates across the Treasury curve to unprecedented levels, but that push lower was largely a technical phenomenon driven by excess demand relative to supply. As the calendar year progressed, the panic that fueled rallies in the Treasury markets subsided rapidly, which led to what we believe is less-technically-driven, more rational economics-based pricing in the interest rate sector. The net result was a relatively sharp sell off across the curve followed by ultimate strength in shorter maturities and record or near-record steepness in the shape of the curve. Through mid-December, the Barclays U.S. Treasury Index indicated a -2.56% total return for the Treasury sector. Within the sector, however, shorter durations outperformed longer ones.

**The short end outperformance and long end underperformance reflects two major factors: one, the Federal Reserve’s position of keeping money market yields highly constrained, and two, uncertainty about future inflationary pressures.** On the first front, the FOMC’s decision to sustain language that they will hold ultra short term interest rates at depressed levels for an “extended period” is the single biggest factor benefitting Treasury yields out to the 2-3 year area of the curve. The Fed initiated its “extended period” language concurrent with cutting interest rates to zero in December of 2008, but focus on the language didn’t come forth until August of 2009. By that point, it was becoming evident that economic growth had resumed and that financial conditions were improving; Bernanke’s decision to maintain the “extended period” language at that point indicated to the markets that the low rate regime would persist long past the conclusion of the Great Recession. In turn, that persistence implies a limited ability for 0-3 year rates to rise with any force, and a strong justification for the short end outperformance in 2009.

The second major fundamental factor affecting the Treasury markets for 2009 was, of course, the threat of greater inflation in the distant future. Especially given firms’ lack of pricing power, it appears that the potential for immediate term inflation is quite limited. At the same time, the aggressive monetary policy and fiscal stimulus regimes deployed in 2009 do create the potential for longer term pressures, which have had the natural effect of pushing long end yields modestly higher. At this point, we believe it’s highly challenging to forecast long term inflation with great confidence, as price levels out past 2015 will likely be driven more by policy decisions in the intervening years than by organic economic conditions. As such, the steep shape of the yield curve, with the two year / ten year spread hovering near their all time highs, should sustain until we see evidence of more conservative monetary and fiscal policies.

**Treasury Market Performance**



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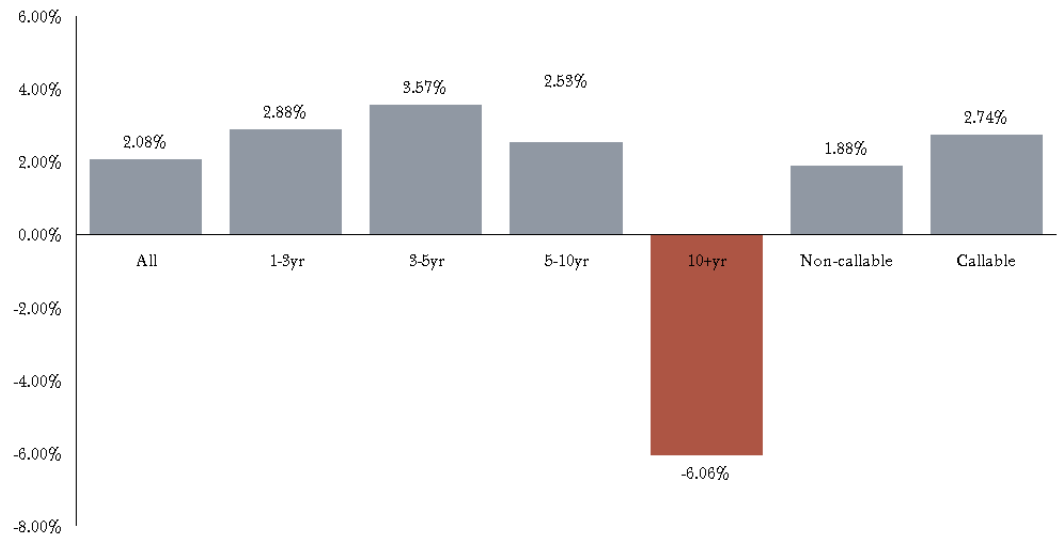
**AGENCIES**

- In our 2009 Fixed Income Outlook, we indicated an “marketweight” position on the agency sector, as bonds were cheap to Treasuries but rich to asset classes with more credit risk.
- FDIC-insured TLGP issuance dominated much of the agency markets, thanks to \$226 billion of 1-3 year paper sold under the program in 2009.
- The emergence of the Fed as a major buyer in the agency markets coupled with shrinking agency balance sheets also helped reduce available supply and tighten spreads.

As the risk aversion trade eased in the beginning portion of 2009, the Treasury markets were the biggest losers, yet agencies also suffered some of the pain. Unlike Treasuries, however, agencies had the benefit of historically wide spreads at the beginning of the year, and a large portion of 2009’s performance was driven by significantly tighter spreads. In the two year area of the yield curve, benchmark agency spreads over Treasuries contracted by roughly 22 basis points, while in the ten year area of the curve, spreads were better by closer to 38 basis points. While in a typical year, this type of tightening would represent a significant outperformance, the even cheaper nature of other fixed income asset classes meant that agencies actually failed to live up to the returns of the broader market. For 2009, agencies posted a total return of 2.08%, with intermediate maturities from 3-7 years performing best and callables beating out non-callables.

The FDIC’s TLGP insured-debt issuance program concluded in October of 2009, but not before banks and other financial companies managed to squeeze off more than \$226 billion in new issuance. TLGP debt was the mechanism of choice for intermediate term bank funding, and speculation that the heavy issuance volumes would crowd out buyer interest in the agency market was a point of great concern early in the year. Ultimately, a few factors managed to limit the risks of this greater supply, namely shrinking balance sheets at Fannie and Freddie resulting net declines in the amount of agency debt outstanding and a large appetite for agency debt in the form of one distinctly monolithic buyer: the Fed.

**Agency Market Performance**



Source: Janney FI Strategy; Barclays

**Far more so than in the Treasury markets, the Fed’s mandate to purchase bonds outright helped aid spread tightening in the agency markets.** The Federal Reserve initially planned to acquire a \$200 billion portfolio of agency debentures, which would have represented around roughly 20% of 2009 total pro-forma agency issuance and (perhaps not coincidentally) about 90% of issuance under the TLGP program. Of course in November, the Fed cut their planned agency purchases, but considering this reduction and the fact that the Fed is only purchasing bullet maturity agencies, the reality is that their buy campaign absorbed as much as two-fifths of all 2009 agency issuance. That single buyer provided much of the oomph needed for a technical drive towards tighter spreads this past year and, as a result, for the outperformance of agencies versus their Treasury benchmarks.

*> The rise and fall of TLGP issuance brought \$226 billion of supply competition to the agency sector, but spreads held up well on Fed buying.*

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*> Higher coupon MBS outperformed lower coupon paper in 2009 as prepayment speed failed to match up to speedy expectations.*

**MORTGAGES**

- In our 2009 Fixed Income Outlook, we indicated an “overweight” position on the agency mortgage markets and retreated to “marketweight” in September.
- The Fed grew from the 750 pound gorilla to the 1,250 pound gorilla when it increased planned mortgage purchases in March.
- A policy-driven refinancing wave, which we identified as the single biggest risk for the mortgage markets, failed to emerge with any force.

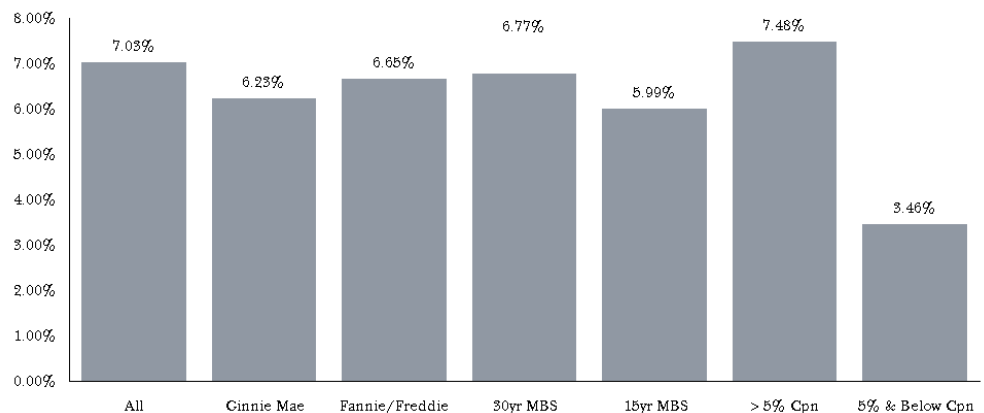
Oh, what we wouldn’t have given for this type of scenario in 2003. Rapidly declining interest rates and limited refinancing prospects is precisely the combination that gives mortgage investors the desire to jump for joy. But when you add on top of that a single mammoth buyer capable of reducing any expected trading patterns to complete rubble, confusion reigns. As a result, while the mortgage markets as a whole posted a second year of strong results, performance within individual sectors of the mortgage markets varied very sharply, with higher coupon premium paper beating out lower coupon paper by a wide margin. According to the Barclays U.S. MBS index, the total sector posted a total return of 7.22% for 2009 with Fannie/Freddie MBS beating out Ginnie Mae’s as spreads tightened throughout the sector.

**Federal Reserve involvement, more so than in other markets, affected pricing and trading activity in mortgages quite heavily.** SIFMA data indicates \$1.45 trillion of agency mortgage issuance through October of 2009; we estimate that number will have increased to \$1.63 trillion when all is said and done. Considering that the agency mortgage markets experienced an average 17.5 CPR prepay rate, pay downs claimed about \$1.09 trillion of mortgage balances, creating net issuance of approximately \$540 billion. Through the middle of December, meanwhile, the Fed has used up about \$1.09 trillion of its \$1.25 trillion mortgage purchase program dollars. By year end, that suggests the Fed will have acquired literally two-thirds of all gross agency mortgage backed securities issued in 2009 and 2.03 times the net amount of mortgage issuance during the year.

Despite the decline in interest rates evident from Treasury yields that, on the short end, are hovering near all-time lows, and a massive Fed-instituted subsidy in the mortgage markets, prepayment rates remained remarkably well constrained. Towards the beginning of the year, consensus expectations on sector-wide prepayments were for a speedy 31 CPR rate; as we noted above, however, realized prepayments clocked in at a much slower 17.5 CPR. These lower speeds fly in the face of traditional interest rate-based prepayment analysis, but do make some semblance of sense in the context of declining housing values, which make homeowner refinancings all the more challenging.

By corollary, impaired housing values are also the major reason behind the massive outperformance of higher coupon mortgage paper. Expectations of faster prepayment speeds were the greatest factor compressing the coupon stack and limiting prices on higher coupon collateral. As prepayments became constrained on those higher coupon mortgages from impaired homeowner refinancings, the higher rate, slower paying MBS provided elevated carry plus a measure of price improvement. Lower coupon collateral, while it received a greater subsidy from Fed purchases than higher coupon paper, benefitted less from errant prepayment forecasts than its higher dollar price counterparts.

**Mortgage Market Performance**



Source: Janney FI Strategy; Barclays



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*> Investment grade spreads tightened massively in 2009, aided by improvements in liquidity conditions as well as the turning of the credit cycle.*

**INVESTMENT GRADE CREDIT**

- In our 2009 Fixed Income Outlook we placed an “overweight” recommendation on the investment grade credit markets before backing down to a “marketweight” position in September.
- IG credit was the beneficiary of a rubber band bounce back, after nervousness got the better of rational analysis in the early days of 2009.
- Improvements in liquidity risk provided the bulk of the strong performance for the credit markets, but a better-than-anticipated default cycle also helped.

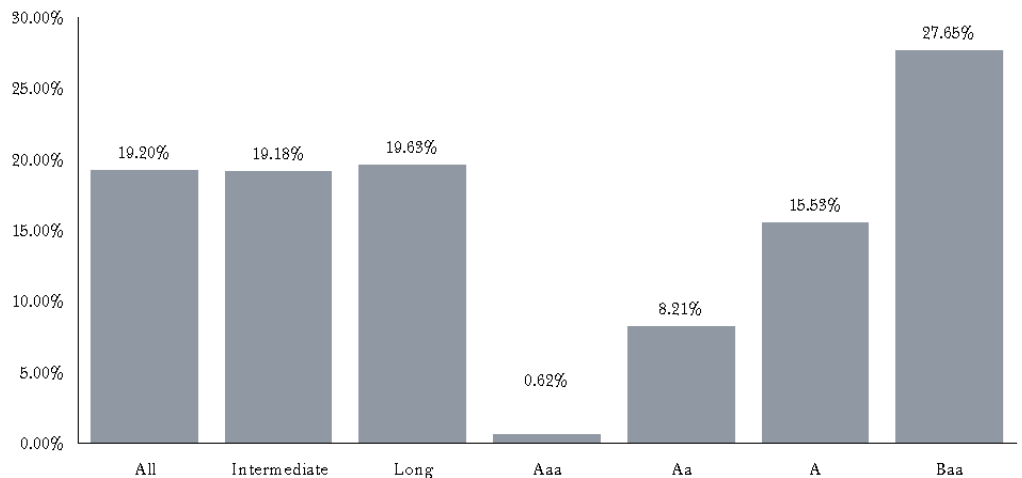
As investor risk aversion reached unprecedented levels in the closing days of 2008 into early 2009, it became evident that a tidal wave of cash was waiting on the sidelines. What the markets lacked in the first few months of the year was a catalyst for that cash to come flooding back into credit space, but a rash of strong financial sector profit reports during the first quarter and evidence of aggressive government support for the financial system allowed for that final piece of the puzzle to fall into place. That cash meanwhile provided the impetus for a recovery in corporations’ ability to issue debt, which was the single major fundamental factor holding credit spreads hostage. As tends to happen in volatile credit markets, the moves tighter were quite swift and, further incremental improvements aside, were largely over by late August. On the year, the IG markets registered a total return of 16.5%, though performance varied significantly by industry.

Evidence of these liquidity trends is most clear in the LIBOR-OIS spread, which attempts to measure firms’ ability to borrow by tracking the difference between a cash lending rate and a derivatives rate that doesn’t require cash outlay. That spread started out 2009 at 125 basis points but has improved to a mere 10 basis points heading into year end, indicating that about half of the credit market’s strength stemmed from the aforementioned liquidity improvements. Of course those improvements were somewhat uneven, as the markets continue to punish corporations with heavy near-term debt maturity schedules.

Once credit market liquidity eased, supply and demand trends provided a strong technical influence on corporate debt spreads. Based on mid-December levels, we estimate 2009 investment grade public bond issuance will total \$1,080 billion, easily a record, though about \$226 billion of this issuance stemmed from the FDIC’s TLGP insured debt issuance mechanism. Despite the heavy issuance—nearly all concentrated in the last seven months of the year—demand was clearly sufficient to maintain a positive technical note in the credit markets. Anecdotally speaking, at least, some of the strongest performing weeks of the year coincided with some of the biggest issuance weeks.

One of our central tenets heading into the year was the idea that, while 2008 was one in which all credits were negatively impacted, 2009 would be a year of “selective improvement” in which certain names in investment grade space far outperformed others. **The reality of the markets was a bit simpler, however, and aside from a group of triple B names that crossed over from investment grade into high yield (and one issuer, CIT, that eventually defaulted), the majority of investment grade names posted positive performance during the year.** In that sense, while differentiating among individual names could have provided protection against a few of these blowups, macro trends had a far bigger impact than micro ones.

**Investment Grade Credit Market Performance**



Source: Janney FI Strategy; Barclays



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*> High yield credit rebounded more aggressively in 2009 than even the stock markets, as investor risk aversion eased and gave way to yield-chasing.*

**HIGH YIELD CREDIT**

- In our 2009 Fixed Income Outlook, we placed a structural “underweight” recommendation on the high yield sector, but noted that there was a good prospect for short term improvement as the year progressed.
- Liquidity improvements generated one of the biggest years on record for high yield space, which led to massive debt issuance in the latter half of the year.
- While restructurings abounded (including 4 of the largest 10 Chapter 11 filings on record), total defaults fell well short of pessimistic projections.

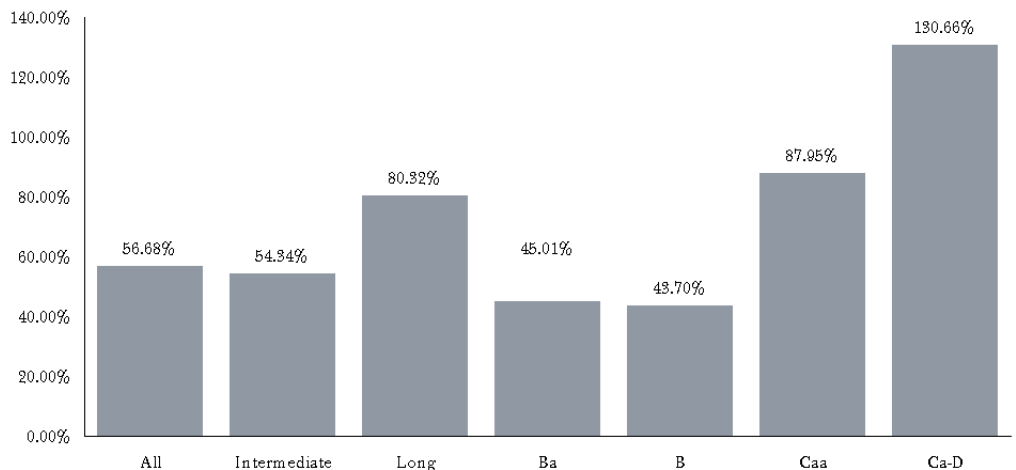
High yield markets proved easily the best performer of the entire capital markets for 2009, both on an absolute and a risk-adjusted basis. Through mid-December, the Barclays U.S. High Yield index posted total returns of 56.68%, which is literally more than double the total return of the S&P 500. The last time the high yield markets witnessed performance of that magnitude was in the early 1990s in the wake of that decade’s consumer recession. A direct comparison doesn’t really apply considering the massive structural changes enacted since those early days of the high yield markets, but the parallels between that period and today are rather intriguing.

Even more so than investment grade credit, the high yield markets were big beneficiaries in liquidity improvement. For highly leveraged firms, paying down debt upon maturity is often not an option; as a result, sub-investment grade firms often rely on their ability to roll over maturing debt into new issues. So long as the capital markets are functioning smoothly and leverage is within reasonable limits, such roll overs shouldn’t theoretically be a problem. When high yield firms’ ability to borrow collapses, however, credit troubles can add up far more rapidly than for investment grade issuers. **As a result, the high yield markets have a higher sensitivity to liquidity conditions than most other sectors and just as the HY universe sold off hard into late 2008 – early 2009, they rallied equally hard as liquidity conditions rebounded.**

The dramatic improvement in high yield corporations’ ability to borrow is clear in a few year-end deals: American Axle (Caa3/CCC+), once a market pariah, sold \$425 million of new notes and industrial firm McJunkin Red Man (NR/B+) brought a massive \$1 billion deal in the last active week of 2009. One thing to note, however, is both these two firms and many others sold secured debt, which has the effect of improving liquidity at the expense of structural subordination for holders lower in the capital structure. That trend has the potential to haunt if the credit cycle turns negative once again 2 – 7 years down the road.

A few high profile bankruptcies (think “autos”) and restructurings (three of which were from Harrah’s) aside, 2009 proved to be much better than anticipated on the default front. Market implied default expectations for speculative grade debt reached a peak of 22% in the closing days of 2008, and while more analytical forecasts were closer to the neighborhood of 16% – 18%, either case would represent the worst default cycle in post-war memory. Total dollar-weighted domestic defaults reached 20.0% in November, though on an issuer-weighted basis, the numbers were far smaller, reflecting the effect of several large failures, most notably GM, Chrysler, and CIT Group. While high yield defaults did in fact reach to forecast levels, it appears that recoveries were much higher and the cycle has proven much shorter than initially expected.

**High Yield Credit Market Performance**



Source: Janney FI Strategy; Barclays

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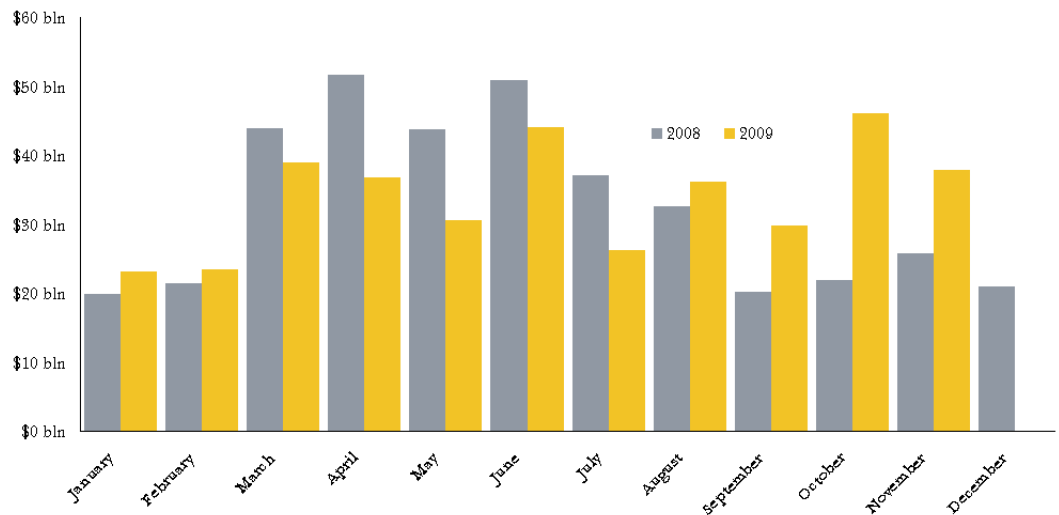
**MUNICIPALS**

- Municipal volume in 2009 picked up during the last half of the year and was close to the recent average annual volume of \$390 billion
- Build America Bonds, taxable municipal bonds, helped the municipal market stabilize; BABs were 15% of municipal new issuance and the program may be extended or made permanent
- Tax-free yields fell across the curve in 2009 and municipal to Treasury ratios have fallen closer to their 10 year averages
- State and local governments are facing some credit deterioration, due to lower tax and aid revenue, but we do not expect a “municipal meltdown”
- Only 9% of municipal issues were insured in 2009, down from almost 50% in 2007

**MUNICIPAL VOLUME PICKED UP DURING THE LAST HALF OF 2009**

Municipal issuers sold \$37 billion of municipal related debt in November, a 46% increase compared to November of 2008 when the municipal market was still trying to find its footing in the wake of the Lehman bankruptcy. Total municipal bond sales volume in 2009 through November was just higher at \$372 billion versus \$368 billion for the same period in 2008, as reported by Thomson. Annual municipal issuance averaged almost \$390 billion from 2002 to 2008 and we expect that at year end, total 2009 issuance will be close to this average.

**Municipal Bond Issuance**



Source: Janney FI Strategy; Thomson Reuters

The Securities Industry and Financial Markets Association’s municipal issuance survey of the leading municipal market participants, including Janney, indicates most believe issuance will rise in 2010 to \$450 billion and contribute to an almost 10% increase in long term tax-exempt issuance. Most significant is the expectation that Build America Bonds (“BABs”) will continue to increase in popularity with both issuers and investors, with a volume increase of almost 50%.

Tax-Exempt Municipal Issuance	Survey 2009 Expected	Janney 2009 Expected	Survey 2010	Janney 2010 Forecast	Survey 2010 %	Janney 2010 % Change
Short-Term Notes	\$65 bln	<b>\$65 bln</b>	\$68 bln	<b>\$70 bln</b>	5%	8%
Variable Rate	\$30 bln	<b>\$30 bln</b>	\$35 bln	<b>\$35 bln</b>	17%	17%
Long Term Bonds	\$322 bln	<b>\$320 bln</b>	\$347 bln	<b>\$350 bln</b>	8%	9%
<b>Total</b>	<b>\$417 bln</b>	<b>\$415 bln</b>	<b>\$450 bln</b>	<b>\$455 bln</b>	<b>8%</b>	<b>10%</b>

Taxable Municipal Issuance	Survey 2009 Expected	Janney 2009 Expected	Survey 2010	Janney 2010 Forecast	Survey 2010 %	Janney 2010 % Change
Build America Bonds	\$58 bln	<b>\$75 bln</b>	\$85 bln	<b>\$115 bln</b>	47%	53%
Other Taxable Bonds	\$17 bln	<b>\$19 bln</b>	\$20 bln	<b>\$20 bln</b>	18%	5%
Tax Credit Bonds	\$1 bln	<b>\$1 bln</b>	\$5 bln	<b>\$1 bln</b>	400%	25%
<b>Total</b>	<b>\$76 bln</b>	<b>\$95 bln</b>	<b>\$110 bln</b>	<b>\$136 bln</b>	<b>45%</b>	<b>43%</b>

Refund. % of Total Issuance	25%	<b>25%</b>	26%	<b>25%</b>	4%	0%
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Source: Janney FI Strategy; SIFMA

> *The municipal market stabilized in 2009 and we’re now anticipating record new issuance for the 2010 calendar year.*



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*> Build America Bonds are a form of municipal bond authorized under the Feb 2009 fiscal stimulus package that pays taxable interest.*

Janney FI Strategy shares the expectation that BABs issuance will grow to an increasing percentage of municipal issuance. BABs volume should reach \$115 billion for 2010, almost 20% of all municipal issuance. BABs will likely continue to gain acceptance among non-traditional buyers of municipal bonds, an increasing number of whom are realizing the benefits of diversifying by investing in municipal credits as an alternative to corporate bonds, U.S. agencies and other taxable securities. Demand for BABs from individual, retail investors should grow due to favorable relative value comparisons between BABs and traditional taxable fixed income investments.

**BABs Relative Value Comparison (Week of Dec. 14)**

Bond Type	Ratings	Issuer	Maturity	Yield	Spread to UST
BAB	Aa2/AA	Mass St. GO	2039	5.74%	1.19%
Corporate	Aaa/AAA	Microsoft	2039	5.06%	0.80%
Corporate	Aa3/A+	JP Morgan Chase	2038	5.61%	1.36%
Corporate	A3/A	Coca-Cola	2036	5.20%	0.95%

Source: Janney FI Strategy; MSRB; TRACE

**BUILD AMERICA BONDS HELPED MUNICIPAL MARKET ISSUANCE RECOVER**

BABs were the major story of 2009, as they helped revive municipal market issuance, and became an important financing tool for municipal issuers. Since the first BAB issue came to market in April these taxable bonds have become popular with issuers and investors alike. Municipal new issue supply was down by 15% over the first half of 2009 versus the same period in 2008. When issuance was the lowest, municipal to Treasury (“M/T Ratios”) were well above historical averages and financing rates were so high that many issuers were locked out of the capital markets. In February, the President signed legislation creating the Build America Bond program as part of the American Recovery and Reinvestment Act (“ARARA”) to help revive faltering liquidity in the municipal market.

**WHAT ARE BUILD AMERICA BONDS (BABs)?**

- Build America Bonds were created by the February 2009 American Recovery and Reinvestment Act
- Although there are two versions, with differing subsidy options, the predominant form, are direct payment BABs whereby the U.S. Treasury rebates 35% of interest costs back to the issuer
- Unlike most municipal bonds, interest on these BABs is subject to federal income tax
- The ARARA legislation authorized the issuance of BABs through 2010 – we believe that date may be extended

BABs are taxable municipal bonds created by the ARARA. They can be issued by state and local government entities, which would normally qualify to issue tax-exempt bonds. There is not a guarantee from the federal government securing BABs; they are secured by the credit of the issuing entity. Direct pay BABs with the 35% subsidy are the most common, although certain bonds, issued for special recovery zone economic development may receive a subsidy of 45%. The U.S. Treasury provides direct cash subsidies to issuers equal to 35% (or 45%) of the interest costs. This subsidy mechanism brings the total funding cost to the issuer close to tax-exempt levels. If the market allows a municipal issuer to issue tax free bonds at 4%, or taxable 35% direct pay BAB at 5.75%, the issuer will likely chose BABs since after receiving the 35% federal subsidy on the 5.75% interest rate, the issuer would be paying an effective interest rate of 3.73%, a lower cost alternative to the issuance of 4% tax-exempt bonds.

In the beginning of 2009 municipal bond issuers faced high financing costs because of the municipal market’s elevated yields. By creating a cost effective (from the issuer’s standpoint) taxable alternative, BABs effectively expanded the universe of potential investors for municipal bonds. These new buyers include institutional investors such as pension funds and property and casualty insurance companies as well as individual investors using IRAs and other tax advantaged accounts. Policy makers expected that broadening the investor base would help to lower financing costs and open the market to future issuance.

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*> The Build America Bond program has accounted for 15% of all municipal bond issuance in 2009, a number which we expect will increase into 2010.*

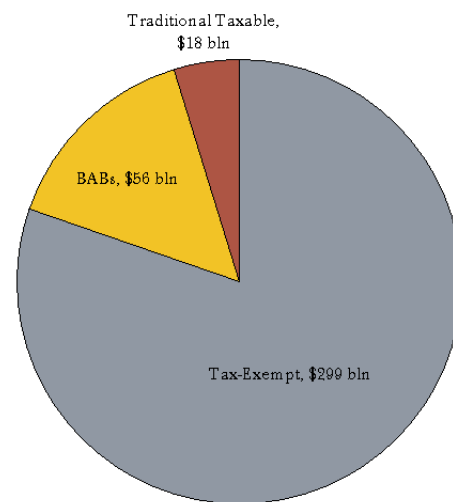
Some market participants expected BAB issuance to be limited because they thought the structures or features municipal issuers typically used would not appeal to non-typical municipal investors. They expected par amounts would be too small, the 10 year call redemption would be a hurdle and non-typical investors would never buy bonds with sinking funds or be interested in smaller issuers who do not frequently come to market. Over \$55 billion of issuance later, we can see that this criticism was misdirected.

Build America Bonds were \$56 billion, or about 15% of municipal market volume through November, particularly significant since the first issues did not come to market until April. Tax-exempt investors may have been disadvantaged by the advent of BABs since more taxable issues meant fewer new tax-free bonds. Decreased supply of tax-frees kept tax exempt yields lower than they would have been without BABs. However, the BAB program did help stabilize the municipal market through 2009.

With nine months of issuance experience, the debt attributes of BABs have moved closer to traditional tax-exempt market structure conventions. Investors have become more familiar with the products and with municipal credits. Recent issues have included serial bonds and 10 year optional redemptions, instead of the typical “bullet” corporate maturities and “make whole” corporate call. Other signs of the maturing market for BABs are narrowing spreads (differences between the issue’s yields and the yields of comparable US Treasuries).

There is talk in Washington of extending BABs beyond the scheduled December 2010 expiration. BABs will likely be around for a while, if not permanently, but there may be adjustments – for example the federal subsidy percentage could be reduced. As noted, we expect BABs to be 20% of municipal issuance in 2010, and if the BABs provisions are extended beyond 2010, demand should continue to grow as investors new to municipal investments grow more comfortable with the asset class.

**YTD Issuance Through November 2009**

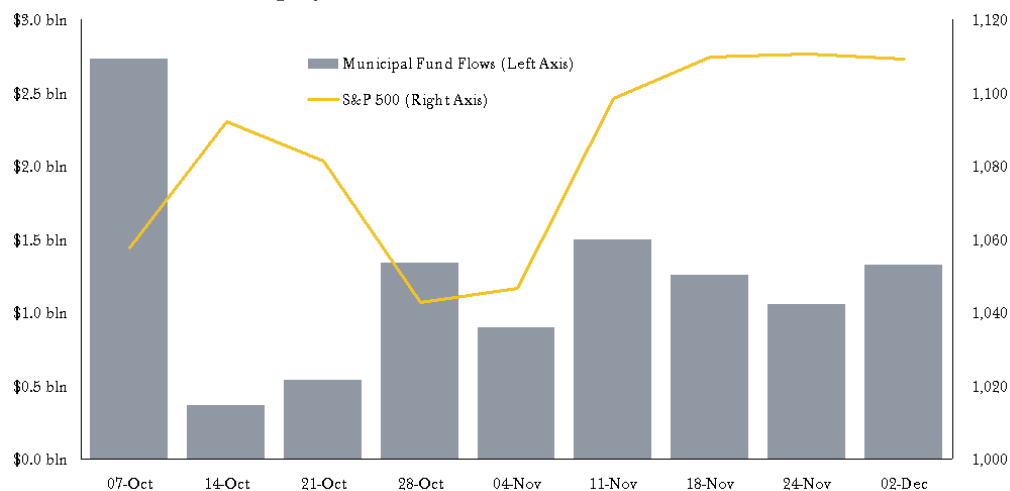


Source: Janney FI Strategy; Thomson Reuters

**BOND FUND FLOWS**

Inflows to municipal bond mutual funds, as measured by Investment Company Institute estimates, averaged almost \$5.5 billion a month during 2009, and the pace was slightly lower in the last quarter with monthly inflows in October and November of \$4.9 billion and \$4.7 billion respectively. A week to week look at muni inflows shows decreases in inflows due to strength in the equity markets. This strength may have absorbed investors’ funds which otherwise might have gravitated to fixed income products.

**Muni Fund Inflows & Equity Market Performance**



Source: Janney FI Strategy; ICI; Standard & Poor’s

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**MARKET PERFORMANCE**

Tax-free yields, as represented by Municipal Market Data's ("MMD") AAA general obligation scale, have been on a see-saw for most of 2009 but have trended downward. Recently, yields for the five and seven year maturities fell 40 and 39 basis points respectively, from November 1 to December 1.

**AAA GO Yields**

Date	1 Year	3 Year	5 Year	7 Year	10 Year	15 Year	20 Year	25 Year	30 Year
<b>1-Jan-2009</b>	0.85%	2.04%	2.48%	2.86%	3.53%	4.47%	4.83%	5.00%	5.05%
<b>1-Oct-2009</b>	0.37%	0.98%	1.57%	2.05%	2.57%	3.05%	3.44%	3.75%	3.82%
<b>1-Nov-2009</b>	0.37%	1.05%	1.85%	2.48%	3.03%	3.47%	3.82%	4.15%	4.23%
<b>1-Dec-2009</b>	0.28%	0.83%	1.45%	2.09%	2.76%	3.29%	3.71%	4.10%	4.25%
<b>Nov-2009 Change</b>	-0.09%	-0.22%	-0.40%	-0.39%	-0.27%	-0.18%	-0.11%	-0.05%	0.02%

Source: Janney FI Strategy; Thomson MMD

MMD yields are published daily by Thomson Reuters, and act as the standard benchmark for the municipal industry. The MMD scale is a listing of yields for each year from the one year maturity to the 30 year and is based on yields of new issues and secondary transactions for AAA municipal issuers such as the state of Delaware; the state of North Carolina or Montgomery County, Maryland. In the way that corporate bond issues trade on a spread to Treasuries municipal yields are frequently referred to by their spread to MMD. Going forward, Janney FI Strategy will use the MMD scale as a reference point and basis for illustrating muni market performance and pricing.

Municipal to Treasury ratios (M/T ratios), the primary relative value indicators for the municipal bond market, are finishing the year close to historical averages. Many investors, particularly mutual funds, which experienced significant outflows, sold municipals during the market panic between September 2008 and April 2009, while Treasury yields fell with the "flight to quality." This caused the 10 year M/T ratio to spike to a high of 186% in December 2008. The ratio has fallen to near historical levels, ranging from 74% to 91%, and averaging 87% over the last four months. On the long end of the curve, the 30 year M/T ratio experienced similar elevated levels at the beginning of the year, but is now close to historical averages.

**Municipal / Treasury Ratios**

Date	2 Year	5 Year	10 Year	30 Year
<b>1-Jan-2009</b>	213%	144%	146%	179%
<b>1-Oct-2009</b>	72%	71%	80%	96%
<b>1-Nov-2009</b>	76%	79%	88%	99%
<b>1-Dec-2009</b>	86%	71%	84%	99%
<b>Change between 11/1 &amp; 12/1</b>	10%	-8%	-4%	0%
<b>10 Year Average</b>	83%	83%	87%	97%
<b>4 Month High</b>	89%	83%	91%	107%
<b>4 Month Low</b>	51%	59%	74%	93%

Source: Janney FI Strategy; Thomson MMD

*> AAA GO yields were lower across the yield curve in 2009, though more recent performance has been stronger on the short end of the yield curve.*

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> *While state and local governments are facing revenue stresses and growing budget deficits, we view a municipal credit “meltdown” as very unlikely.*

**STATE AND LOCAL GOVERNMENTS FACE LOWER REVENUES**

State tax collections are falling throughout the country. States collected almost 11% less revenue from July to September 2009 versus the same period last year. In addition to falling revenue, states face other pressures, including rising unemployment and high foreclosure rates. A Pew Center on the States table paints a grim picture of states’ fiscal condition.

**State Budget and Economic Statistics**

	Change in Revenue <sup>1</sup>	Size of Budget Gap <sup>2</sup>	Rise in Unemploy. Rate <sup>3</sup>	Foreclosure Rate <sup>4</sup>	Supermajority Budget Vote Req'd
<b>US Average</b>	<b>-11.7%</b>	<b>17.7%</b>	<b>4.4</b>	<b>1.37%</b>	<b>17 yes, 33 no</b>
California	-16.2%	49.3%	4.6	2.02%	Yes
Arizona	-16.5%	41.1%	3.0	2.42%	Yes
Rhode Island	-12.5%	19.2%	4.5	1.50%	Yes
Michigan	-16.5%	12.0%	6.0	1.47%	Yes
Oregon	-19.0%	14.5%	6.4	0.86%	Yes
Nevada	1.5%	37.8%	5.2	3.12%	Yes
Florida	-11.5%	22.8%	4.4	2.72%	Yes
New Jersey	-15.8%	299.0%	3.7	1.18%	No
Illinois	-10.9%	47.3%	3.5	1.44%	No
Wisconsin	-11.2%	23.2%	4.4	0.96%	No

<sup>1</sup> From 1Q08 - 1Q09      <sup>2</sup> For FY10, as of Jul09      <sup>3</sup> From 2Q08 to 2Q09  
<sup>4</sup> New foreclosures in 1Q09

Source: Janney FI Strategy; Pew Center on the States

The last budget cycle caused many state governments to shrink allocations to higher education, school districts and local governments. Anticipating this stress to local governments, Moody’s assigned a negative outlook to the U.S. local government sector in April 2009. The rating agency reported that the “negative outlook reflects the significant fiscal challenges local governments face as a result of the housing market collapse, dislocations in the financial markets, and a recession that is broader and deeper than any recent downturn.” Some state and local governments have been downgraded and we expect further rating deterioration to occur as local governments try to balance their books. Higher taxes may also be necessary in some areas and we think that requests for federal assistance to aid in balancing budgets over the near term will be common.

**MUNI MELTDOWN UNLIKELY**

We do not expect that there will be a “municipal meltdown” or a high proportion of defaults in traditional safe municipal sectors. Defaults on municipal bonds have, to date, stayed in the riskier sectors. In the last half of 2009, approximately 138 (\$3.5 billion) issues filed default disclosure with trustees. This amounts to about 0.13% of the entire \$2.8 trillion municipal market. None of the issues were in the “safe sectors,” such as general obligation, tax-backed or essential service bonds. We are not seeing and do not expect there to be credit deterioration to the point where municipal defaults will consist of a large percentage of outstanding issues.

**Major Credit Events by Muni Sector (2H 2009)**

Sector	Default Notices		Tap Reserve Funds	
	Amount	Number	Amount	Number
<b>Land Secured</b>	\$992 MM	65	\$1,530 MM	75
<b>Toll Road/Transit</b>	\$882 MM	2	\$779 MM	2
<b>Multi-Family Housing</b>	\$539 MM	23	\$73 MM	5
<b>Retirement</b>	\$341 MM	14	\$130 MM	5
<b>Hotel/Casino</b>	\$339 MM	6	\$116 MM	3
<b>Student Housing</b>	\$87 MM	3	\$43 MM	2
<b>IDB</b>	\$86 MM	7	\$161 MM	7
<b>Hospital</b>	\$44 MM	2	\$18 MM	2
<b>Other Risky Sectors</b>	\$241 MM	16	\$292 MM	15
<b>"Safe" Sectors (GO, Wtr, Sls Tax)</b>	\$0 MM	0	\$198 MM	11
<b>Total</b>	<b>\$3,551 MM</b>	<b>138</b>	<b>\$3,340 MM</b>	<b>127</b>

Source: Janney FI Strategy; Municipal Market Advisors

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*> Municipal defaults have been limited in every rating category.*

**S&P Cumulative Muni Obligor Default Rates 1986 - 2008**

Rating	Year 1	Year 3	Year 15	Year 20	Year 23
AAA	0.00%	0.00%	0.00%	0.00%	0.00%
AA	0.00%	0.01%	0.07%	0.14%	0.32%
A	0.00%	0.02%	0.11%	0.19%	0.25%
BBB	0.01%	0.08%	0.37%	0.37%	0.37%
BB	0.20%	0.97%	2.07%	2.07%	2.07%
B	1.46%	3.84%	7.70%	7.70%	7.70%
CCC/C	13.77%	23.95%	41.76%	41.76%	41.76%
Investment Grade	0.00%	0.03%	0.16%	0.22%	0.29%
Speculative Grade	1.56%	3.46%	6.75%	6.75%	6.75%
<b>All Rated</b>	<b>0.02%</b>	<b>0.07%</b>	<b>0.23%</b>	<b>0.29%</b>	<b>0.37%</b>

Source: Janney FI Strategy; Standard & Poors

Municipal defaults, from a historical perspective, have been limited—especially compared to corporate bond counterparts—in every rating category. As noted in the table, cumulative default rates on municipal debt rated AAA by S&P have been zero over the nearly quarter century period between 1986 and 2008, while only 0.32% of AA rated municipals have defaulted over that same timeframe (technical

note: the methodology S&P used measures the default rate “x years” after an issuer was first rated; for example, Y3 includes the default rates on all defaults on debt issued from 1986-2008 during the third year after issuance).

**MONOLINE BOND INSURER UPDATE**

The use of municipal insurance has fallen to only 9% of new municipal issues versus 18% in 2008 and 46% in 2007. Issuers are still using insurance when available and cost effective. In 2009, that was mostly for smaller issuers rated in the low A category or below. Issuers who do use insurance, nearly always apply for an underlying rating, something not routine a few years ago. In fact, Fitch announced that they would no longer rate insured municipal issues unless there was an underlying rating. During 2009 only Assured Guaranty Corp. (Assured); Assured Guaranty Municipal Corp., formerly FSA; and Berkshire Hathaway Assurance Corp. (BHAC) insured new bond issues.

Going forward we expect to see bond insurance continue, in some form, as a viable product. Issuers will continue to use it as long as investors have a demand for it. One of the key advantages for investors is that insurers, when they underwrite insurance policies for municipal issues, usually perform more sophisticated levels of analysis and due diligence than individual investors can typically perform. The point is that insurance does continue to offer value to investors. Currently, the world of monoline insurers is segmented into tiers. The top tier consists of insurers who are actively writing new municipal business and are financially viable companies. Gone are the pure AAA insurers after Moody’s downgraded BHAC to Aa1.

**Bond Insurer Credit Ratings**

Company	Moody's Rating	S & P Rating	Fitch Rating
ACA Financial Guaranty Corp.	Not Rated	Not Rated	Not Rated
Ambac Assurance Corp.	Caa2	CC	Not Rated
Assured Guaranty Corp.	Outlook Developing	Negative Outlook	AA-
Assured Guaranty (FSA) Municipal Corp.	Aa3	AAA	AA
Berkshire Hathaway Assurance Corp.	Review for Downgrade	Negative Outlook	Negative Outlook
CIFG Assurance North America Inc.	Aa3	AAA	AA
Financial Guaranty Insurance Co.	Review for Downgrade	Negative Outlook	Negative Outlook
MBIA Insurance Corp.	Aa1	AAA	Not Rated
National Public Fin Gte Corp (formerly MBIA Ins of Illinois)	Stable Outlook	Negative Watch	Not Rated
Radian Asset Assurance Inc.	Ca	CC	Not Rated
Syncora Guaratee Inc. (formerly XL CapAssurance Inc.)	Outlook Developing	Negative Outlook	Not Rated
	Not Rated	Not Rated	Not Rated
	B3	BB+	Not Rated
	Negative Outlook	Negative Outlook	Not Rated
	Baa1	A	Not Rated
	Outlook Developing	Outlook Developing	Not Rated
	Ba1	BB	Not Rated
	Stable Outlook	Negative Outlook	Not Rated
	Ca	R	Not Rated
	Outlook Developing		

Source: Janney FI Strategy; Moody's; Standard & Poors; Fitch



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> *Assured Guaranty is the only company actively insuring new municipal issues, both through the original insurer and through FSA, now named Assured Guaranty Municipal Corp.*

**TOP TIER INSURERS**

- **Assured Guaranty Corp./Assured Guaranty Municipal Corp.** – Assured Guaranty Corp. (“Assured”) and Assured Guaranty Municipal Corp. (“AG Muni”) combined on July 1, and together account for most of the \$33 billion of insured bonds in 2009. But both insurers were downgraded during the year. Most recently, on November 12, 2009, Moody’s downgraded its rating of Assured from Aa3 from Aa2 and left the rating on review for further possible downgrade. Moody’s affirmed the credit ratings on AG Muni (formerly Financial Securities Assurance Inc.) at Aa3 and placed that entity on negative outlook. Analysts are estimating as much as \$600 million in mortgage related losses for Assured, which, while small in comparison to other insurers, is nonetheless a substantial portion of the company’s \$2.7 billion in claims paying resources.
- **Berkshire Hathaway Assurance Corp.** – BHAC lost its Aaa from Moody’s back in March and Standard and Poor’s placed Berkshire Hathaway Inc. and its affiliates, including the municipal insurance arm, BHAC, on “Watch Negative” on November 4, 2009. The downgrade was based on Berkshire’s planned \$44 billion acquisition of Burlington Northern Santa Fe. S&P believes the purchase will decrease the liquidity and capital adequacy of the insurance operations because they expect a significant part of the cash for the acquisition to come from the insurance business. A rating adjustment is not expected to exceed two notches and the analysis is expected to be completed by the end of January 2010. Berkshire Hathaway Assurance Corp. insured a minimal number of municipal issues in the beginning of 2009 and hardly participated at all as the year finished. Although we included BHAC in the top tier, we do not expect BHAC to be a major player in the municipal insurance market going forward.

**LOWER TIER INSURERS**

- **Ambac** - In the middle of June, Ambac postponed its efforts to start Everspan, its new municipal bond insurer. Ambac was not able to raise enough third party capital to finance the new insurer. Ambac's ratings were downgraded to below investment grade by all rating agencies. The company is now effectively in run-off mode and will not underwrite new insurance business. We do not expect them to re-enter the market.
- **CIFG Assurance** - At the beginning of November, 2009, Moody’s downgraded CIFG Guaranty, which includes the municipal insurer business CIFG Assurance North America to Ca from Caa2 based on increased loss estimates on some of the firm’s insured CDOs. This action concluded the review initiated in August when CIFG’s rating was downgraded to Caa2 and left on review for a possible downgrade. Moody’s also said that CIFG may not have sufficient capital to pay out on insurance claims and notes “that the risk of regulatory intervention is meaningful,” as a result.
- **Financial Guaranty Insurance Co.** - New York insurance regulators ordered Financial Guaranty Insurance Co. (“FGIC”) to suspend paying on insurance claims because of the company’s inability to maintain the required levels of statutory capital, according to a FGIC press release, from the week of the Thanksgiving holiday. FGIC’s capital deficit measures over \$800 million and the company is required to file a plan to restore its capital by Jan. 5 or face potential seizure.
- **MBIA/National** - MBIA split its insurance business into two pieces, its public finance business and structured finance products. The public finance business is now National Public Finance Guaranty Corp. (National). National is not currently underwriting new business and it does not look like they will reenter the market anytime soon, if at all. MBIA is waiting the outcome of litigation which challenged its creation of National.
- **Radian Asset Assurance Inc.** – At the end of November, Standard and Poor’s downgraded insurer Radian Asset Assurance (Ba1/BB/NR) to junk status. The monoline insurer is currently in run-off mode and the rating agency cited significant exposure to several asset classes which have experienced severe credit deterioration as the leading cause for the downgrade. Radian’s ratings remain on Negative Creditwatch.
- **Syncora Guarantee Inc.** - Syncora, the municipal insurer formerly known as XL Capital Assurance, became the first formerly AAA rated insurer to not honor an insurance payment when it failed to pay a claim on Jefferson County, AL sewer debt, in accordance with orders from regulators. Syncora completed a restructuring that included a “cut-through reinsurance arrangement”, creating a new insurer called Syncora Capital Assurance. Syncora Capital Assurance has not yet received authorization to pay out on claims from the New York State Insurance Department.

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**THE FUTURE OF MUNICIPAL BOND INSURANCE**

The Municipal Infrastructure and Assurance Corp. (MIAC) was licensed by the New York State Insurance Department in October 2008 and is a partnership between Macquarie Group and Citadel Investment Group. The company is still waiting for ratings so it can begin insuring municipal issues. MIAC is expected to insure only investment grade municipal credits which are "essential to the daily functioning of the communities in which they reside," according to a message on the company's web-site. Therefore, we anticipate a focus on the sectors with less risk such as general obligations and water and sewer facilities. We expect MIAC to be among the Tier 1 insurers when they receive their ratings but we do not anticipate they will be rated AAA by all rating agencies, as we believe the AAA municipal insurer rating is now unattainable.

A potential new municipal bond insurer, BondModel Co., is waiting for ratings and regulatory approval. BondModel hired a base staff of municipal professionals from firms such as Goldman Sachs and CIFG and is expecting to use a patented funding structure to price municipal insurance products. We expect this approval and ratings process to be lengthy and do not expect BondModel to be ready to insure bonds in 2010.

**CONCLUSIONS**

We continue to recommend investors look to bonds backed by stronger state governments, school district bonds backed by state intercept programs and high quality and essential service revenue bonds. Investors should keep the fiscal stresses to state budgets in mind, especially the states listed on the State Budget and Economic Statistics on page 12, such as California, Rhode Island, New York and Illinois. As the states' credit deteriorates, so do the organizations which rely on them for funding.

In 2010, we believe the ability of state and local governments to make a comeback will be dictated by the prospects of the economic recovery. States are expecting the continuation of one of the worst fiscal situations since the Great Depression in the near term. States face large budget gaps, decreased general fund spending, and more spending cuts. According to data from the National Association of State Budget Officers, most states expect lower revenues to continue through 2010. We expect the economy to battle double digit unemployment through 2010 but for economic prospects to improve.

The federal government may very well create another stimulus package aimed at state and local governments, but the key issue for local governments is going to be how they are able to respond to declining revenues as a result of the economic crisis and the effects from the resulting recession. Local governments are facing continued school aid, health care and higher education cuts as states report lower tax revenue and we believe many local governments will be at the mercy of states' budget processes. On the positive side, if the events of 2008 and 2009 have shown us anything, they have illustrated that the United States government is willing to intervene in the capital markets with capital injections or innovative programs aimed at key industries. Resources aimed at the municipal bond market demonstrate its importance in the eyes of the federal government.

*> We prefer many of the lower risk elements of the municipal bond markets, including state and local GO debt.*

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### ANALYST CERTIFICATION

We, Guy LeBas & Tom Kozlik, the Primarily Responsible Analysts for this report, hereby certify that all of the views expressed in this report accurately reflect our personal views about any and all of the subject economies, indicators, sectors, industries, issuers, and securities. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

### DEFINITION OF OUTLOOKS

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

**Stable:** Janney FIS believes there are factors which point towards stable issuer 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 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.

### DEFINITION OF RATINGS

**Overweight:** Janney FIS expects the target asset class or sector to outperform the comparable benchmark (below) in its asset class in terms of total return

**Marketweight:** Janney FIS expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return

**Underweight:** Janney FIS expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return

### BENCHMARKS

**Asset Classes:** Janney FIS ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclay's U.S. Aggregate Bond Market Index" as a benchmark.

**Treasuries:** Janney FIS ratings employ the "Barclay's U.S. Treasury Index" as a benchmark.

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

**Mortgages:** Janney FIS ratings employ the "Barclay's U.S. MBS Index" as a benchmark.

**Investment Grade Credit:** Janney FIS ratings employ the "Barclay's U.S. Credit Index" as a benchmark.

**High Yield Credit:** Janney FIS ratings employ the "Barclay's U.S. Corporate High Yield Index" as a benchmark.

**Municipals:** Janney FIS ratings employ the "Barclay's Municipal Bond Index" as a benchmark.

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