

TOP 10 SURPRISES FOR '12

JANNEY FIXED INCOME STRATEGY

JANUARY 3, 2012



As the calendar turns to 2012, we publish our list of events which have a good chance of occurring, yet aren't effectively priced into the markets.

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TOP 10 SURPRISES FOR '12

Each January, we publish our Top Surprises for the New Year, which we define as macroeconomic and capital markets-wide events which have a reasonable chance of occurring, yet which are not priced into the markets efficiently. Keep in mind that these events are not absolute forecasts per se, but rather possibilities that, in our view, present trading opportunities based on a "grey swan" philosophy (these events aren't nearly unlikely enough as to qualify as a black swan).

For 2011, five of our eleven surprises came to pass, including our high- bet on home price declines triggering further mortgage defaults, our moderate-probability surprise of further Fed policy expansion, and, most significantly, our moderate-probability concern that a Greece re-bailout leading to troubles in the Eurozone. On this last count, it seems that one of our top surprises of the prior year has become a market-dominating event, though the fact that Greece's challenges fed through into Italian distress means the surprise went deeper than we anticipated.

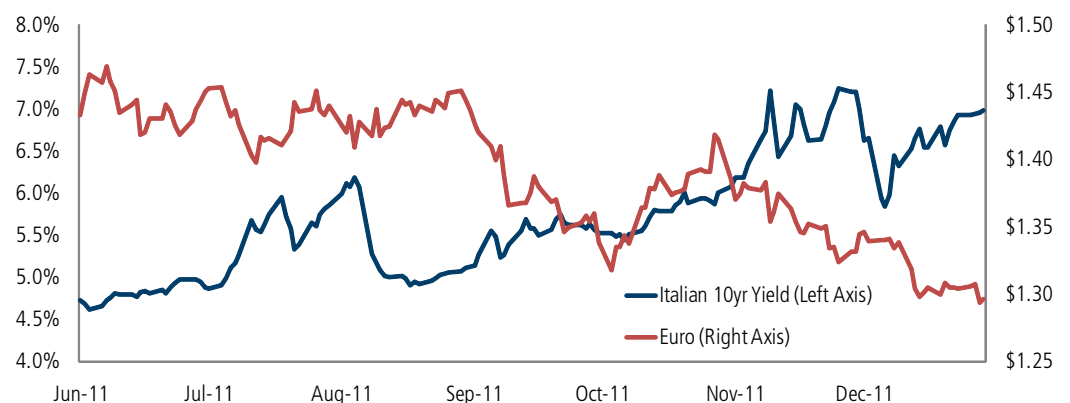
Looking to the coming year, we believe that market performance will be increasingly contingent on policymakers' response to global economic and liquidity phenomena, which in turn makes more of our surprises dependent on policy actions, which tend to be binary (e.g., either the ECB buys sovereign debt or it doesn't). Key highlights of the list include a still-substantial risk of US recession from a credit pullback, concerns about Congress' efforts to blunt the Budget Control Act and the effect on the US' ratings, and a possible optimistic surprise out of China, whose policymakers may have actually gotten it right on the whole soft landing thing.

HIGH IMPACT SURPRISES

1. Greece issues a credible threat on and makes preparations for exiting the Euro currency, though the country does not yet execute on the threat. The Euro continues to fall and sovereign credit spreads blow out 100bps further versus German bunds.

- ▶ Moderate probability, high impact

In Oct, Bank Repatriation Slowed the Euro Decline, But Downward Trend Remains



Source: Janney Fixed Income Strategy

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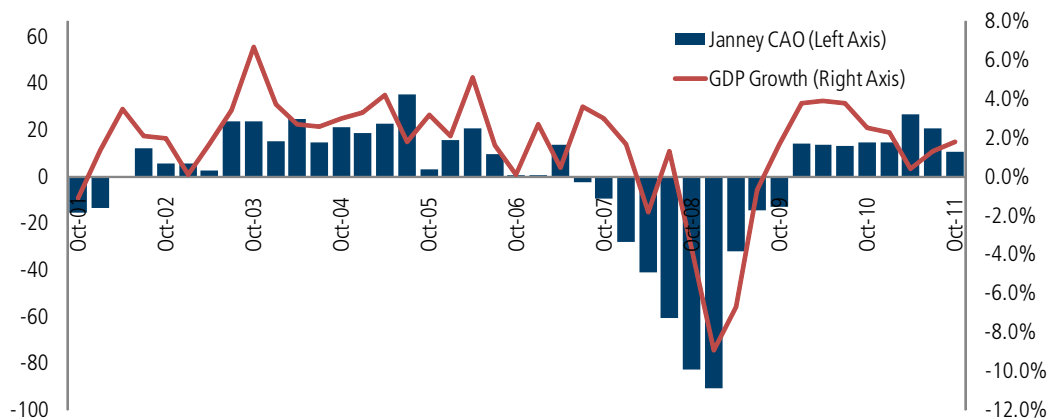
A great deal of the 2012 landscape will depend on policymakers' ability and willingness to respond to market and economic stresses.

2. Several EU member nations reject proposed treaty changes requiring greater fiscal coordination, thereby reducing value of those provisions and failing to solve root of sovereign credit problems.
 - ▶ Moderate probability, high impact
3. Faced with a Greek exit and/or inaction from fiscal powers, the ECB agrees (is forced?) to purchase EU peripheral sovereign debt aggressively, reversing the spread blowout and, ironically, supporting the value of the Euro.
 - ▶ Moderate probability, high impact
4. Congress waters down the Budget Control Act, casting doubt on the US' willingness to achieve deficit reduction, and causing real yields to rise in 7yr and beyond maturities. Moody's and Fitch downgrade the US to Aa1/AA+, S&P warns about a downgrade to AA.
 - ▶ Moderate probability, high impact
5. Domestic non-financial corporate profitability growth slows markedly along with business spending, thereby compressing margins, and stimulating a major pickup in M&A activity to \$1.5 trillion domestically from \$1.0 trillion in 2011.
 - ▶ Moderate probability, high impact
6. A further flare up in tension between Israel and Iran including limited military action results in a sharp spike in energy prices, with crude briefly clearing 2008 highs.
 - ▶ Moderate probability, high impact

MODERATE IMPACT SURPRISES

7. A European-driven credit pullback makes access to credit tougher and further weakens sentiment, causing the US economy to fall into recession, albeit a relatively shallow one.
 - ▶ Moderate probability, moderate impact

Janney Credit Avail. Oscillator Shows Risk Of Liquidity Stress Hitting Economy



Source: Janney Fixed Income Strategy

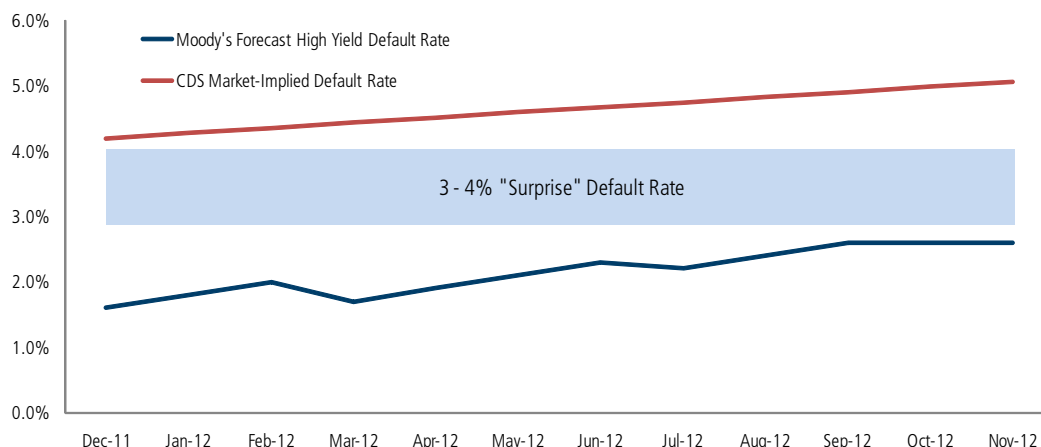
8. High yield US corporate default rates tick higher from 1.7% in 2011 to 3-4% range for 2012 as global liquidity stress creates challenges in refinancing debt maturities. Still, defaults are the exception not the rule, and the high yield markets outperform.
 - ▶ Moderate probability, moderate impact

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Although high yield defaults have a chance of ticking higher in 2012, the markets are overpricing default risk.

High Yield Markets Pricing In Higher Default Rate than Even our "Surprise" Level

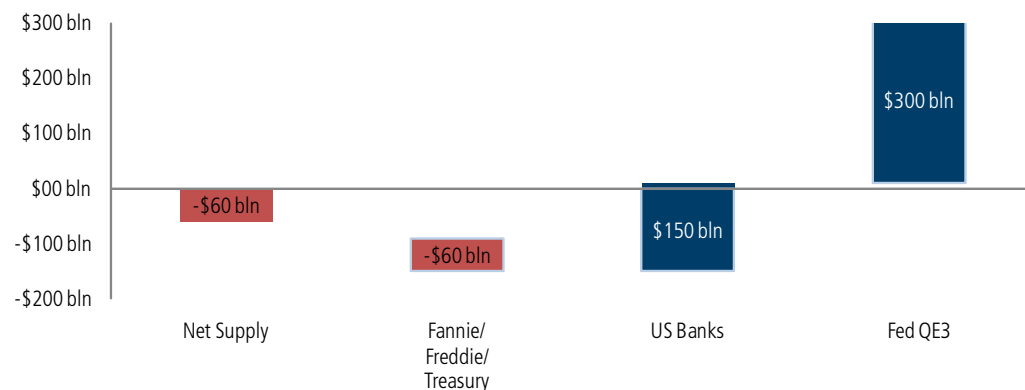


Source: Janney Fixed Income Strategy; Moody's; Markit

HIGH PROBABILITY SURPRISES

9. The Fed launches QE3 by midyear, causing the yield curve to initially steepen on higher inflation expectations, followed by a flattening reversion, and causing MBS spreads to tighten.
 - ▶ High probability, low impact

Net Demand for MBS Would Be Supported by a Fed QE3 Buying Program



Source: Janney Fixed Income Strategy

10. China's economy slows far less than feared (executing the so-called "soft landing"), as policy-makers have efficiently tamed inflation risk in the country, though nervousness about property bubbles keeps external investments in China constrained.
 - ▶ High probability, low impact

CONCLUSION

As our list of 2012 surprises suggests, the predominant risks to the outlook remain not only policy-oriented, but also Euro-centric. So long as the European community over-promises and under-delivers, it's bound to be a challenging period for capital markets performance, with volatility, both upside and downside, an unavoidable feature of the landscape. The good news is that the necessary structures for Europe to support liquidity do exist. The bad news is that it might take a deepening of problems before policymakers are willing to activate those structures.

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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.

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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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

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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.

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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.

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