

Basis Points

Fixed Income Strategy

Portfolio Strategy & Research Group

January 10, 2012

The 'Difference Maker'

Synopsis:

- There will be no changes to our Fixed Income Model Portfolios.
- US economic data have come in better than expected for 4Q 2011, but we expect this pace of growth to slow to begin the new year. Policy-related issues in the Euro Zone and the US should dominate the headlines in the months to come. As expected, the Fed will be enhancing their communication mechanism by providing forecasts for fed funds.
- While the last few years have seen 'parallel experiences' in many ways, early in 2012, some differences have begun to emerge, especially with the Fed, inflation and rate outlooks.
- The UST market should remain volatile, with the 10-yr moving roughly between the 1.70% to 2.40% range in the near to medium term. Even if the safety premium were to be removed, soft economic conditions and a lack of inflation pressures should keep intermediate to longer-dated yields historically low.
- Our preferred strategic target maturities are as follows:
 - US Treasuries: 3-yr to 7-yr
 - Investment Grade Corps: 7-yr to 10-yr
 - High Yield: 2-yr to 5-yr
 - Tax-exempts: 6-yr to 14-yr
- *Taxable Fixed Income:* We maintain our preference for Investment Grade credit to High Yield, given the significantly lower volatility of potential spreads movement.
- *Municipals:* While headline events will still be monitored, one of the bigger risks for the municipal market in 2012 should be interest rate volatility.

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The statistics listed below are as of January 10, 2011:

Fed Funds Target Rate	zero to 0.25%
Year-Over-Year Change in CPI	3.4%
GDP (3rd Qtr 2011)	1.8%
DXY Index	80.86
Unemployment Rate	8.5%

Source: Morgan Stanley Smith Barney, Bureau of Labor Statistics, Bureau of Economic Analysis

Upcoming Federal Open Market Committee Meetings:

- January 24 and 25
- March 13
- April 24 and 25

Source: Federal Reserve Board

Fixed Income Asset Allocation

There will be no changes to our Fixed Income Model Portfolios.

Conservative Model

Reduced inflation expectations combined with the potential that CPI has, or is close to peaking, has created a less-friendly investment environment for inflation-linked securities, such as TIPS. As a result, we remain underweight to TIPS. UST-related weightings are as follows: TIPS 5%; US Treasuries 20%. Our primary overweight position for the investment grade (IG) asset class remains at 35%.

Moderate Model

We expect the USD to retain its recent firmness versus developed market currencies such as the Euro, British Pound and Australian Dollar. We recently cut our weighting to the Non-USD component in half, leaving the new allocation at 5%. For now, a more defensive posture is being taken, as the proceeds were reallocated to CDs, where the new weighting will be 15%. IG Corporates will remain our primary overweight position in this model as well, but the allocation is a bit higher at 40%.

Aggressive Model

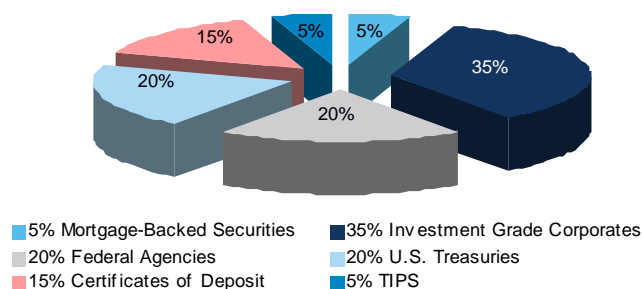
In keeping with the aforementioned theme of a more bullish USD setting in the medium term, we also reduced our weighting to the Non-USD component in this model, with the new weighting being 5% as well. We continue to see IG Corporates as a better relative value option and recently boosted the allocation here by 5% to a new weighting of 45%. Policy-related developments remain front and center, with uncertainty an integral part of the investment landscape. As a result, we are keeping our High Yield (HY) securities allocation at 15%.

Tax-Advantaged Model

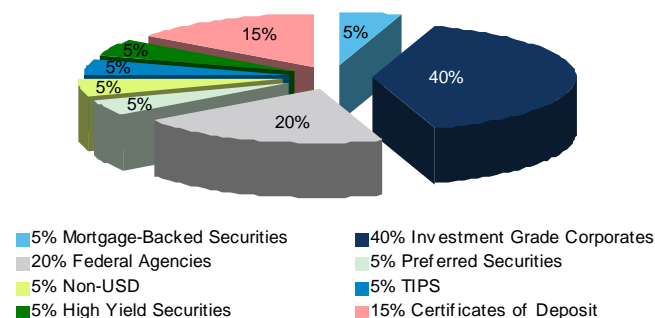
Investors should consider state GOs, and essential services, such as water and sewer. Our value focus is in the mid-tier "A" ratings and higher.

Recommended Fixed Income Model Portfolios

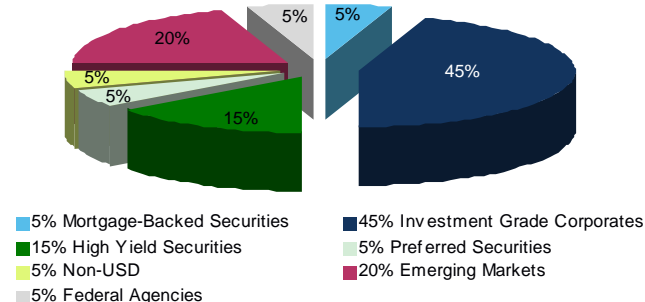
Conservative Fixed Income Portfolio



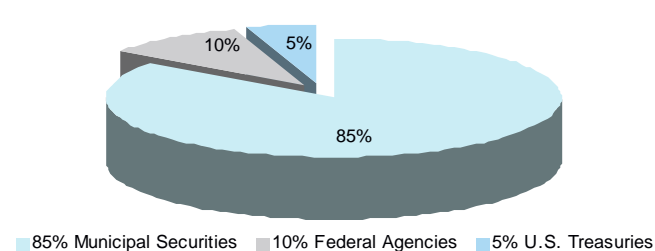
Moderate Fixed Income Portfolio



Aggressive Fixed Income Portfolio



Tax-Advantaged Fixed Income Portfolio



Source: Morgan Stanley Smith Barney Fixed Income Strategy

Investment Backdrop: The 'Difference Maker'

A primary theme of ours in 2011 was to highlight the similarities investors were facing within the fixed income landscape on a year vs. year basis. As last year got underway, the money and bond markets were operating under similar assumptions as was the case in 2010, namely, the economy was improving, inflation expectations were rising and the Fed would commence on some sort of exit strategy that would culminate in the first fed funds rate hike. Needless to say, history taught us something different, and of course, the sovereign debt crisis came racing into the picture. So here we are beginning another new calendar year with the natural questions being what's similar and what, if anything, is different?

The similar part of the question is rather straightforward. Specifically, the broader key forces (US economic prospects and the Euro Zone) remain intact. On the growth front, 4Q 2011 economic data have, for the most part, come in better than expected, with the latest employment report underscoring the point. As we witnessed a year ago, the unemployment rate is in the midst of a descending trend, albeit from rather lofty levels. The December jobless rate came in at 8.5%, the lowest reading since February 2009 and the fourth consecutive decline from its recent peak of 9.1%. A year ago, the descent took you from 9.8% down to 8.9% (also a 4-month phenomenon) before flattening back out at the aforementioned 9.1% reading. For the near term, we believe the jobless rate has entered into a modestly lower range of perhaps 8 1/4% to 8 3/4% vs. the prior band of 9% to 9 3/4%. Obviously, this would remain an elevated reading from a historical perspective. In addition, the civilian labor force participation rate was unchanged at 64.0, and continues to track at the lows of the early 1980s. Despite the relatively improved labor market setting, the economic outlook is not one for sustained improvement, but rather some slowing from the Q4 pace, with fears of recession still lurking.

The money and bond markets also remain focused on developments within the Euro Zone, and rightfully so. We have consistently discussed the twin threats: funding and financing. While the funding aspect continues to reveal pressure, there has been some relief lately, albeit of modest proportions. It would appear as if the Fed's central bank liquidity swap facility (up \$97.5 billion in the three weeks leading into the end of Dec) and the ECB's three-year LTRO program have helped in this regard. After a relentless upward trajectory, 3-month Libor settled a bit

and has actually set .003 lower as of this writing, the first sustained period of flat and/or declining levels since early summer.

The financing part of the equation remains a concern as many EMU members need to come to market with sovereign debt this year, a scenario that has already been playing out the last few weeks (see Jon Mackay's Credit section). It would appear as if S&P decided to not play Scrooge or the Grinch, but their rating decisions are looming, and as we've been mentioning, could come at any time. The question is: what is allowed for in the markets? Looking at French 10-yr spreads vs. like maturity German bunds, one could make the case that a one-notch downgrade has been discounted. Indeed, this spread has traded in the +135bp to +150bp area as compared to other AAA-rated European spreads of roughly +40bp. For the record, UK 10-yr gilts (also AAA) are only 19bp above bunds. If S&P decides to downgrade Germany by one notch and France by two notches, we would not be surprised to see a knee-jerk negative reaction in the Euro bond markets. Conversely, if Germany is left alone and France only gets dinged one notch, a knee-jerk relief rally is not out of the realm of possibility, but would probably be short-lived due to the ongoing challenges that remain.

Perhaps the most noteworthy difference from an economic vantage point is the inflation picture. Unlike last year when expectations, as well as actual yr/yr CPI readings were on the rise, we enter the current calendar year with reduced expectations and the prospect that headline inflation has most likely peaked. In fact, global central banks, the Fed included, will most likely utilize this different inflationary setting as a reason to provide more easing moves. Certainly, when one looks at the commodity markets, it is understandable for this altered outlook. To be sure, a year ago, broad commodity indices, such as the ThomsonReuters/Jefferies CRB index were revealing a definitive upward trajectory, whereby a peak reading was printed in late April 2011. The level as of this writing is down 16% from that high point.

The Fed: Another 'Difference Maker'

As alluded to in the prior section, the Fed outlook has done a complete 180-degree turn from this time a year ago. In early 2011, exit strategies, the end of QE2 and the potential for the first fed funds rate hike were all part of the discussion. For the record, fed funds futures were pricing in a rate hike move that never came. Obviously, this is not the case this time around. Entering 2012, we felt the Fed would continue to look for ways to provide stimulus. While the focus always seemed to be centered on the QE front,

it looks like the policymakers will utilize their communication mechanism yet again before going down the asset purchase option. Specifically, within the December 2011 FOMC minutes, the Committee decided to now provide their fed funds rate assumptions as part of the Fed's Summary of Economic Projections (SEP), beginning with this month's meeting on Jan 24-25. Thus, besides providing their central tendency estimates for economic growth, unemployment and inflation, the new SEP will now include projections for the target fed funds rate in the fourth quarter of this calendar year and for the following few years as well. In addition, there will be longer-run projections for when the first rate hike may occur as well as a narrative regarding the Fed's balance sheet. The latter consideration is where QE comes into play.

While the aforementioned shift in communication is being viewed as an additional policy tool, in our opinion, it may have little impact on current investor psychology. Indeed, financial markets are already operating under the assumption the Fed will be on hold for a while, so spelling it out in projections seems of little value to us. Although the money and bond markets could react if their assumptions prove contrary to conventional wisdom, this tool would have probably been more effective this time last year when market talk revolved around exit strategies and the potential for a 2012 rate hike. Notwithstanding the better-than-expected US economic data, the Fed seems to want to move into the realm of QE3, but with the focus being on MBS purchases. In the Fed's white paper that was released earlier this month on housing, the policymakers see housing as not only the key going forward, but also a major stumbling block to their prior easing moves.

The US Treasury Market: 'Difference Maker #3'

Certainly, the intermediate to longer-dated UST rate outlook is different than in the prior two years. In each instance, despite QE1 and QE2, the 10-yr yield still managed to climb higher, rising to roughly 4% in April 2010 and then 3.74% in February of last year. Given the potential for policy-related mistakes both here and in the Euro Zone, it is unlikely to see such a spike in rates this year, as the safety premium is a strong supportive force for the back end of the curve. As we have written before, even if the safety premium were removed, last year's experience showed us the 10-yr yield could move back to the 2.75% level, perhaps even 3% on an overshoot, certainly not back to the 3.75% to 4% range. In other

words, we have entered into a period of lower highs in terms of 10-yr yields.

The new year did see some initial selling pressure in intermediate to longer-dated Treasuries. No doubt, heading into the turn, investors took a rather cautious approach, pushing the UST 10-yr yield down to 1.88%. The opening trading frames in 2012 have seen a slight reversal of this safety trade, but the UST market's reaction to the better-than-expected economic data has been instructive because it has failed to result in visibly higher intermediate to longer-dated yields. This tells us the Euro Zone, and attendant safety premium, remains as strong a force as ever. We see no reason for this situation to change, and remain committed to our 1.70% to 2.40% trading range for the 10-yr.

Municipal Market Outlook

When we continue our theme of highlighting potential differences to the 2011 and 2012 fixed income landscapes, the municipal market definitely comes to mind. In contrast to last year's experience, there have been no nationwide prognostications involving widespread defaults for 2012. We are fully cognizant that headline risks are not necessarily going away anytime soon, but as the MSSB Municipal Strategy team has been discussing for quite some time, widespread defaults are not the base case scenario either. That being said, state and local fiscal conditions will continue to be monitored, and at times, will no doubt make their way into the mainstream media.

On that note, S&P recently reported on state tax revenues. It was noted that the expected reduction of federal funding would represent a headwind on the state budget front, but there has been some improvement in tax revenues. According to the S&P report, the "U.S. Census Bureau data indicate tax revenues for state governments were up 5.6% in the third quarter of 2011, compared to the same period the previous year." Although this pace was off a bit from the first two quarters of 2011, it still represented the seventh quarter in a row of year-over-year growth.

The MSSB Municipal Strategy team has continued to emphasize how supply and the direction of rates in the UST market will play an integral role in the municipal market during the current calendar year. As highlighted in their publication, *Dealing with Today's Markets: Reality Trumps Perception*, dated December 16, 2011, they "anticipate a significant rise in supply for 2012, on the order of 15% to 20%." Looking at relative value, according to Municipal Market Data, AAA-rated state GO yields continue to reside at historically high levels as compared to their Treasury counterparts. However, within the 10-yr

sector, we have witnessed some reversal of the ascending trend that was evident during the October/November period. Indeed, after posting a high point of 129.1% in early October, the 10-yr ratio has since fallen to 94.4% as of this writing. For the record, the long-term average comes in at 84.1%.

Fixed Income Sector Commentary

Credit – Watch Your Step

Anyone hoping we would start the new year with some semblance of market direction has to be a little disappointed. The investing landscape has not changed much in terms of potential negative and positive catalysts. There are still more of the former than the latter and we expect the level of heightened volatility we experienced in the last couple of months of 2011 to continue in 2012. Recent economic data point to some progress on the economic home front, yet a lot of that may be due to payback from the supply disruptions in the spring of 2011 and might prove temporary in nature. In addition, corporate fundamentals cannot get much better and may actually deteriorate somewhat this year as earnings growth slows and companies feel more pressure to return value to shareholders. Both of these factors have been positive drivers of credit spreads recently but in our opinion, the most pressing issue for investors in the near term remains the unfolding of events in Europe.

Long-term sovereign bond yields in the European periphery are still at unsustainably high levels despite the ECB's recent injection of liquidity into the European banking system, through a three-year LTRO. This is likely due to many banks putting these funds back on deposit at the ECB or at best, it is being used by banks to buy very short-term sovereign issues. It would be nice if troubled sovereigns could roll everything short term but that would leave them with very little in the way of refunding wiggle room. A more effective solution needs to be found, such as a European-style TLGP program for the banks, yet this is unlikely, in our view, until policymakers are pushed to act by the markets.

Bond refunding needs, excluding bills and spending requirements, are very high in the first quarter of 2012 for countries like Italy with €40 billion, Greece with €14.5 billion, and Spain with slightly more than €5 billion. Italy has a €25.8 billion issue maturing on February 1. This will likely be the first true test of whether or not investors have any faith that either the ECB or European policymakers will come to the rescue of another country in need,

especially one with the debt burden Italy carries. In addition to sovereign refunding needs, Greece is still working toward completing the requirements set forth to receive their third bailout, worth €130 billion. One of these requirements is the restructuring of privately held Greek sovereign bonds, which might occur by the end of January. If this fails, which is a possibility given recent talk of imposing greater than 50% haircuts on bondholders, Greece may not receive the bailout and thus could default and be forced out of the Euro Area.

Corporate spreads ended the year on a tightening trend with High Yield (HY) spreads in roughly 28bp in the month of December and Investment Grade Corporate (IG) spreads in by almost 10bp. The spread tightening led to a positive December for both asset classes, with HY posting a 2.66% monthly total return and IG generating a 2.16% return for the month. Despite a strong late surge by HY, at the end of the year IG corporates won the day. For the year, IG outperformed HY by more than 300bp with an 8.15% total return, almost matching the 9% total return in 2010. Within IG, lower quality outperformed higher quality as a thirst for yield drove Baa-rated credits to a 9.05% full-year return versus 7.68% for A-rated credits. Long duration also outperformed short duration as the credit curve flattened.

In our view, news out of Europe will continue to be the primary driver of credit performance over the coming months. Taking a slightly longer view, we see the investing environment possibly getting worse but believe that credit markets are providing adequate compensation for that risk, more so in IG credit and to a lesser degree in HY. We believe IG credit provides one of the most attractive investment opportunities, on a risk-adjusted basis, across asset classes over the next 12 months. We see more scope for tightening than widening in IG credit and expect full-year 2012 total returns in the 4%-5% area. We continue to recommend extending duration in IG, as we continue to see value in a steep credit curve. From a sector perspective, we see value in US Banks, which trade at a very wide spread to Industrials.

We see the HY market generating full-year returns in the 4%-6% area, similar to Investment Grade but with a much higher level of volatility and more scope for downside if the bear case materializes. Stick with higher-quality HY issuers. For a more in-depth discussion on our outlook for credit in 2012 please see "The Credit Report – 2012 Outlook: IG is the Place to Be."

Foreign Exchange and International Markets Update

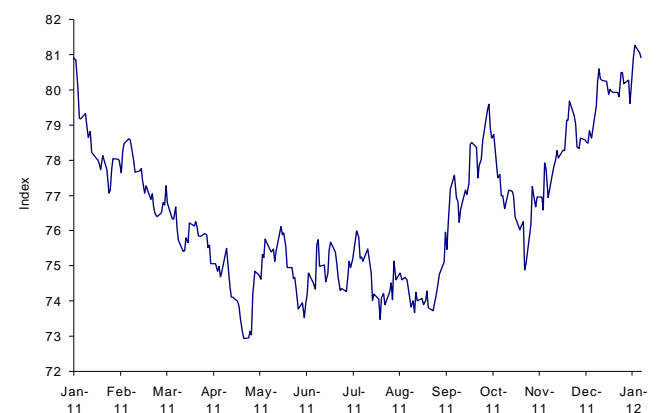
Slower global growth and the ongoing European sovereign debt crisis have dampened our outlook for international bonds and currencies. Headlines from Europe have pushed investors to safe-haven assets, leading to strong U.S. dollar performance. Since October 27, the U.S. dollar index is up over 8%, as seen in Figure 1. While December's European Summit gave investors a glimmer of hope, many of the details are still being finalized. We hope to get more details at the next European Summit, scheduled for later this month. Over the next 12 months we believe the U.S. dollar will remain a safe haven, and should perform well against most developed market currencies. Given the low-growth outlook and austerity measures, we expect the euro to depreciate against the USD. According to Morgan Stanley's forecast, the euro could depreciate over 6% by the end of 2012 from its current level. For investors seeking exposure to the Euro area, we continue to favor core, AAA-rated countries, but would point out that it is a relative call. Even Germany has experienced some troubles as of late, as their recent auctions have seen a fall in demand and they have been placed on CreditWatch Negative by S&P. Although the risk of an AAA-rated country defaulting or receiving a bailout is minimal, yields in a relative "Euro safe haven" like Germany may continue to drift higher. We expect a decision from S&P regarding its Negative Outlook on the Euro Zone fairly soon. However, it appears that many market participants have begun to discount a downgrade already, and yields on both core and peripheral European bonds could already reflect the lower rating.

Although our base case is for USD strength, we think there could be pockets of value in other developed countries. Recent positive economic data should help the commodity currencies, such as the Australian dollar, New Zealand dollar, and Canadian dollar. For investors looking for international bonds, we continue to like the fundamentals of Australia and New Zealand, as well as the yield pick-up over other developed market countries. Australia has an inverted yield curve, so investors looking for AUD exposure should stay short and invest in securities with maturities of two years or less. New Zealand's yield curve is positive sloping, but slightly flattens out at five years. However, both currencies may continue to be under pressure in 2012 versus the US Dollar. Both Morgan Stanley and Citi forecast USD strength through next year. Despite the expected fall, we believe that the AUD and NZD can outperform most other

developed market currencies. We expect Canada to experience positive, albeit below-trend, growth in 2012, as the economic outlook remains hazy. The CAD has benefited from the recent risk rally, the rise in oil prices, and the relative strength of the Canadian economy. Canada still enjoys an Aaa/AAA rating from Moody's and S&P, respectively, with a Stable Outlook at both rating agencies. Canadian bond yields inside of five years offer the largest yield advantage over U.S. Treasuries. While we expect the Canadian dollar to drop in 2012, we believe that it should recover in 2013.

We are maintaining our 20% allocation to emerging market bonds for aggressive accounts. The option-adjusted spread (OAS) on the Barclays Capital Emerging Markets index currently sits at 446 basis points (bps), compared to the 5-year average of 363 bps. While EM fundamentals remain fairly strong, external factors pose the most significant risks. Although spreads may revert to the mean, a major shock to the financial markets, such as a major sovereign or bank default in Europe, would pose significant downside risk. In 2011, USD-denominated emerging market debt had a total return of 6.97% according to the Barclays index data, compared to a total return of 4.98% for the U.S. high yield market. Local currency bonds also generated positive returns, but lagged a bit at 3.87%. USD-denominated emerging market bonds have now experienced positive returns for three straight years, with returns of 34.23% and 12.84% in 2009 and 2010, respectively. Central banks have lost their hiking bias, as a few countries have already begun cutting rates. If the global economy continues to "muddle along," EM debt may continue to generate positive returns through carry and possible spread tightening, but in a recurring theme, a major financial shock could lead to negative relative and absolute returns.

Figure 1. Trade Weighted US Dollar Index (DXY)



Source Bloomberg as of 1/10/2012

Fixed Income Snapshots: Treasuries and Municipals

U.S. Treasury Yield Curve (2s/5s: 2s/10s)



Source: Morgan Stanley Smith Barney, Bloomberg. Data as of 1/5/2012

Differential in yields between U.S. Treasury 10-year maturity and U.S. Treasury 2-year maturity, and differential in yields between U.S. Treasury 5-year maturity and U.S. Treasury 2-year maturity.

10-Yr Municipal Yield to Treasury Ratio



Source: Municipal Market Data (MMD), Bloomberg. Data as of 1/5/2012

The 10-yr AAA municipal bond yield as a percentage of the benchmark 10-yr U.S. Treasury note yield. The 10-yr AAA municipal index, which is derived from MMD's daily generic yield curves, represents the average yield of non-insured AAA-rated State G.O. bonds and reflects the offer-side of the market determined from trading activity and markets. The benchmark 10-yr U.S. Treasury yield is the yield of the most recently auctioned 10-yr Treasury note reported on a daily basis (as of the prior day's close).

Fixed Income Snapshots: Agencies and Mortgage Backed Securities

5-Year Federal Agencies Spread to Treasuries



Source: Morgan Stanley Smith Barney, Bloomberg. Data as of 1/5/2012

Fair Market Value U.S. Government Federal Agency spreads to Fair Market Value U.S. Treasuries for 5-yr maturities. Federal Agency and Treasury indices shown are derived from Bloomberg's Option Free Fair Market Yield Curves, which provide the composite yield of all outstanding securities around each maturity point. For example, the Federal Agency 5-yr includes all outstanding Federal Agency securities maturing in 2017.

30-Yr Fannie Mae MBS Current Coupon Spread to 10-Yr Treasuries



Source: Morgan Stanley Smith Barney, Bloomberg. Data as of 1/5/2012

Fair Market Value 30-yr FNMA MBS Current Coupon spread to Fair Market Value 10-yr Treasuries. Due to risks of MBS structure (e.g., prepayments and extension risk), the 10-yr Treasury is used as the benchmark for the 30-yr FNMA maturity. The MBS and Treasury indices shown are derived from Bloomberg's Option Free Fair Market Yield Curves. The 30-yr FNMA MBS index represents the composite yield of all outstanding FNMA MBS current coupon securities maturing in 2042, while the 10-yr Treasury index represents the composite yield of all outstanding Treasury notes maturing in 2022.

Fixed Income Snapshots: Investment Grade and High Yield Corporates

Investment Grade Corporate Index to Treasuries



Source: FactSet. Data as of 1/6/2012

The Barclays Capital US Aggregate Corporate Investment Grade Index is comprised of US\$ Investment Grade corporate securities with minimum ratings of Baa3/BBB-, minimum denominations of \$250 million, minimum maturities of 1-year, minimum par amount of \$1,000 and a fixed coupon.

High Yield Corporate Index to Treasuries



Source: FactSet. Data as of 1/6/2012

The Barclays Capital US Aggregate Corporate High Yield Index is comprised of US\$ Non-Investment Grade corporate securities with a maximum rating of Ba1/BB+ and a minimum rating of C, minimum denominations of \$100 million, minimum maturities of 1-year, and a minimum par amount of \$1,000.

The Barclays Capital Emerging Markets Index provides a broad-based measure of the market for Emerging Market Sovereign Bonds. Barclays maintains a USD denominated index and a local currency index.

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International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

The majority of \$25 and \$1000 par preferred securities are "callable" meaning that the issuer may retire the securities at specific prices and dates prior to maturity. Interest/dividend payments on certain preferred issues may be deferred by the issuer for periods of up to 5 to 10 years, depending on the particular issue. The investor would still have income tax liability even though payments would not have been received. Price quoted is per \$25 or \$1,000 share, unless otherwise specified. Current yield is calculated by multiplying the coupon by par value divided by the market price.

The initial rate on a floating rate or index-linked preferred security may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating/linked index. However, there can be no assurance that these increases will occur.

Some \$25 or \$1000 par preferred securities are QDI (Qualified Dividend Income) eligible. Information on QDI eligibility is obtained from third party sources. The dividend income on QDI eligible preferreds qualifies for a reduced tax rate. Many traditional 'dividend paying' perpetual preferred securities (traditional preferreds with no maturity date) are QDI eligible. In order to qualify for the preferential tax treatment all qualifying preferred securities must be held by investors for a minimum period – 91 days during a 180 day window period, beginning 90 days before the ex-dividend date.

CDs are insured by the FDIC, an independent agency of the U.S. Government, up to a maximum amount of \$250,000 (including principal and interest) for all deposits held in the same insurable capacity (e.g. individual account, joint account) per CD depository, through December 31, 2013. On January 1, 2014, the maximum insurable amount will return to \$100,000 (including principal and interest) for all insurable capacities except IRAs and certain self-directed retirement accounts, which will remain at \$250,000 per depository. Investors are responsible for monitoring the total amount held with each CD depository. All deposits at a single depository held in the same insurable capacity will be aggregated for purposes of the applicable FDIC insurance limit, including deposits (such as bank accounts) maintained directly with the depository and CDs of the depository held through Morgan Stanley Smith Barney. A secondary market in CDs may be limited. CDs sold prior to maturity are subject to market risk and therefore investors may receive more or less than the amount invested or the face value. Callable CDs are callable at the sole discretion of the issuer. For more information about FDIC insurance, please visit the FDIC website at www.fdic.gov.

Contingent return (e.g. index-linked) CDs are treated as having original issue discount (OID) for tax purposes. Although interest is not received until maturity, the CD is assumed to pay a pre-determined interest rate that will be treated as current income for tax purposes if held in a taxable account. Investors should be made aware that contingent return CDs generally feature an "averaging" method of return calculation, which averages the changes in value of the relevant index as measured on predetermined dates over the life of the CD. Therefore, the CD's return will not mirror the actual index value or return. If the measured index return using the averaging method is zero or negative, the investor receives no interest. Some contingent return CDs also have a participation rate (the degree to which an investor participates in the measured return of the index) that is less than 100%. Interest on contingent return CDs is not eligible for FDIC insurance before the final valuation date.

Principal is returned on a monthly basis over the life of the security. Principal prepayment can significantly affect the monthly income stream and the maturity of any type of MBS, including standard MBS, CMOs and Lottery Bonds. Yields and average lives are estimated based on prepayment assumptions and are subject to change based on actual prepayment of the mortgages in the underlying pools. The level of predictability of an MBS/CMO's average life, and its market price, depends on the type of MBS/CMO class purchased and interest rate movements. In general, as interest rates fall, prepayment speeds are likely to increase, thus shortening the MBS/CMO's average life and likely causing its market price to rise. Conversely, as interest rates rise, prepayment speeds are likely to decrease, thus lengthening average life and likely causing the MBS/CMO's market price to fall. Some MBS/CMOs may have "original issue discount" (OID). OID occurs if the MBS/CMO's original issue price is below its stated redemption price at maturity, and results in "imputed interest" that must be reported annually for tax purposes, resulting in a tax liability even though interest was not received. Investors are urged to consult their tax advisors for more information.

Interest income from taxable zero coupon bonds is subject to annual taxation as ordinary income even though no interest payments will be received by the investor if held in a taxable account. Zero coupon bonds may also experience greater price volatility than interest bearing fixed income securities because of their comparatively longer duration.

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

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