

NOVEMBER 13, 2009

*Taxable and
Tax-Exempt Securities*

Basis Points

By Kevin Flanagan, Executive Director / Fixed Income Strategist

Key Takeaways

- We are making changes to our Moderate and Aggressive Taxable Fixed Income Portfolios. We are reducing our weighting in government/agency MBS and reallocating the proceeds to non-USD sovereigns.
- As expected, the Great Recession came to an end in the third quarter as real GDP grew by 3.5%, breaking a string of four consecutive negative performances. Economic activity for the final three months of 2009 is expected to remain in positive territory with the Morgan Stanley tracking estimate coming in between 2.5% to 3.0%.
- The results of the November Federal Open Market Committee (FOMC) meeting confirmed our belief the Fed will not be raising rates any time before mid-2010. The policymakers did not provide any sense of urgency in reversing their accommodative stance and seem to be waiting for signs the economy can 'stand on its own two feet' before making a move.
- A continuation of the 'flow-driven' trade is expected to remain a visible force within the US Treasury (UST) market for the next month. A reversal of this 'trade' is envisioned once the calendar turns to 2010 and we expect to see longer-dated rates move noticeably higher. As a result, the yield curve should retain its steep construct.
- Our preferred strategic target maturity ranges are as follows:
 - > **Taxables: 2-year to 5-year**
 - > **Tax-exempts: 5-year to 10-year**
- **Taxable Fixed Income:** Our strategy focuses on playing the 'higher rate call.' We continue to see value in the IG space and focus on sectors that could hold value during a rising rate environment such as **forest & paper products, metals/mining and energy**. We would tend to avoid consumer products and retail stores. Looking at preferred securities from strictly a rate perspective, and not credit, higher long-term rates usually serve as a negative force and would tend to argue for some unwinding in this asset class.
- We continue to recommend taking profits in the government/federal agency MBS space. Concerns about future extension risk and a significant narrowing in spreads reinforces our view that investors should take some 'chips off the table.'
- **Municipals:** Although the US economy produced a positive performance in the third quarter, state and local budget stresses remain a primary theme in the municipal investment arena. As a result, **our concentration on state general obligation (GO) paper and essential services remains the dominant strategy**. However, the prospect for higher taxes and reduced traditional tax-exempt supply due to the Build America Bond program should help to mitigate interest rate risk in the municipal arena.

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KEY STATISTICS AND DATES

*The statistics listed below
are as of November 12, 2009:*

Fed Funds Target Rate	zero to 0.25%
Year-Over-Year Change in CPI	-1.3%
GDP (3rd Qtr 2009)	3.5%
DXY Index	75.13
Unemployment Rate	10.2%

Upcoming Federal Open Market
Committee Meeting:

- > December 15 & 16, 2009
- > January 26 & 27, 2010

Source: Morgan Stanley Smith Barney, Federal Reserve Board, U.S. Department of Treasury

Fixed Income Asset Allocation

We are making changes to our Moderate and Aggressive Taxable Fixed Income Portfolios. Specifically, our weighting in government/agency MBS is being reduced with the proceeds being reallocated to non-USD sovereigns. Please see the commentary below for the new weightings in each asset class within the respective model portfolio. In addition, a more comprehensive discussion regarding the reasoning behind these allocation changes will follow.

Conservative Model:

We remain overweight in the investment grade (IG) corporate arena. Within our preferred 2-yr to 5-yr space, spreads versus like maturity Treasuries in the CD market have widened out again and stand roughly at +100bp. With respect to CD investing, we would advise investors to strongly consider any FDIC insurance limitations which may exist, especially in the current environment of regional/local bank stresses.

Moderate Model:

Our overweight status (40%) in IG corporate bonds remains in place in this model as well. However, we are reducing our weighting within the government/agency MBS sector by 5% to 30%. The entire proceeds will be reallocated to the non-USD sovereign grouping which will now carry a weighting of 10%.

Aggressive Model:

We build on our overweight theme in IG corporate bonds in this model by according this asset class a weighting of 45%. Within this model, we are also reducing the government/agency MBS grouping by 5% and reallocating the entire proceeds to non-USD Sovereigns. As a result, the new non-USD weighting will be 15%, and for MBS, the new level will be 30%.

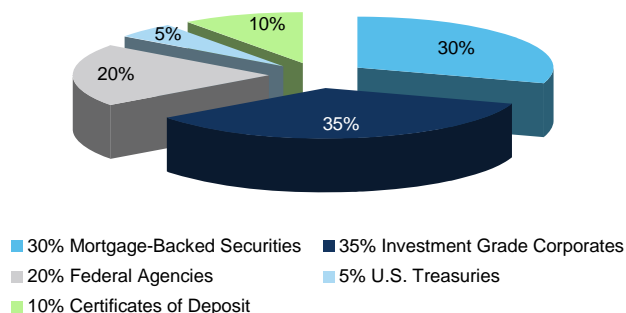
Tax Advantaged Model:

We continue to advocate focusing on underlying credit quality. Our base case remains A+/A1 or above rated paper, but investors with an elevated risk profile and longer-term investment horizon could begin considering 'high' BBB-rated bonds.

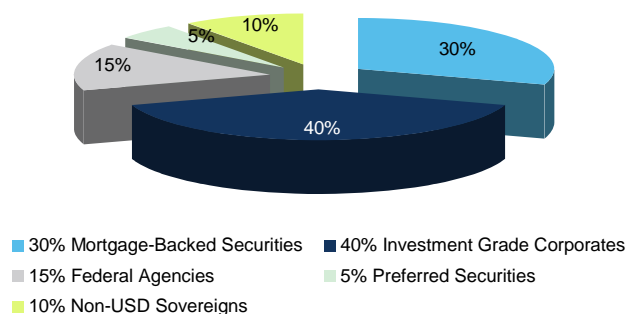
The fixed income model portfolio allocations can help you decide which securities may be suitable for you based on four investment styles. See page 9 for a description of each fixed income model portfolio.

Recommended Fixed Income Model Portfolios

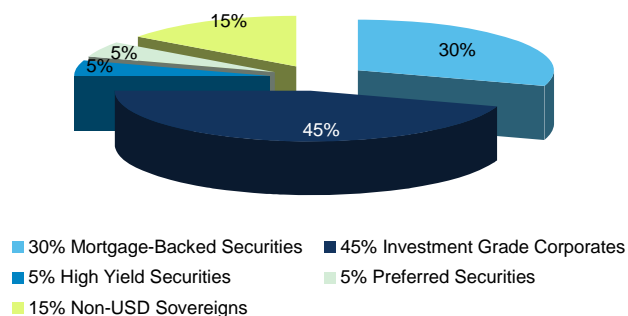
Conservative Fixed Income Portfolio



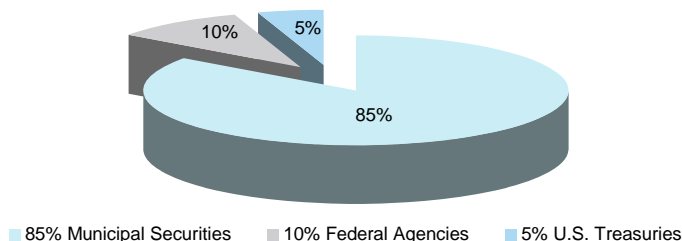
Moderate Fixed Income Portfolio



Aggressive Fixed Income Portfolio



Tax Advantaged Fixed Income Portfolio



Fixed Income Sector Commentary

ASSET ALLOCATION CHANGES

It is important to point out that our increased weighting to non-USD sovereigns is not necessarily due to a belief that the greenback is about to embark on a new level of noticeable depreciation that could result in record lows. Our concern revolves around the current and prospective fiscal policies of the US government as well as the USD's shifting status as a trade vehicle. In other words, we feel the strategic forces at play will essentially make it difficult for the US currency to sustain any type of upside momentum in the months ahead, and could possibly experience some additional selling pressure. Once again, relationships can certainly vary by individual currency, and our strategy is one that is based more in the aggregate. From this perspective, we don't necessarily see the DXY index falling below the all-time low of 70.698 (intra-day) that was printed in March 2008, but investors could see some further erosion from the reading as of this writing which was 75.370. For the record, the Morgan Stanley Global Currency Research Team is constructive on the Norwegian Krone (NOK), the Mexican Peso (MXN) and the South Korean Won (KRW). We would add to this list the traditional commodity-based currencies as well.

There is no doubt that the global investment community is concerned about the lack of any budget discipline coming out of Washington, D.C. Indeed, the federal government ran-up a budget deficit of \$1.4 trillion in Fiscal Year (FY) 2009, almost a full trillion dollars from the prior fiscal year's record tally. For FY 2010, the Treasury recently reported the primary dealer community and Congressional Budget Office are projecting another \$1.4 trillion shortfall, while the Office of Management and Budget is even more pessimistic at \$1.5 trillion. This budgetary concern also follows on the heels of the Fed's non-stop printing press. To be sure, at the November FOMC meeting, the Fed did nothing to dispel the notion that any tightening in monetary policy is not on the horizon. As a result, global investors have become somewhat wary regarding the Fed's inflation-fighting resolve and signs have emerged that alternatives to the USD are being sought. While we are not a believer in the 'alternate reserve currency' argument, some large dollar holders are looking to the gold market instead. A perfect example of this development was India's recent purchase of US\$6.7 billion of gold from the International Monetary Fund (IMF). While we continue to see Chinese buying of Treasuries going forward, as a hedge, it is also believed that China could be interested in buying gold in order to diversify their reserves.

Another turn of events that runs counter to the Econ 101 playbook revolves around the dollar's place as a trading vehicle. Typically, we were taught that improving economic conditions combined with the potential for higher interest rates were USD bullish developments.

However, the 21st century, or at least current trading strategies, suggest a different approach, namely a better outlook removes the need for a 'risk-free asset' like the dollar and funds are shifted into more riskier assets as a result. This strategy has certainly been on display of late and does not show any signs of being altered in the near-term. With that being said, 'all is not lost' on the USD front. We do see the greenback's traditional role, from a trading standpoint, returning. Perhaps more importantly, from an intermediate perspective, export-reliant nations are beginning to feel the ill effects of their currency's strength and the USD's weakness. In order to protect their own economic interests, investors could see the discussion regarding FX intervention being elevated. In fact, even though actual USD buying by foreign central banks may be a while off, some jawboning has already occurred.

From a tactical perspective, we had been advocating taking profits in the government/federal agency Mortgage Backed Security (MBS) space, but now feel a strategic shift in asset allocation is in order. We continue to see the MBS space getting 'richer' and residing at levels that will most likely not be sustainable over time, and run the risk of experiencing a sell-off in the months ahead. In addition, our outlook for higher long-term rates carries the potential for future extension risk for MBS (principal not being returned as quickly). Utilizing the 30 year FNMA current coupon, the spread versus the 10 year Treasury stands at only +71bp. This reading is 59bp below the ten year mean and only 2bp above the low that was printed over the last decade. These considerations, along with the fact that spreads have narrowed by a considerable 161bp from the all-time high that was printed last November, reinforces our view that investors should take some 'chips off the table.' In addition, while the Fed did extend its deadline for government/agency MBS purchases by three months to the end of 1Q2010, there does not appear to be any indication that these purchase will be expanded. Thus, if the Fed were to actually achieve their stated purchase goal of \$1.25 trillion, the MBS market will be faced with one less enormous buyer next year and could begin 'discounting' this fact ahead of time. With only about \$250 billion left in the program, the magnitude of future purchases will most likely begin to get dialed down sooner rather than later.

TAXABLE FOCUS

Our fixed income strategy will be focused on how to invest in a higher interest rate setting. Traditionally, floating rate notes (FRN) tend to offer the fixed income investor a degree of protection in a rising rate environment. In fact, if issuers get the sense there is a demand for such a vehicle, supply, and attendant liquidity, could be enhanced, accordingly. Along the same lines, for the more sophisticated investor, an investment which is based upon a constant maturity swap (CMS), especially one that is tied to a longer-dated maturity, can serve a similar purpose.

While High Yield (HY) spreads are expected to narrow over the intermediate to longer-term, our preference remains on the Investment Grade (IG) market. At present, the aggregate IG spread stands at 194bp, or a little less than 20bp above the long-run average. However, if one were to look at the mean prior to August 2007, the date at which the funding markets seized up and the once in a generation financial crisis began, the long-run average spread was a lot lower at 117bp. As a result, we continue to see value in the IG space and focus on sectors that could hold value during a rising rate environment such as forest & paper products, metals/mining and energy. We would tend to avoid consumer products and retail stores. Typically, financials would underperform in this setting as well. However, given the beating this sector took, spread levels still remain out of balance and history may not repeat itself entirely. Looking at preferred securities from strictly a rate perspective, and not credit, higher long-term rates usually serve as a negative force. This consideration combined with the rather visible rebound on the price front from earlier this year would tend to argue for some unwinding in this asset class.

TAX-EXEMPT FOCUS

Unfortunately, the tenuous position of some state and local budgets will remain the primary theme in the municipal securities market for the next year or so. As a result, our concentration on state general obligation (GOs) paper and essential services remains the dominant strategy. This key factor will be juxtaposed against the real prospect for higher taxes going forward. At a minimum, the Bush tax cuts for the highest bracket will revert back to 39.6% in 2011. In our opinion, such a scenario will have a direct impact on the municipal bond market and could serve as somewhat of an offset to traditional fundamental forces. In addition, in order to close their own budget gaps, taxes at the state level are also vulnerable to the upside.

Another key factor in the municipal space comes from the supply side. With the introduction of Build America Bonds (BAB), issuance of these securities has lessened the supply of traditional tax-exempt paper. In October alone, the BAB share of new issuance in the municipal market was placed at roughly 37%. As measured by relative value, AAA-rated GO's in the 10 year space now yield 86.2% of comparable maturity Treasuries versus a ten year average of 87.7%. Due to our call for higher long-term rates in the UST market, we have brought in the outer band of our target range and are now concentrating our efforts within the 5 to 10 year maturity space.

Investment Backdrop

ECONOMY & THE FED

As expected, the Great Recession came to an end in the third quarter as real GDP grew by 3.5%, breaking a string

of four consecutive negative performances. Economic activity for the final three months of 2009 is expected to remain in positive territory with the Morgan Stanley tracking estimate coming in between 2.5% to 3.0%. In terms of the economic outlook, our base case does not subscribe to the 'double dip' economic scenario, but rather we see more of an uneven recovery, as supporting factors such as exports and production will be going up against headwinds such as a weak labor market and tight credit conditions.

With respect to employment, the October jobs report did come in a bit softer than expected, but it did not break any new ground from an economic/rate perspective. It is worth noting that there has been some improvement when it comes to the payroll data. While we still appear to be months away from a return to actual job growth, the pace of job losses is truly decelerating. To provide perspective, through the first six months of 2009, the average monthly payroll decline came in at 560,000, but this has since been cut in a noticeable fashion to a shortfall of 216,000. Perhaps the more important figure this time around was the unemployment rate itself, not from an economic standpoint but from a political one, as this figure resonates with 'Main St.' As a result, get ready for 'second stimulus' talk of some sort to be ratcheted up. In fact, there have been reports that a new jobs tax credit is circulating through the halls of Congress, a development that could certainly add a new 'twist' to the employment outlook, perhaps later this year and into 2010.

At the recently completed FOMC meeting, investors were greeted with a more 'dovish' response as the policymakers chose to retain the "exceptionally low levels" and "extended period" phrases when referring to the outlook for the fed funds rate. Not only did the policymakers retain these phrases, they also put in some qualifiers: "low rates of resource utilization, subdued inflation trends and stable inflation expectations." By including the aforementioned qualifiers, the Fed is no doubt trying to walk that fine line between not raising rates too fast and not spooking bond investors on their inflation-fighting credibility. These additions to the prior wording are important because it tends to underscore the fact the Fed is in no hurry to begin tightening. Remember, the policymakers are still easing via their asset purchase program. To get to the next step, they have to begin to offset the effects of buying MBS and agencies. Thus, investors will be hearing the term 'reverse RPs' (repurchase agreements) quite frequently in coming months. In addition, the fact the vote was unanimous points to no real dissension and a commitment to not raise rates until the Fed sees evidence the economy can stand on its own two feet.

While the Fed kept to their end of 1Q 2010 timeline for ending the asset purchase program, the policymakers did reduce the size of the agency portion by \$25 billion to \$175 billion. There is nothing policy-related to read into this change as it merely reflects reality: "the limited availability of agency debt." The bottom line is we still see

the first rate hike coming no sooner than the scheduled June 2010 FOMC meeting.

US TREASURY MARKET

At present, the 'flow' effect seems to still be operative and should help to prevent any near-term rise of consequence in longer-dated rates. According to the Morgan Stanley Technical Analysis Group, support for the 10 year resides at 3.58%, and then 3.69%. We expect this supportive influence to fade as 2009 turns into 2010. Our concerns on this front revolve around the potential for heightened inflation expectations, especially if the Fed is perceived to be dragging their collective feet when tightening. While we can have a great debate regarding the prospects for inflation/deflation, we have repeatedly emphasized the importance we think supply is going to have on longer-dated rates in the future, with the key fact being that Treasury supply is going up, not down, and the Treasury market will be losing a key buyer, the Fed. During the final trading days of this past October, the Fed's \$300 billion Treasury purchase program came to a close. Since March (when the Fed program came to light), it is estimated the Fed has purchased 25% of the securities that came to market.

It is projected the Treasury may need to issue upwards of \$2 trillion in new coupon supply in FY 2010 at the same time a buyer who accounted for one-fourth of the purchases, disappears. The next point has also been vital to our call; the maturity mix of the upcoming new supply. The Treasury has increasingly ramped up new issuance in longer-dated maturities in order to increase the average maturity of outstanding debt. The debt managers' target appears to be in the six to seven year range, versus the current level of about four years. In order to achieve their objective, it is obvious that future supply will need to be back-loaded towards longer-dated maturities.

In conclusion, our base case for the end of 2009 and into calendar year 2010 would argue for the 10 year UST yield to be closer to 4%, than 3%, and for the 2 year/10 year spread to remain steep in the +225bp to +275bp band. Given our concerns on the vulnerability of rising long-term rates, we remain committed to new money in the taxable fixed income market being concentrated within the 2 to 5 year sector of the curve.

Fixed Income Snapshots: Treasuries and Municipals

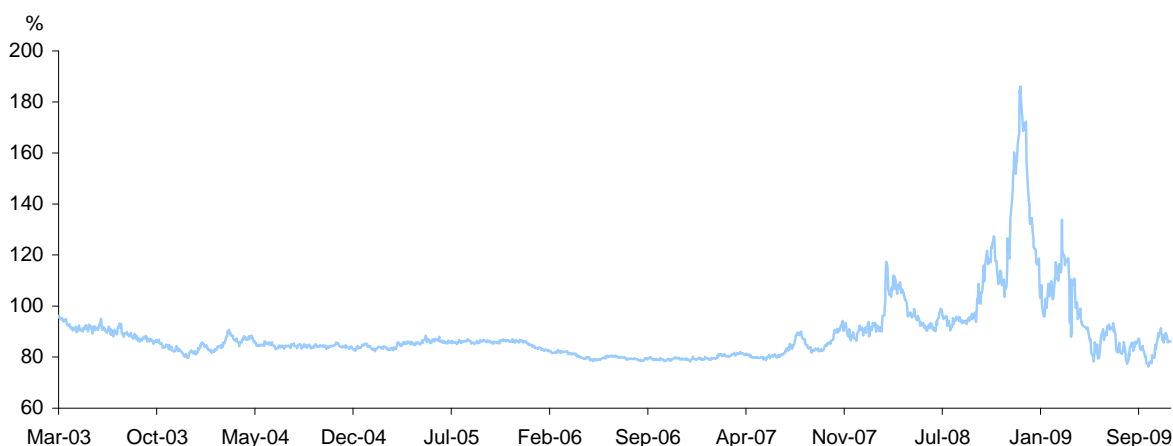
U.S. Treasury Yield Curve (2s/5s: 2s/10s)



Source: Morgan Stanley Smith Barney, Bloomberg

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

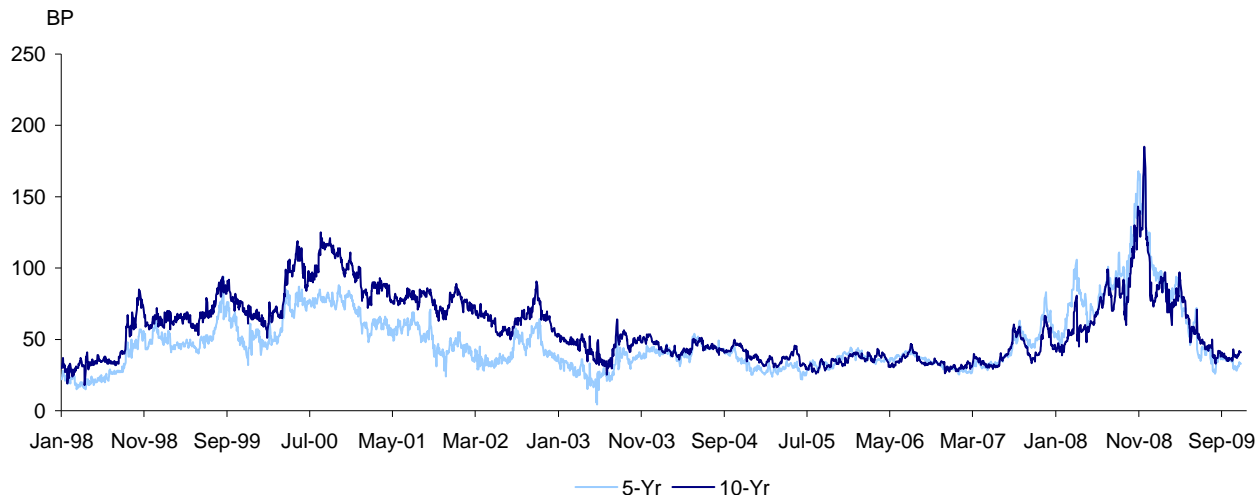


Source: Municipal Market Date (MMD), Bloomberg

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

Federal Agencies Spread to Treasuries



Source: Morgan Stanley Smith Barney, Bloomberg

Fair Market Value U.S. Government Federal Agency spreads to Fair Market Value U.S. Treasuries for 5-yr and 10-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 2014.

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



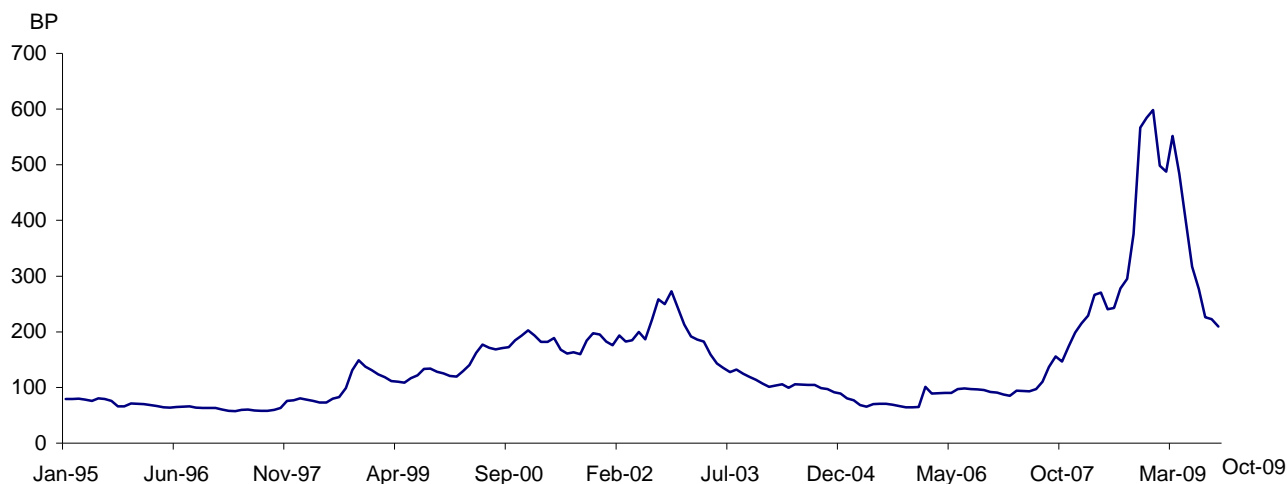
Source: Morgan Stanley Smith Barney, Bloomberg

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 10yr Treasury is used as the benchmark for the 30yr 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 2039, while the 10-yr Treasury index represents the composite yield of all outstanding Treasury notes maturing in 2019.

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Fixed Income Snapshots: Investment Grade and High Yield Corporates

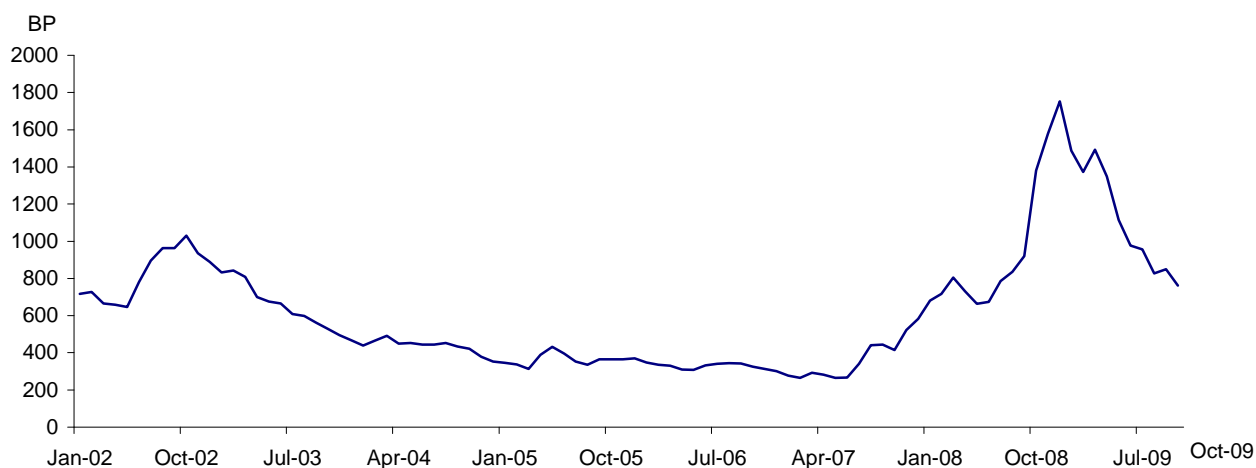
Investment Grade Corporate Index to Treasuries



Source: Morgan Stanley Smith Barney Credit Strategy

Investment Grade Corporate Index option adjusted spread to aggregate Treasuries (1 – 30 yr maturities). The Investment Grade Corporate Index is an aggregate index of all outstanding investment grade (BBB and higher) corporate bonds with maturities of 1 through 100 years (average 'A' rating, 6.2 year duration and 6.07% coupon).

High Yield Corporate Index to Treasuries



Source: Morgan Stanley Smith Barney Credit Strategy

High Yield Index option adjusted spread to aggregate Treasuries (1 – 30 yr maturities). The High Yield Index is an aggregate index of all outstanding non-investment grade (BB and lower) corporate bonds with maturities of 1 through 100 years. 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 products. High yield products should comprise only a limited portion of a balanced portfolio.

Fixed Income Model Portfolios

Fixed Income asset allocation models are created by Kevin Flanagan, Fixed Income Strategist. The model fixed income allocations are designed to help investors decide which securities may be suitable for them based on four investment styles:

- The Conservative portfolio emphasizes low credit risk for the conservative investor.
- The Moderate portfolio may be appropriate for fixed income investors willing to tolerate a reasonable elevation in risk profile with the expectation of a higher income stream. Some of the increase in risk exposure may be due to credit quality issues and/or volatility stemming from either extension or prepayment risks in the mortgage-backed market.
- The Aggressive portfolio is created to further enhance returns (income stream and/or growth) by moving out on the risk curve. However, capturing a potentially more aggressive return means investing in fixed income instruments that can be sensitive to both interest rate and credit quality considerations.
- The Tax-advantaged portfolio is suitable for investors in higher tax brackets who place importance on the tax considerations that their investments carry.

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