MACRO FIXED INCOME PERSPECTIVES
Fourth Quarter 2011

Overview

Amid heightened market volatility and a seemingly endless barrage of negative headlines, the U. S. economic recovery has persistently inched forward, confounding both bulls and bears along the way. By some measures, the economy has proven to be remarkably resilient, successfully weathering a series of unexpected shocks (spike in commodity prices, U. S. credit rating downgrade, European debt crisis flare-ups, financial market turmoil, etc.) to expand at a moderate rate for 28-consecutive months. In other ways, this consistently weak expansion has failed to meaningfully reduce the unemployment rate or to create a reasonable margin for error against the risk of a double-dip recession.

Looking forward, we expect the performance of the U. S. economy in 2012 and 2013 will closely resemble the general trends in aggregate activity over the past 2.5 years. In our base-case forecast, we envision that the combination of moderate consumer spending, robust business investment, strong exports, and highly accommodative monetary policies will continue to support mediocre GDP growth in the 2.0% to 2.5% range. However, the factors that have conspired to make the 2009 – 2011 expansion the weakest recovery in the past 60 years will likely prevent the economy from sustaining real growth significantly above 2.5% for some time to come. In this regard, we anticipate that consumer de-leveraging, the lackluster housing market, and depressed confidence levels will continue to suppress the economy's overall growth rate.

While our "most-likely" scenario foresees the recovery remaining on a choppy and uneven upward trajectory, we continue to be quite concerned about the potential downside risks to our forecast. Topping the list of possible threats to our outlook is the unresolved sovereign debt crisis in Europe. In our view, the lingering European saga represents a clear and present danger to the stability of international financial markets and the health of the global economy. Implicit in our projections is the assumption that European policymakers will eventually take the appropriate steps to bring this situation under control. While EU leaders appear to be slowly converging on a comprehensive solution, the odds of a second downturn in the U. S. will remain in the 30% to 40% range until European authorities overcome political hurdles and implement a credible and adequately funded rescue plan.

Slow growth in the domestic economy, coupled with the downside risks from Europe, should continue to foster a low interest rate environment. The Federal Reserve has successfully driven real, risk-free rates into negative territory across the yield curve and shows no signs of relaxing its aggressive strategies. Although the limitations of monetary policy are becoming increasingly apparent, the Fed appears biased to provide further stimulus in 2012, as the gridlocked U. S. political system seems incapable of producing long-term oriented, pro-growth legislation prior to next year's elections.

Economic uncertainty, coupled with exceptionally low bond yields, create formidable challenges for fixed income investors. While U. S. government debt has generated impressive total returns this year, the Treasury, Agency, and GSE MBS sectors appear to be fairly valued to slightly rich, with less than compelling risk/return profiles, particularly on the short-end of the yield curve. Relative value analysis appears to strongly favor the "spread sectors", but the poor prospects for a near-term conclusion to the rapidly evolving story in Europe suggest that investors should continue to tread lightly in the higher beta sectors of the bond market. Disciplined strategies that gradually scale up credit risk exposure over time, as warranted by economic conditions, should allow investors to take partial advantage of the recent spread widening, while maintaining an overall conservative portfolio with the crisis still raging in Europe. Assuming the risk of European contagion is ultimately lowered, we would encourage investors to allocate additional capital to the bond market's more credit-sensitive sectors.

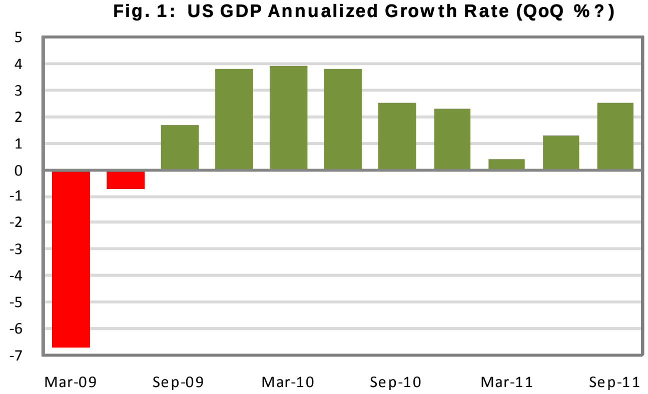
Refer to page 10 of this report for Stifel Nicolaus Fixed Income Capital Markets disclosures and analyst certifications.

Economic Outlook

There are two ways to view the track record of the U. S. economy since the middle of 2009: surprisingly resilient or disappointingly weak. Taking the positive arguments first, while GDP growth has certainly been less than stellar over the past 2.5 years, the economy has managed to overcome a number of obstacles to steadily advance for ten straight quarters. So far in 2011, the recovery has successfully withstood the following challenges: 1) a spike in commodity prices that absorbed disposable income and constrained real consumer spending; 2) the shocking display of dysfunctional government during the ugly debate over the U.S. debt ceiling; 3) the unprecedented downgrade to the nation's AAA credit rating in August; 4) the broadening scope of Europe's sovereign debt crisis beyond the peripheral countries; and 5) the sudden increase in market volatility and the associated broad-based sell-off in risk assets during August and September. Despite this laundry list of unwelcome developments, GDP grew at a 2.5% annualized rate in the third quarter and is on track to post a similar growth rate over the last three months of the year.

Despite these signs of resiliency, by most metrics the current economic recovery represents the slowest rebound since 1950. Faced with the dual headwinds of a prolonged deleveraging cycle and a depressed housing market, this expansion has consistently struggled to gain traction. Government policies with a heavy emphasis on new regulations and short-term stimulus measures have provided little in the way of durable economic benefits. As shown in Figure 1, rather than building momentum over time, this recovery lost steam in 2011 and came very close to completely stalling during the first half of the year.

Fig. 1: US GDP Annualized Growth Rate (QoQ %?)



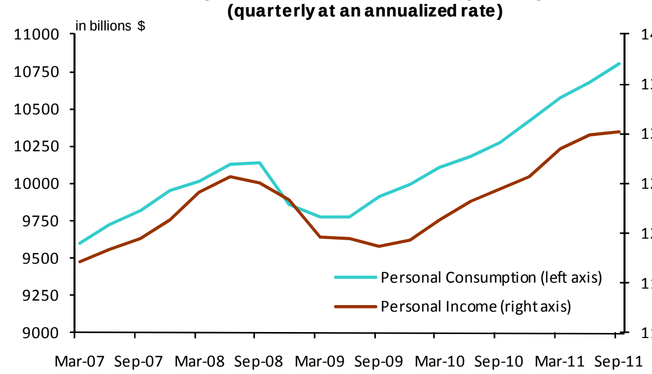
Source: Bureau of Economic Analysis 10/28/2011.

Although the downward trend in GDP growth during the January to June period was clearly worrisome, more recent indicators suggest that the economy has successfully slogged its way through another soft patch in growth, given the 2.5% print on third quarter GDP. Since the middle of 2009, three core sectors of the economy have consistently underpinned the recovery: consumer spending, business investment, and net exports. We expect these three key economic sectors will remain supportive of GDP growth in 2012.

Factors Supporting Economic Growth

Defying predictions of tapped out U. S. consumers, household consumption has repeatedly outpaced economists' expectations. While the debt-fueled overconsumption of the housing boom years has clearly ended, spending has steadily advanced in proportion to consumer income, as shown in nominal terms in Figure 2.

Fig 2: Consumer Income vs. Spending
(quarterly at an annualized rate)



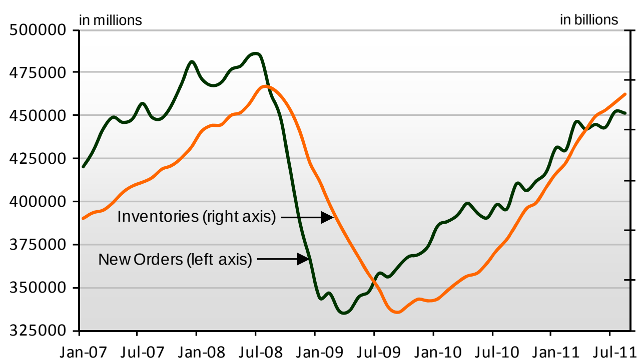
Source: Bloomberg Finance LP as of 9/30/2011.

The above graph suggests that the long-standing relationship between income and spending has largely remained intact and was not materially altered by the "Great Recession." For the 60-year period prior to the 2008 downturn – spanning the bulk of the post WW II era – annual real consumer spending growth averaged 3.6%. Over the past nine quarters, real consumer spending has grown at a slower pace of 2.2%, without the benefit of new debt to supplement income. While considerably slower than the debt-mania years, a 2% real household consumption rate provides a solid base for GDP growth, as consumer spending accounts for over two-thirds of overall U. S economic activity.

To maintain this upward trend in personal consumption, the U. S. economy must continue to create new jobs at a reasonable pace. While the labor market hasn't improved enough to make a material dent in the unemployment rate, private payrolls have expanded for 20 consecutive months, and total payrolls have consistently increased for the past 13 months, as 1.6MM net new jobs have been added to the economy during this period. We expect this moderate rate of job growth to continue, with total nonfarm payrolls averaging +100K per month through the end of 2012.

Relief from the unexpected inflationary pressures that surfaced earlier in 2011 should also lend some support to consumer spending next year. Real household consumption was relatively soft through the first three quarters of 2011, with an annualized growth rate of 1.7%, as the higher cost of necessities diverted disposable income away from discretionary purchases. The PCE price index has risen sharply on a year-over-year basis, almost doubling from 1.5% in January to 2.9% in September. While this bounce in prices resulted in a brief period of stagflation, the leading indicators point to a decline in the headline inflation numbers over the coming months. Since reaching its 2011 peak in April, the CRB commodity index has fallen by about 14%, with WTI crude oil futures shedding about $15 per barrel during this period. Likewise, a key measure of medium-term inflation expectations (the five-year, five-year forward break-even rate) has dropped by about 80 bps over the past six months.

Fig 3: Manufacturers New Orders & Inventories

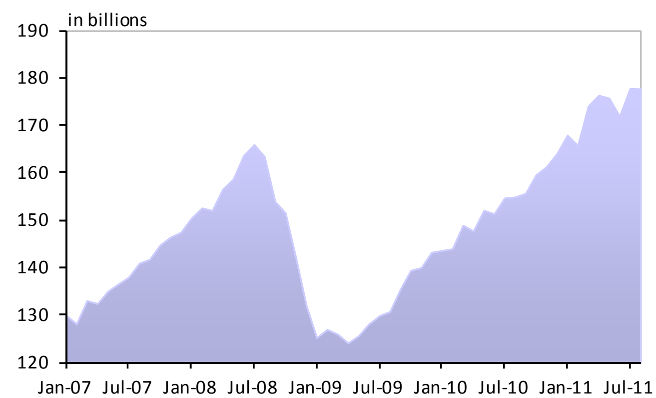


Source: U.S. Census Bureau as of October 14, 2011.

Beyond consumer spending, business cap-ex should continue to provide another pillar of support for the tepid recovery. Throughout this period of economic malaise, the companies that have flourished have generally increased their level of productivity. While the substitution of machines and technology for labor has suppressed job growth, this development has been a boon for manufacturers that produce goods for businesses (Figure 3). Business investment in equipment and software grew at an annualized rate of 11% through the third quarter of 2011, and we view an additional 8% to 10% growth in 2012 as a realistic target.

With the more developed countries struggling under the weight of excessive debt, the emerging economies have assumed a leadership role in the global recovery. Emerging markets have generally posted strong growth rates, spurring demand for goods and services produced in the U. S (Figure 4). Exports have grown at an annualized rate of 5% this year, and we are looking for a 7% to 9% increase in 2012 due in part to the decline in the value of the U. S. dollar relative to the currencies of our major trading partners. The recent passage of free trade agreements with South Korea, Panama, and Columbia should also be helpful in encouraging U. S. exports and rebalancing our economy.

Fig 4: U. S. Exports (by monthly dollar volume)



Source: U.S. Census Bureau as of October 13, 2011.

In addition to positive contributions from these key components of GDP, we expect the Federal Reserve will continue to supply the economy with exceptionally low interest rates for at least the next two to three years. Although there are limits to what monetary policy can accomplish in isolation, without more substantial support from fiscal policy, the Fed will likely continue to pursue creative strategies for maintaining favorable financial conditions.

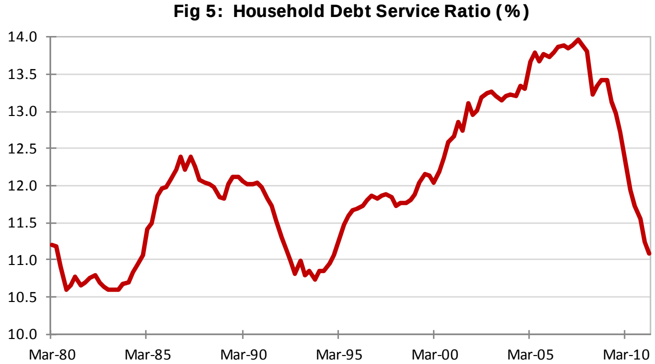
On the fiscal front, we have not built any additional stimulus into our forecast. It appears highly doubtful that any component of the president's "jobs bill" will pass Congress. While we do expect the deficit super committee to reach a last minute agreement to prevent across the board spending cuts, the final deal will likely contain a number of budget gimmicks and defer all major fiscal policy decisions until after the 2012 elections.

Impediments to a Stronger Recovery

While the factors supporting moderate growth appear to be well entrenched, other powerful forces will likely continue to restrain the economy's overall rate of output. Specifically, household de-leveraging, housing market distress, and weak confidence levels should temper GDP expansion.

According to the Fed's Flow of Funds report, the total amount of debt on household balance sheets has been steadily declining since 2008. While there are many different ways of analyzing consumer de-leveraging trends, the household debt service ratio (Figure 5) is a useful metric since it appears to be mean-reverting through cycles. This ratio, which compares monthly disposable income to monthly debt service requirements (including mortgage payments), peaked at a record of nearly 14% in September 2007 and has been on a steep downward path ever since.

Fig 5: Household Debt Service Ratio (%)



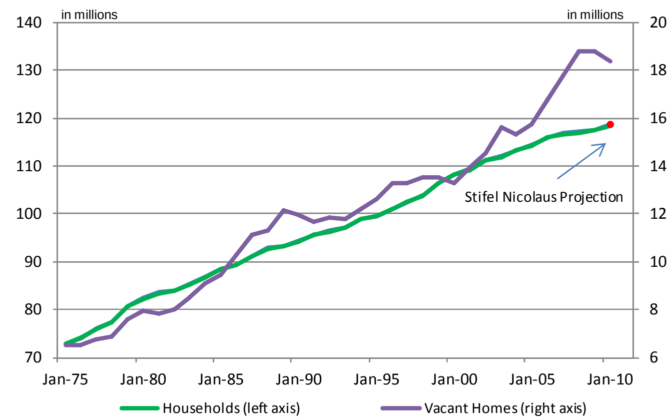
Source: Federal Reserve as of 6/30/2011.

Following recessions in the early 1980's and early 1990's, the debt service ratio stabilized between 10.5% and 11.0% and remained within that range for an average of two years. Aided by historically low interest rates and a cavalcade of mortgage defaults, we project that the debt service ratio will dip below 11.0% by the end of 2011. Assuming the two year "bottoming out" period from past cycles holds, we wouldn't expect consumer debt growth to provide any meaningful support to household consumption until 2014 at the earliest.

Closely related to the de-leveraging story is the protracted horror show in the housing market. Until consumers believe that home prices have stopped falling, demand for housing will remain weak. Sub-par demand is one factor that is contributing to the backlog of excess housing inventory, which in turn is keeping downward pressure on prices (Figure 6). Over time, we expect this "chicken and egg" problem to eventually be solved by new household formations, exceptional affordability, and easier underwriting standards, but it will likely take another two to three years to restore equilibrium between supply and demand in this distressed sector.

Until the number of vacant homes is reduced by at least 2.5MM units, there will be little need for new residential construction. After adding about 0.5% to GDP growth annually during the boom years in the first half of the 2000s, housing has been a consistent drag on the economy over the past six years.

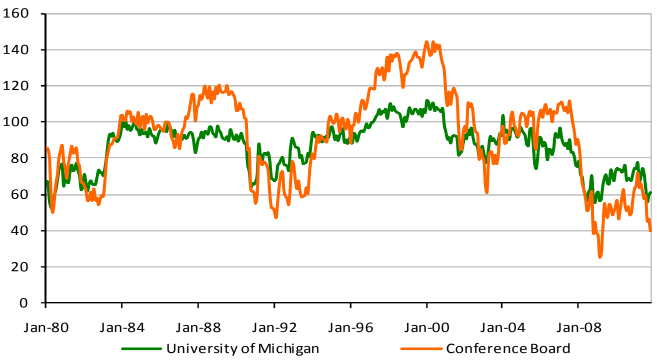
Fig 6: Vacancies vs. Total Households



Source: Bloomberg Finance LP as of 6/30/2011

In addition to slowly working its way through the aftermath of the credit and housing bubbles, the recovery has consistently been saddled with weak confidence levels among consumers and businesses. As shown in Figure 7, the major surveys of consumer sentiment are languishing at recessionary levels, due to high unemployment, above average market volatility, uncertainty over Europe, and lack of faith in U. S. political leaders. Until confidence improves significantly, hiring will likely remain restrained and spending should continue to be rather muted. In the short-term, it is difficult to identify a clear catalyst to jump start confidence. Perhaps the results of the 2012 elections will significantly improve the national mood, but what is shaping up to be a bitterly partisan campaign probably won't do much to bolster confidence in the meantime.

Fig 7: Consumer Confidence



Source: University of Michigan and the Conference Board as of October '11.

After carefully considering each of these positive and negative factors, we arrived at the economic forecast shown in Figure 8.

Figure 8: Economic Forecast

	GDP			Core Inflation			Unemployment Rate		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
FI Strategy Group Forecast	1.7%	2.0%	2.3%	1.9%	1.5%	1.4%	9.0%	8.8%	8.6%

We expect a double-dip recession to be narrowly averted, but for GDP growth to struggle to rise much above 2.0% though the end of 2012. As the headwinds gradually diminish in 2013, we look for the economy's tempo to accelerate somewhat but to remain below its long-term potential growth rate.

In the context of sluggish growth, core inflation should stabilize around 2.0% by the end of this year, then slowly decline over the remaining forecast period. While helpful in containing inflation, a weak expansion will do little to improve the dismal conditions in the labor market. Without a sustained burst of +2.5% GDP growth, the unemployment rate should continue to hover around 9.0% for many months to come.

While we believe there is a reasonable basis for cautious optimism entering 2012, we are monitoring the potential downside risks from Europe very closely. In a highly interconnected global economy, the unresolved sovereign debt crisis has the potential to wreak havoc on the financial markets and to deliver a powerful blow to the U. S. economy.

EU policymakers have been searching for a definitive solution to the debt crisis for over two years, but through multiple iterations of various bailout schemes have not yet crafted a credible, comprehensive program. The bailout facilities established by the EU to date appear to be adequate to address the medium-term funding needs of Greece, Ireland, and Portugal. However, these arrangements are wholly insufficient to address the liquidity (and possibly solvency) challenges in the larger, distressed countries within the Eurozone, in our view.

With more outstanding government debt than the three bailout-recipient nations combined ($2.1T vs. $854B), Italy now finds itself in the eye of the storm. Italy has the second highest ratio of sovereign debt to GDP among EU countries at 118%, trailing only Greece's 145% ratio. In light of the EU's proposed 50% "voluntary" haircut on privately held Greek debt, investors are becoming increasingly concerned that similar losses could be crammed down on Italian bondholders. Since the end of June, the yield on the 10-year Italian bond has soared by more than 200 bps and is currently bouncing around the critical 7.0% threshold. The weaker peripheral countries were forced to turn to outside assistance once their long-term borrowing costs exceeded 7%, and speculation is mounting that Italy may soon need to seek external relief from unsustainably high interest rates.

If Italy becomes unable to access the capital markets at reasonable rates, it would likely be forced to borrow from the European Financial Stability Facility (EFSF). The problem with this scenario is the lack of sufficient resources within the fund. After accounting for the loan commitments already pledged to Greece, Ireland, and Portugal, the EFSF has remaining firepower of around $300 billion by our estimates. Compared to Italy's $2.1 trillion in outstanding debt, with bond maturities of $400 billion through the end of 2012, the fund's remaining cash would be exhausted in relatively short order. While EU leaders have agreed in concept to lever up the EFSF to as much as $1.0 trillion, so far no parties have stepped forward to provide the necessary funding.

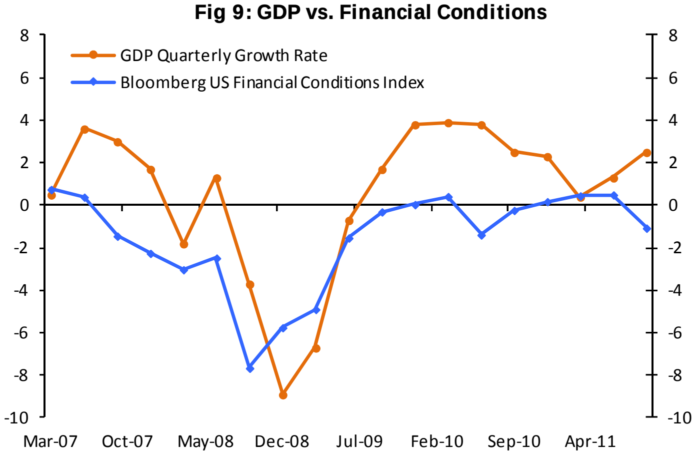
Italian debt is widely held within the European banking system. According to the European Banking Association, the 90 largest European banks hold $440B in Italian debt. A disorderly default by Italy could spark a cascade of bank failures (or government rescues) across the continent. In turn, an impaired banking system would significantly increase the risk of a deep and prolonged recession in

Europe, with negative consequences for global economic growth. Under this adverse scenario, the U. S. would likely be directly impacted through reduced exports to Europe and lower profits for multinational corporations with significant European operations.

Beyond the trade channel, the U. S. economy could experience serious contagion via the financial markets. An Italian default would probably trigger widespread dumping of risk assets, as investors scramble for safe-haven investments including gold and U. S. government bonds. Like the aftermath of the Lehman bankruptcy, we would envision a rapid and severe deterioration in U. S. financial conditions. From our perspective, interbank borrowing rates would increase materially, credit spreads would widen significantly, equity prices would plummet, and volatility levels would jump.

Even before a sovereign default has actually occurred, U. S. financial conditions have already weakened notably due largely to the unsettled situation in Europe. The Bloomberg Financial Conditions Index (BFCIUS), which takes into account trends in equity prices, credit spreads, and market volatility, tends to be an accurate leading indicator of economic activity, as illustrated by Figure 9. Given its recent downward trend, this index is signaling danger ahead for the economy in 2012.

Fig 9: GDP vs. Financial Conditions



Source: Bloomberg Finance LP as of 11/11/2011.

In August 2007, the BFCIUS index dipped into negative territory, four months prior to the official start of the 2008/2009 recession. A drop in this index during the spring of 2010 also correctly foreshadowed the deceleration in GDP growth over the second half of the year. Since early August, the BFCIUS index has remained below zero on a sustained basis, which does not bode well for economic growth in early 2012. At a time when GDP is struggling to break the 2.0% barrier, a forceful push from adverse financial conditions could easily knock the economy back into recession.

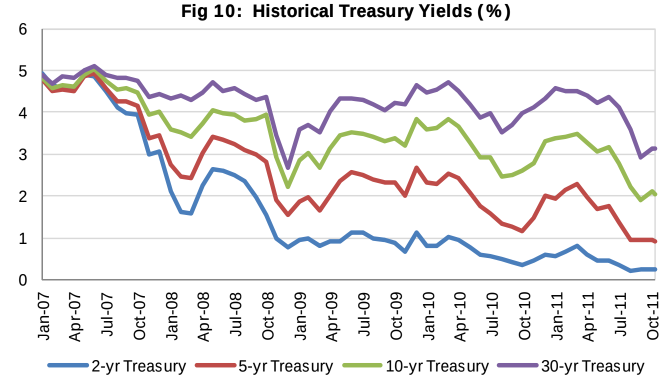
As a direct consequence of the turmoil in Europe, we see a 30% to 40% chance that U. S. GDP growth will turn negative in 2012. Still, our base case view is that EU policymakers will eventually settle on the proper set of policy solutions to keep Italy from defaulting and the Euro from imploding. It may take further market rioting to cajole politicians into making difficult and unpopular decisions, but we believe these steps will ultimately be taken.

The ECB is the one entity that could quickly calm the markets by engaging in massive quantitative easing to substantially lower Italian bond yields. Germany is resisting this approach, due to the potential inflationary implications, but may be forced to support a more expansive role for the ECB given the lack of more attractive alternatives. The IMF also has additional resources that could be brought to bear on the problem, though assistance from this agency would likely be provided directly to distressed countries rather than through the EFSF as a leveraging tool. Italy appears reluctant to reach out to the IMF, given the strict conditions that will likely accompany any aid package, but it soon may have no choice but to seek help from all possible sources.

Interest Rate Forecast

The combination of lackluster growth, downside economic risks, and aggressive monetary policy will likely keep a lid on Treasury yields over the next several quarters. Rates are currently near their lowest levels since the crisis began over four years ago, as shown in Figure 10.

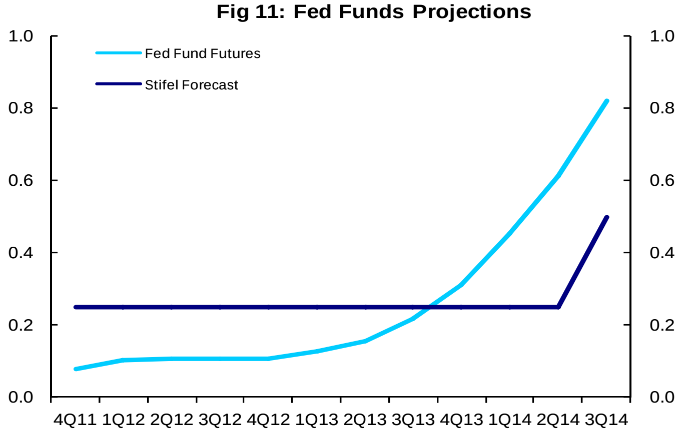
Fig 10: Historical Treasury Yields (%)



Source: Bloomberg Finance LP as of 11/11/2011.

At its August meeting, the FOMC signaled that it would likely hold the fed funds rate near zero through at least the middle of 2013. Based on our outlook, we would put the timing of the first policy tightening even further into the future. As illustrated by Figure 11, fed funds futures contracts are priced for a funds rate below 0.50% through March 2014. Our forecast calls for an even longer delay, with the fed funds rate not surpassing the 50 bps mark until the third quarter of 2014.

Fig 11: Fed Funds Projections



Source: Stifel Nicolaus and Bloomberg Finance LP as of 11/11/2011.

A stable fed funds rate should keep short-term Treasury yields well anchored. The Fed is also intent on holding long-term rates near their current levels through "Operation Twist". In light of these policies, our rate forecast in Figure 12 assumes Treasury yields remain relatively unchanged through March 2012, then gradually trend higher over the balance of the year, as the safe-haven bid fades and concern over Europe hopefully subsides.

For a variety of reasons, we expect yields will remain extremely low by historical standards for several more years. But just as Europe introduces considerable downside risk to our economic forecast, there is also a non-trivial chance that yields could finish 2012 well below our projected levels.

Fig 12: Yield Curve Projections

	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12
Fed Funds	0.25%	0.25%	0.25%	0.25%	0.25%
2-year	0.25%	0.25%	0.25%	0.30%	0.40%
5-year	1.00%	1.05%	1.10%	1.45%	1.80%
10-year	2.00%	2.10%	2.20%	2.45%	2.65%
30-year	3.00%	3.15%	3.30%	3.60%	3.95%
2s to 10s	+175 bps	+185 bps	+195 bps	+205 bps	+225 bps

**As of October 7, 2011*

Source: Stifel Fixed Income Research and Strategy Group.

In the context of its dual mandate, the Fed faces a difficult dilemma regarding future policy decisions. With unemployment likely to remain extremely elevated for an extended period, we believe the FOMC remains biased to take further action to support the economy. Indeed, at its November 2nd meeting, Charles Evans dissented from the decision to maintain a status quo policy, arguing in favor of additional accommodation. Chairman Bernanke has also signaled his desire to take further steps to support economic growth during his latest round of public comments.

While the dismal outlook for the labor market suggests that more monetary stimulus may be appropriate, it will be difficult for the Fed to justify another round of quantitative easing in the context of its "price stability" mandate, given the unexpected run up in inflation over the past nine months. Unless core inflation, headline inflation, and inflation expectations all fall significantly from their latest readings, we wouldn't expect the Fed to potentially exacerbate the recent unwelcome climb in prices by pouring even more excess reserves into an oversaturated banking system.

Faced with these conflicting pressures, we expect the Fed will continue to develop creative strategies that have the potential to drive borrowing rates lower but with fewer side effects in terms of inflation. The policy decisions following the August and September meetings were both examples of this type of balanced approach. In August, the FOMC's policy statement indicated that economic conditions would likely "....warrant exceptionally low levels for the federal funds rate at least through mid-2013." At the September meeting, the Fed unveiled "Operation Twist", a program designed to reduce long-term interest rates by shifting the composition of its Treasury portfolio toward longer duration securities without increasing the overall size of its balance sheet.

Just as it did in November, the Fed will likely stand pat at its December meeting. But given the predilection toward intervention that it has consistently demonstrated over the past four years, we doubt the FOMC will make it through the first quarter of 2012 without unveiling a new program. The next tool we expect the Fed to deploy is linking the time frame for its zero rate policy to specific economic outcomes. For example, the Fed could pledge to keep the funds rate below 25 bps until the unemployment rate declines below 7.0%, subject to the PCE price index staying below 3.0%.

Although the inflation numbers don't presently favor QE3 in the near future, we wouldn't rule out another round of large scale bond purchases if prices roll over and inflation expectations fall dramatically. Assuming the Fed does decide to pursue QE3 at some point, we would look for the central bank to buy MBS rather than Treasuries. A wider than normal spread between Treasury yields and 30-year mortgage rates is blunting some of the impact from "Operation Twist". Based on a 2.0% 10-year Treasury yield, normalizing this spread relationship would drop 30-year mortgage rates into the 3.25% to 3.50% range, which at the margin should spur some incremental refinancings and home purchases. The Fed's decision in August to reinvest principal payments from its GSE debt and MBS holdings into mortgage securities may be a precursor to providing more substantial support to the sagging housing market. While QE3 would not likely be a game changer for housing or the broader economy, the Fed appears committed to utilizing every tool at its disposal to foster favorable financial conditions.

Bond Performance/Strategy

2011 has proven to be an extremely challenging year for bond portfolio management, and this task probably won't get much easier in 2012. While the Broad Market Index has outpaced the S&P 500 by a wide margin on a total return basis through the end of last week (6.96% vs. 2.27%), investors have endured a whipsaw performance environment this year, as shown in Figure 13.

Figure 13: Bond Market Total Return Performance

Bond Index	Total Return % 1H 2011	Total Return % July - Nov 2011	Total %
Broad Market Index	**2.76**	**4.21**	**6.96**
Municipals	4.76	4.159	8.92
Treasuries	2.30	6.34	8.64
Investment Grade Corporates	3.29	3.86	7.15
Mortgage-Backed Securities	2.86	2.34	5.20
US Agencies	1.80	3.01	4.81
Commercial MBS	3.51	1.22	4.73
High Yield Corporates	4.93	-1.78	3.15
Asset-Backed Securities	1.28	0.06	1.34

Source: Bank of America Merrill Lynch Indices as of 11/11/2011.

After posting impressive total returns through the first six months of 2011, the credit-sensitive sectors have trailed government debt since the end of June. Meanwhile, the government-affiliated sectors, which were out of favor at the beginning of the year, have staged a remarkable rally over the past four months due to the ongoing turmoil in Europe and concerns over the strength of the U. S. economy.

In setting portfolio strategy for 2012, investors now face a difficult conundrum. On a relative value basis, the government-affiliated sectors (Treasuries, U. S. Agencies, and GSE MBS) appear rich while the credit sectors (Corporates, ABS, CMBS, and Municipals) seem to offer more compelling alternatives. However, as the past few months have demonstrated, U. S. government bonds can provide useful protection against unfavorable developments in Europe as part of a diversified portfolio.

Recognizing that investors will need to balance several opposing forces in 2012, we offer the following recommendations for bond portfolio strategy.

- Investors should continue to tread lightly in a highly volatile market that is prone to sharp swings in sentiment based on the daily news flow from Europe.

- With yields approaching 0%, there appears to be scant value in short-term government debt. In our view, these securities have little room for further price appreciation, and consequently, will not likely offer much of a hedge against deterioration in risk assets from a portfolio diversification standpoint. We would suggest investors lighten exposure to short-term securities (< 3 years) in the government-affiliated sectors.

- Conversely, U. S. government-backed bonds in the intermediate – to long-end of the yield curve may still provide reasonable total returns from a combination of yield and price appreciation under adverse economic scenarios. For example, the 10-year Treasury yield traded as low as 1.70% in September 2011. Starting from its current yield of 2.06% as of November 11th, a 10-year Treasury bond would produce a total return of 4.93% (2.06% yield + 2.87% price appreciation) if its yield were to drop to 1.70% at the end of a 1-year time horizon. Although we wouldn't be aggressively adding to long-term government bond positions at current levels, given our view that yields are more likely to rise than fall over time, investors should maintain current holdings as a hedge against unfavorable macro outcomes.

- In the credit-sensitive sectors, we believe spreads have widened sufficiently to provide investors with reasonable risk premiums in the context of our economic outlook. Relative values appear compelling across sectors, but we would advise gradually scaling up exposures to corporate bonds (investment grade and high-yield), structured debt (ABS, non-agency MBS, and CMBS), and municipal bonds. We would suggest starting with the highest credit quality, least economically sensitive bonds in each category and slowly adding exposure over time to the more cyclical, lower-rated credits as economic conditions warrant. To implement this strategy, we would initially focus on A-rated or higher industrial corporate bonds, AAA-rated super-senior CMBS, and AAA- or AA-rated essential-service revenue or general obligation municipal bonds. This type of balanced approach should allow investors to take partial advantage of the recent pullback in credit, while maintaining a relatively conservative portfolio risk posture during a time of considerable uncertainty.

We would encourage individual investors to discuss the ideas presented in this report with their Stifel Financial Advisors in the context of their overall financial objectives and constraints. Depository institutions, total return money managers, and other institutional investors should review the latest editions of Bank Investor and Alpha Advisor for more in-depth strategy recommendations.

Jim DeMasi, CFA
Managing Director & Chief Fixed Income Strategist
443-224-1227
jdemasi@stifel.com

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