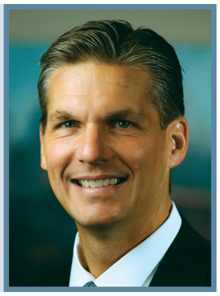
INVESTMENT PERSPECTIVES

JUNE 2009

JANNEY MONTGOMERY SCOTT LLC

Sub-Prime Time Stock Market Rally



By Mark Luschini, Chief Investment Strategist

Equity investors have been treated to an impressive rally over the last three months. After falling almost 20 percent through February, the S&P 500® has risen a remarkable 26 percent from the beginning of March through the end of May. Not only has the return of the stock market been strong over the three previous months individually, collectively the year-to-date figure for the S&P 500 is up by 3 percent.

The equity market turnaround is a result of the eradication of concerns over financial Armageddon, restored investor confidence as a byproduct of the perceived success of the Treasury Department's stress tests, and accumulating evidence that the pace of economic deterioration has begun to slow. In the aggregate, risk appetites have improved encouraging investors to move some cash back into the equity markets in search of higher returns than offered by cash equivalents.

Interestingly, while the recovery in the stock market has been robust, the participation in the updraft has not been completely agnostic. In fact, companies that are generally defined as "lower-quality," per Standard & Poor's definition[1], had actually done much better than higher-quality companies. Of the 500 companies populating the S&P 500, 443 have a quality rating. Seventy eight companies were assigned the rating of A or better, including household names like Johnson & Johnson, McDonald's, Wal-Mart, Exxon Mobil, Pepsi and Disney. Among companies in the lower-quality category are Macy's, American Airlines, CBS, Amazon, Motorola and Sirius Satellite. The quality of any of these companies is not necessarily a reflection of its products; rather, it speaks more to the cyclicality of its business and the sensitivity of its products to the vagrancies of the economy. (For the curious, the only company with the lowest-quality rating of D is General Motors, which given recent events including Monday's filing for protection under Chapter 11 of the bankruptcy code, requires no explanation.)

What does beg for an explanation, however, is the disparate performance between the stocks rated higher-quality and those rated lower-quality. In Chart A, the columns titled One-Month (May only), QTD (April and May only), and YTD (January through May) illustrate a noticeably better performance from the lower-quality stocks than the higher-quality stocks. This was not always the case throughout 2008. Even after this year's out-performance by lower-quality stocks, the trailing One-Year column clearly illustrates the distinct advantage of the companies with higher-quality ratings.

Chart A

	S&P 500 Companies	One-Month Returns	QTD Returns	YTD Returns	One-Year Returns
A+	36	2.22	13.60	4.39	(20.12)
A	42	4.28	18.76	1.73	(28.41)
A-	49	5.34	19.98	1.35	(27.86)
B+	137	5.51	21.35	4.91	(32.55)
B	104	5.59	26.54	11.56	(35.57)
B-	58	7.99	37.71	21.67	(39.00)
C	16	10.78	42.21	55.48	(35.37)
D	1	(60.94)	(61.34)	(76.56)	(95.61)
NA	57	12.18	41.54	25.91	(35.65)

(Source: Data from Standard & Poor's — Chart: Janney Montgomery Scott)

The short covering by investors who were betting on the shares of the lower-quality companies continuing to suffer contributed to the disparity. Under an X-ray, the past three month's stock market performance would show a correlation between above-market performance and those companies whose shares were the most heavily shorted. In addition, money is coming back into the stock market directly or through purchases of mutual funds and exchange-traded funds (ETFs). The sentiment held by many individual and professional investors anticipating a recovery is near. If consumers release their pent-up spending spirits, conventional wisdom tells us that investing in these economically-sensitive stocks (retailers being one of the best-performing categories in this rally), will enable these types of companies to bounce back first.

Even if it traces behind the markets' returns in the near-term, we hold that quality is the side to error on. This has not been a normal recession either in duration or magnitude. Policymaker intervention has registered historic proportions using tools rarely if ever enlisted to resuscitate the economy. We believe that it will eventually respond to these measures, and to some degree it already has. However, the unevenness of the recovery from such severe conditions, coupled with the unintended consequences that may linger well after the metrics declare the economy clear of the recessionary infection, will make investing tricky.

To mitigate risk in the event of a relapse, high-quality companies, which in many cases are offered with no premium to their lesser-quality brethren, and share dividends with their shareholders greater than that which is yielded by high-quality bonds, deserve attention in a diversified portfolio. Understanding the composition of the market's performance helps to explain what is registering in the minds of investors. This tool is often useful to determine the proverbial path which may have been laid by the usual convention instead of considering the prospects for the unexpected. ■

[1] By Standard & Poor's measures, low-quality companies from a long-term perspective are those with higher business or financial risk which could endanger the predictability of profits, cash flows and possibly dividend performance.

The Best Things Sometimes Come in Fours

By Gregory M. Drahuschak, Market Strategist

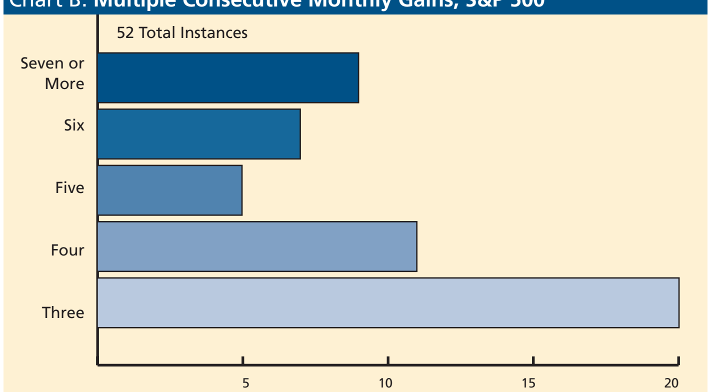
The 5.31 percent gain of the S&P 500® in May marked its third straight monthly increase. Last month, was also the fourth best gain in May over the last 59 years.

After rising for three straight months, and considering the widely-mentioned sell in May and go away notion, it might "sell in May and go away" seem reasonable to assume that the market could face some pullback in June. Historically, however, three consecutive monthly gains are not the rarity you might assume.

There is another view when you consider more than just March through May. In 253 of the 713 months from January 1950 through May 2009, the S&P 500 was in the process of producing a monthly gain that was part of a string of three or more consecutive monthly increases.

Through this 59-year period the S&P 500 has increased for three or more consecutive months 52 times (Chart B), not counting this year. Thirty-three of those times, the S&P 500 went on to produce at least a fourth-straight monthly gain. One of the stretches of monthly gains lasted for 12 months. Four or more consecutive monthly gains were widely dispersed through the calendar, including numerous summer periods.

Chart B: **Multiple Consecutive Monthly Gains, S&P 500**

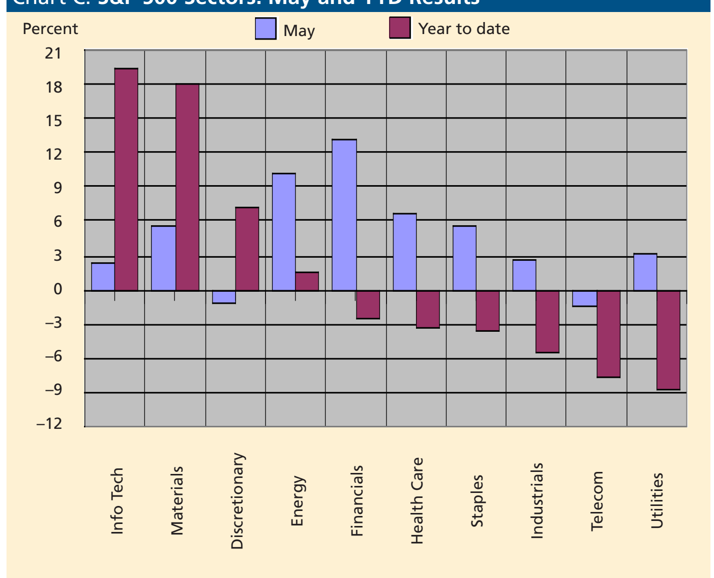


(Source: Janney Montgomery Scott)

There have been 13 times when March, April and May have posted consecutive gains in the last 59 years. In eight of those years the S&P 500 also posted a gain in June.

The stock market's sector emphasis changed as the overall market strengthened. For a period, technology was the runaway winner (Chart C), but as more people accepted the notion that the economy may be close to a bottom, other cyclical sectors, such as materials and discretionary, moved up aggressively. Technology still topped the sector performance list on a year-to-date basis (up 19.27 percent), but the margin over the material sector (up 18.05) was considerably smaller than it had been previously.

Chart C: **S&P 500 Sectors: May and YTD Results**

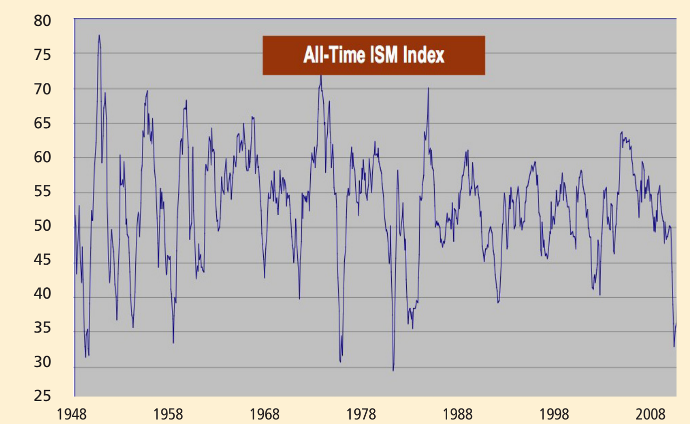


(Source: Data from Standard & Poor's — Chart: Janney Montgomery Scott)

The June 1 ISM Index report continued a nascent recovery in an economy measure that we have found to have a close corollary with a stock market recovery.

The ISM Index has not yet made it back to 50, which is the demarcation level between a rising or contracting economy, but the December 2008 low was very close to levels that in prior years marked an end to a period of economy and market deterioration over its 61-year history (Chart D).

Chart D: All-Time ISM Index



(Source: Institute for Supply Management — Chart: Janney Montgomery Scott)

While signs that the worst erosion in the economy may be over, there are not many indications that solid growth is on the near-term horizon. However, one of the most positive aspects of the ISM Index report was the jump in the production sub-component of the ISM data as well as a move above 50 in the new orders component.

Coming from the deeply depressed levels in the overall market it might seem to be normal for highly economically-sensitive sectors to outpace everything else. This, however, may not be the positive it appears to be.

Oftentimes, as a market transitions from a steep decline to recovery, market leadership changes by moving toward other groups than the previous bull market leadership. The upswing in materials, and more recently energy, helped these two sectors to fare better than they had previously.

In part, this raises the question of whether this market upswing is the start of a secular bull market or whether it is merely a potentially solid rally in the context of a longer-term bear market. For the time being, we are not comfortable providing a conclusive opinion to this question; however, we are comfortable suggesting that even with the recent market move, the high for this year has not been set. Nonetheless, we are approaching June with a cautious near-term view. The speed and extent of the recent rally created some imbalances that may need to be corrected.

We suggest monitoring activity this month with an eye on the trading-range parameters of the S&P 500, which appear to border on the low end by the index's 50-day moving average and the 950–1000 range on the high side.

As long as the rising 50-day moving average is not broken (approximately 870 as of June 3) a pullback should offer another attractive entry point. ■

2009 Index Performance

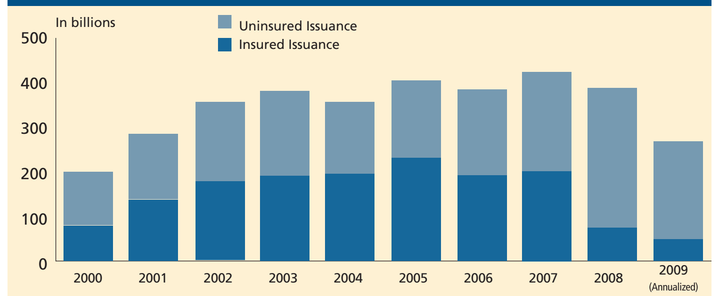
2009 Market Data		Prior Close	Last	Change	% Daily	% Yearly	% Jan	% Feb	% Mar	% Apr	% May	1st Quarter	2nd Quarter
DJ Industries	.DJIA	8403.80	8500.33	96.53	1.15	(3.15)	(8.84)	(11.72)	7.73	11.72	4.07	(13.30)	11.72
S&P 500	SPX	906.83	919.14	12.31	1.36	1.76	(8.57)	(10.99)	8.54	15.20	5.31	(11.67)	15.20
NASDAQ Comp	COMP	1751.79	1774.33	22.54	1.29	12.51	(6.38)	(6.68)	10.94	16.08	3.32	(3.07)	16.08
SOX Index	SOX	268.65	271.31	2.66	0.99	27.87	(1.84)	(5.11)	13.89	18.24	7.86	8.14	18.24
Biotech Index	BTK	632.67	648.69	16.02	2.53	0.23	(1.95)	(6.01)	7.55	1.13	1.83	(0.88)	1.13
DJ Transports	.TRANS	3074.71	3202.45	127.74	4.15	(9.46)	(16.16)	(15.73)	7.40	19.31	1.85	(24.12)	19.31
DJ Utilities	.UTIL	338.40	340.99	2.59	0.77	(8.03)	(0.29)	(12.37)	1.67	3.53	2.03	(11.16)	3.53
Volatility Index	VIX	31.67	28.92	(2.75)	(8.68)	(27.70)	12.10	3.37	(4.77)	(34.48)	(20.77)	10.35	(34.48)
S&P Midcap 400	MID	566.53	575.52	8.99	1.59	6.92	(7.36)	(9.87)	9.75	16.68	2.56	(8.36)	16.68
S&P 100	.OEX	422.60	427.56	4.96	1.17	(0.92)	(9.33)	(11.01)	8.37	13.31	5.31	(12.56)	13.31
Gold ETF	GLD	94.24	96.20	1.96	2.08	11.19	5.54	1.45	(2.54)	6.56	10.23	4.35	6.56
Russell 1000 Index	.RUI	495.17	501.95	6.78	1.37	2.91	(8.29)	(10.67)	8.52	15.74	5.27	(11.09)	15.74
Russell 2000 Index	.RUT	492.21	501.58	9.37	1.90	0.43	(11.20)	(12.29)	8.67	18.65	2.88	(15.36)	18.65

(Source: Standard & Poor's)

The Future of Muni Bond Insurance

By Guy LeBas, Chief Fixed Income Strategist

Chart E: Muni Issuance Mix



(Source: Janney Montgomery Scott)

Throughout this credit crisis, there are few events that brought with them more stakeholder surprise than the weakness of the monoline bond insurers. Perceived safety of triple A insurers was shattered as losses on insured collateralized debt obligations (CDOs) and residential mortgage-backed securities (RMBS) began to mount. So far in 2009, however, improvements in capital markets conditions and dramatic spread-tightening in nearly every high risk area of the debt markets has allowed some of the monolines to recognize write-ups on some of the same insurance polices they wrote down in prior quarters.

MBIA, Inc., for its part, recognized a $1.6 billion gain on its derivatives portfolio that serves in lieu of CDO/RMBS insurance policies. During the quarter, MBIA also created and transferred all municipal insurance policies, along with claims-paying resources totaling about $5.5 billion, to National Public Finance Guarantee Corp (National; insurer rating Baa1/AA-). Baring the success of legal action which seeks to reverse the transfer, this restructuring suggests that muni policyholders should be less concerned with the strength and performance of the parent company and more with the strength and performance of the National subsidiary. Overall, we don't expect National to see triple A ratings in the foreseeable future, although proof that National can write new policies is an unspoken condition for any upgrade above the low double A region.

In contrast to MBIA's solid quarterly results, Ambac (insurer rating Ba3/A) posted what would be described as a distant second place finish to the quarter. Despite impressive spread-tightening, Ambac nonetheless posted a $392 million 1Q loss. More important, however, was that policyholder surplus shrank from $1.6 billion to $394 million, which brings Ambac close to the point of regulatory intervention. While management has indicated optimism over the creation of a muni-only subsidiary (Everspan), the ability to successfully launch this insurer is declining along with the policyholder surplus. Failure to launch Everspan would likely force Ambac into run-off mode, either voluntarily or through the mechanism of regulatory intervention.

The divergent performance of MBIA and Ambac offers a few interesting lessons for the bond insurance industry. First, while credit default swaps on structured finance obligations fired the opening salvos in this war on the insurers, the ability/inability to write new business is what will support or sink the ships. This suggests a growing need for these firms to focus on the long run. MBIA, for one, was able to accomplish this by executing a restructuring that put its core business ahead of more immediate concerns. Conversely, Ambac, has spent more energy defending against and commuting structured finance obligations to the point where its long-run hopes have a much diminished probability of coming to fruition.

Despite this distinctly large road bump, we believe bond guarantors will remain a significant component of the municipal market structure. The fragmented nature of muni issuers creates a challenging task for investors—without the ability to rely on a guarantor, investors need to undertake the laborious process of analyzing each issuer. While the ratings agencies fulfill this need to some degree, their surveillance capabilities leave something to be desired, which consequently creates demand for some form of guarantor or other secondary credit support. Notice we used the term "guarantor," rather than "insurer," and for good reason—there is no stone tablet to suggest that any guarantor be structured similarly to the current bond insurer model. In fact, there are several structures which might prove even more efficient, including a national government-sponsored guaranty agency, broader state intercept programs that extend beyond school districts, and even an association of issuers that takes care of its own, similar to what the Federal Home Loan Bank (FHLB) system does for community banks.

Based on our concept of muni guarantor demand, we estimate market penetration of insurance or other guarantors would be in the range of 25% – 30% of long-run issuance. This estimate is contingent upon a number of factors and assumes a relatively similar muni issuance mix (Chart E) to be realized between 2005 and 2008. If the last six months are any indication, we also assumed that healthcare debt won't be insurable and state governments would only issue uninsured debt. Finally, we built in the assumption that taxable debt, such as the Build America Bonds, would come to market uninsured because taxable investors are more familiar with the concept of insurance. This 25% – 30% market penetration represents a sharp departure from the sector's heyday in which as much as 57% of all muni issuance was covered by insurance. At the same time, it's a long cry from the demise of the insurance concept that seemed like a probable prospect as losses at the major monolines mounted in 2008. ■

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