

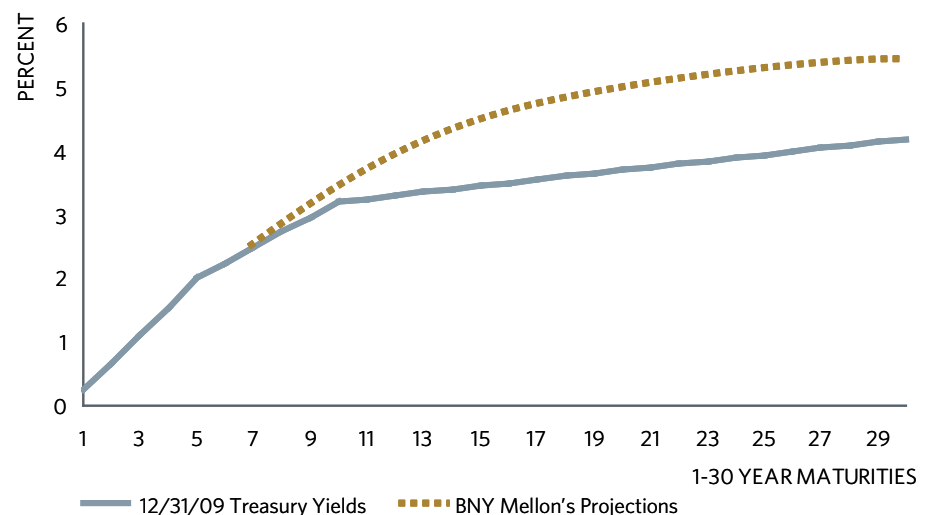
During this past holiday season, with two young sons, I was reminded of the drama surrounding gift giving. I watched as my older son gleefully tore through wrapping paper to unveil a coveted new bike. Like clockwork, his elation was overshadowed by my younger son's full out tantrum. Why hadn't he received a bike? Fortunately, like most kids, my younger son's acute anguish lasted only as long as it took him to open his next gift.

In many ways investors in the 2009 bond market shared my youngest son's fleeting feeling of devastation as their memories of the extreme market conditions in 2008 quickly faded. In some ways, the 2009 bond market followed this holiday season pattern. Much like my son's fleeting feeling of devastation and my inevitable inability to preplan, investors' memories of the extreme market conditions of 2008 seem to have faded. Just over a year ago, when our economy was on the brink of a financial disaster, investors flocked to the safety of U.S. Treasuries. It did not take long, however, for investors to become frustrated with near zero returns on cash and seek higher yielding investments. In fact, 2009 inflows to riskier fixed income sectors, such as commercial mortgage-backed securities, emerging market debt, and high yield bonds, were record setting.

Treasury Bonds

After experiencing considerable demand in 2008, in 2009 the U.S. Treasury market suffered its worst annual return in more than 30 years. The Barclays Treasury Bond Index fell 0.82% and the benchmark 10-year Treasury note had a return of -9.76%, with the majority of losses occurring in the first six months. Longer dated Treasuries, such as the 30-year bond, were down 25.88% compared to the two-year bond's modest returns of 1.29%. Over the last decade, the spread between short-term Treasuries and long-term Treasuries (i.e., two-year versus 30-year) averaged 150 basis points. In 2009, yields rose steadily from historic lows, with intermediate and long-term rates rising more than short-term rates, resulting in a steeper yield curve. Based on concerns about the massive budget deficit and possible negative ramifications of a weaker U.S. dollar, the market anticipates higher yields on shorter-term securities in the quarters ahead.

12/31/09 Treasury Yields vs. BNY Mellon Wealth Management Projections



Sources: Bloomberg LP, BNY Mellon Wealth Management

Treasury Inflation Protected Securities (TIPS)

Despite our negative outlook for Treasuries, we are again optimistic about TIPS. At the beginning of 2009, we noted that the breakeven inflation rate for 10-year TIPS had fallen from above 2% to roughly 0.5%. Despite the rebound to back above 2%, and the corresponding excess return of 15% in 2009, we still believe TIPS offer inexpensive insurance for investors concerned about the potential risk of rising inflation. We could very well see the breakeven rate gravitate toward the upper range of 3% experienced in recent years. However, we advise tax-sensitive investors to purchase TIPS through a mutual fund and preferably to hold TIPS in a tax-deferred account such as an IRA.

Corporate Bonds

Corporate bonds produced unbelievably high returns in 2009 — generating in excess of 20%, as measured by the Barclays Corporate Index. The average yield spread between investment grade corporates and Treasuries tightened from over 500 basis points at the beginning of 2009 to roughly 150 basis points by year end. Corporations took advantage of dramatic yield tightening and refinanced debt to improve their balance sheets. New issues also posted a record in 2009 as investors were eager to get additional yield. Lower credit quality corporate bonds outperformed higher quality bonds, with BBB rated corporates returning almost 40%. High yield corporate bonds produced an astonishing total return of 57% in 2009, as measured by the Bank of America Merrill Lynch High Yield Index.

10-Year Treasury Inflation Protected Securities (TIPS)

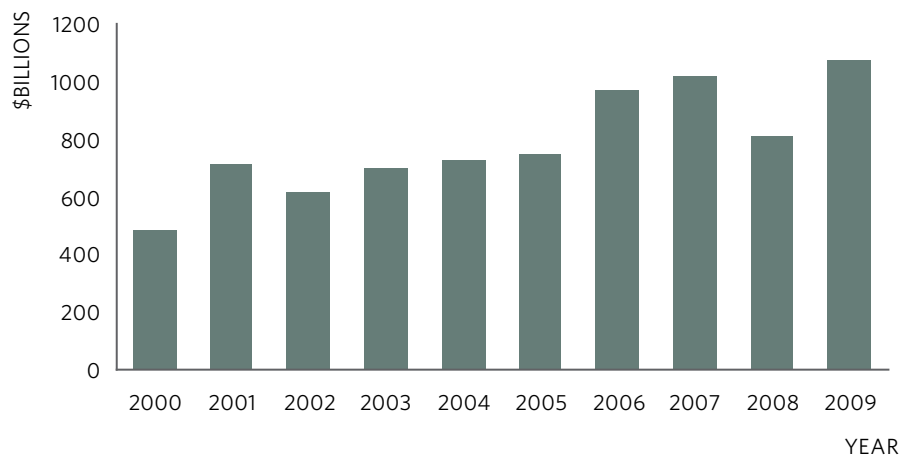
Implied Breakeven Spread



Dotted line represents BNY Mellon Wealth Management prediction of future yield spreads.
Sources: Bloomberg LP, BNY Mellon Wealth Management

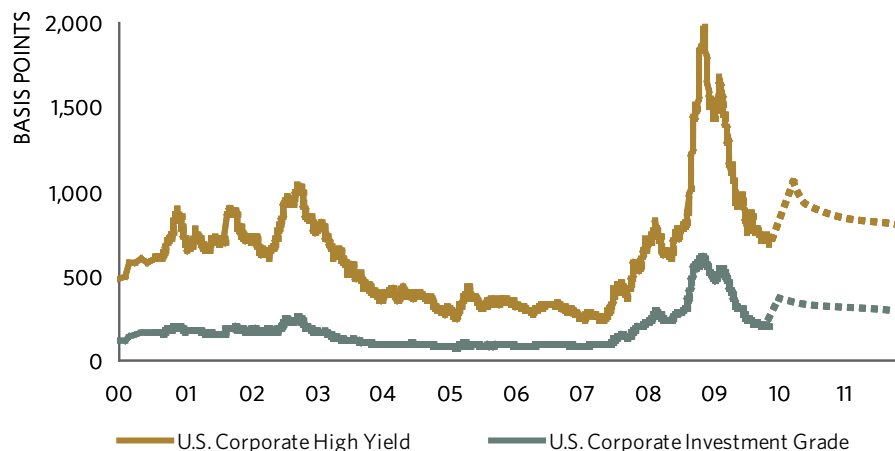
Annual Corporate Bond Supply

Year-to-Date as of 12/31/09



Source: Barclays Capital

Corporate Bond Yield Spreads



Dotted lines represent BNY Mellon Wealth Management prediction of future yield spreads. As of 12/09. Source: Barclays Capital, BNY Mellon Wealth Management.

Mortgage-Backed Securities

High quality, straight-pass-through, mortgage-backed securities continued to perform well during 2009. The mortgage-backed security component of the Barclays Aggregate Bond Index produced a positive total return of 5.89%. The Federal Reserve followed through with its promise to keep mortgage rates low by committing more than \$1 trillion dollars for open market purchases of mortgage-backed securities. New originations of mortgage-backed securities have been nonexistent, corresponding to the decline in residential housing activity. Prepayments have been muted despite low nominal rates of near 5% for conventional conforming mortgage loans as many loan pools have poor loan-to-value ratios making it more difficult to refinance.

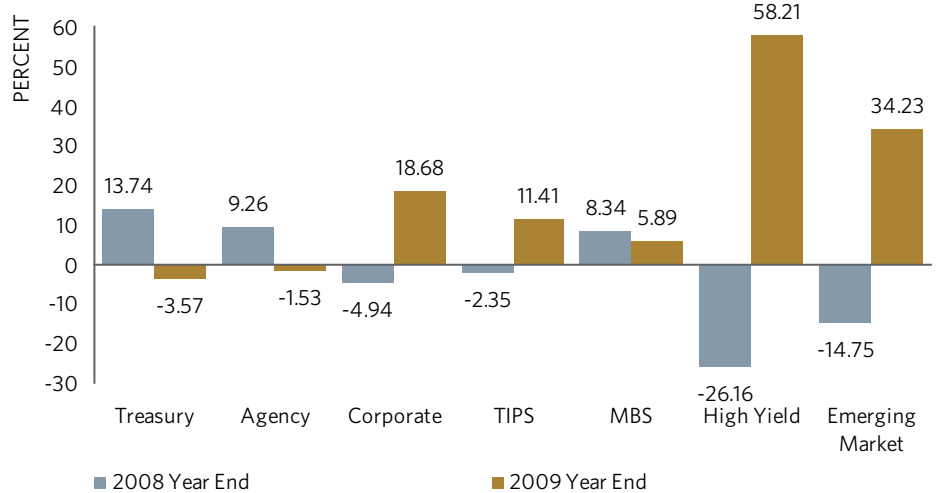
Municipal Bonds

Last year marked a very good year for municipal bonds as strong demand and constrained supply in the second half of the year resulted in increased bond prices. In fact, municipal bond mutual funds raked in a record \$45 billion compared to the previous record of \$28.6 billion set in 1993. Searching for higher yields, investors quickly forgot their fears of higher inflation and credit quality deterioration facing most municipal issuers. The major benefactors of increased demand were long dated and lower rated municipal securities, which more than recouped their negative 2008 performance.

One of the major influences on the municipal bond marketplace over the last nine months has been the Build America Bond (BAB) program. The

Taxable Fixed Income Sector Returns

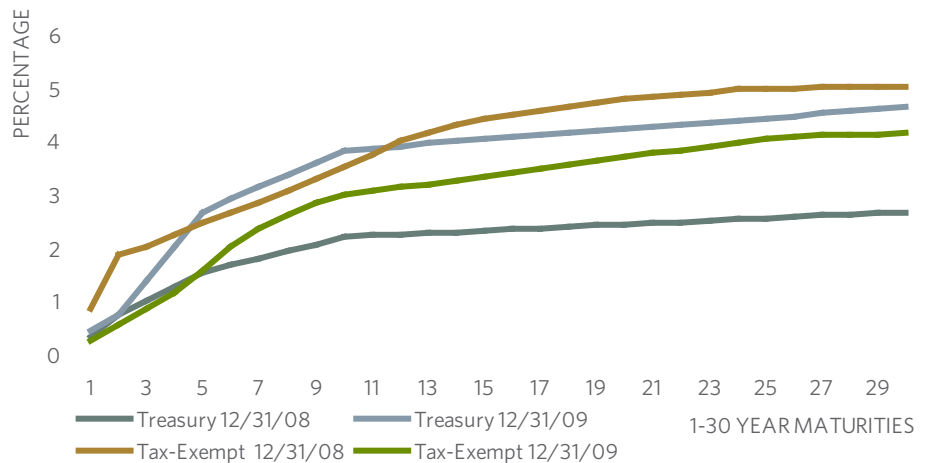
Selected Sector Returns, Year-to-Date as of 12/31/09



Source: Barclays Capital. Returns represent Barclays Capital U.S. Aggregate Bond Index.

Yield Curve Comparison

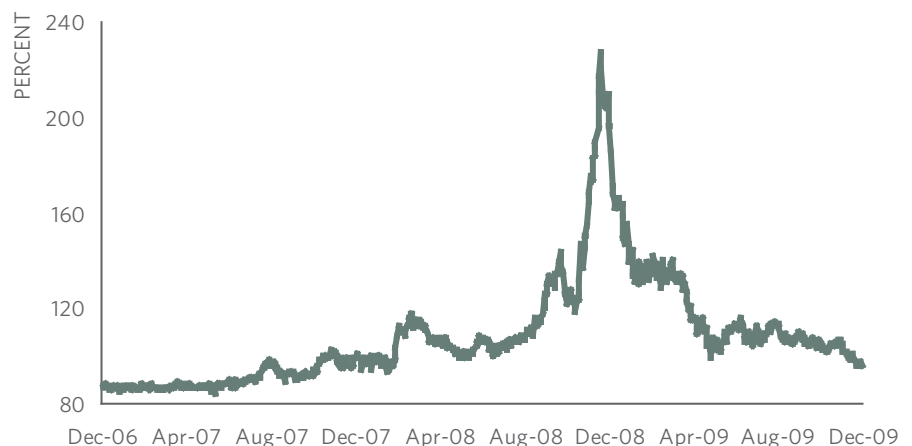
Treasury vs. Municipal



Tax-exempt: MMD Aaa scale, Treasury: Bloomberg

Municipal Bond Yields as a Percentage of Treasuries

Credit and Safety Concerns Caused Spreads to Widen Dramatically



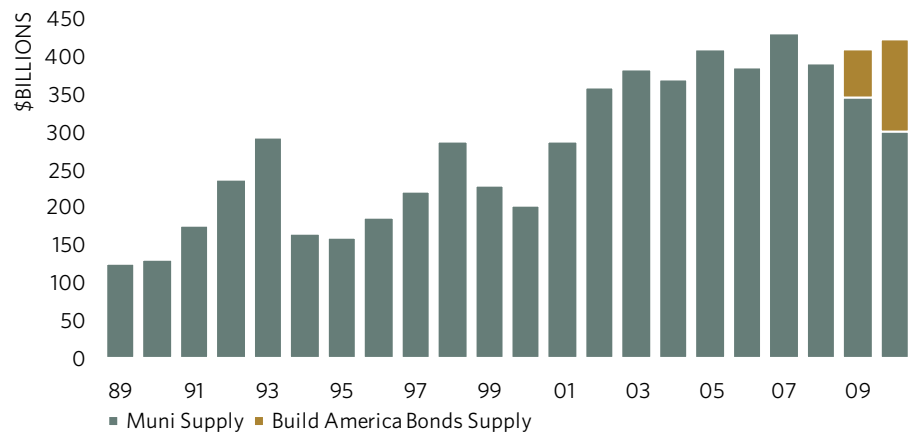
Source: Bloomberg LP

program, which emanated from the American Recovery and Reinvestment Act of 2009 (ARRA), allows most issuers of municipal bonds to choose between issuing traditional tax-exempt or taxable debt. The government rebates the issuer of taxable debt 35% of the interest expense paid annually over the life of the bond. Since the second quarter of 2009, many municipal bond issuers have chosen to issue BABs over tax-exempt municipal bonds. The total supply of BABs in 2009 reached \$64 billion, or 15.6%, of all municipal bonds issued. The taxable municipal bonds were predominantly between the 20- and 30-year maturity ranges. During 2010, we anticipate the BAB total issuance may potentially reach \$125 billion, or roughly 28%, of all municipal debt. The plan was for the BAB program to expire at the end 2010, however, we believe there will be an extension, though at a rebate level lower than 35%.

Credit Quality

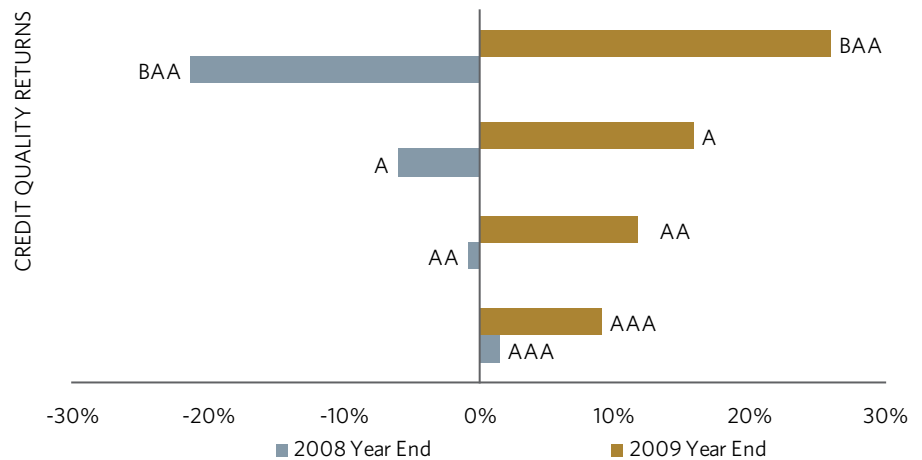
As widely anticipated, credit quality ratings of municipal bonds declined during 2009. For the first time in over a decade, there were more downgrades than upgrades. The ratio of upgrades to downgrades declined from an average of more than 3:1 prior to 2009 to slightly below 0.7:1 during 2009. Given the weak economy and corresponding fiscal strains, it might seem perplexing that it did not deteriorate further. However, as we have mentioned in previous reviews, municipal ratings are a lagging indicator. This is because many municipalities collect revenues, such as local property tax, using past period trailing averages as far back as five years. Over the next couple of years, we expect further

Annual Municipal Fixed Income Supply



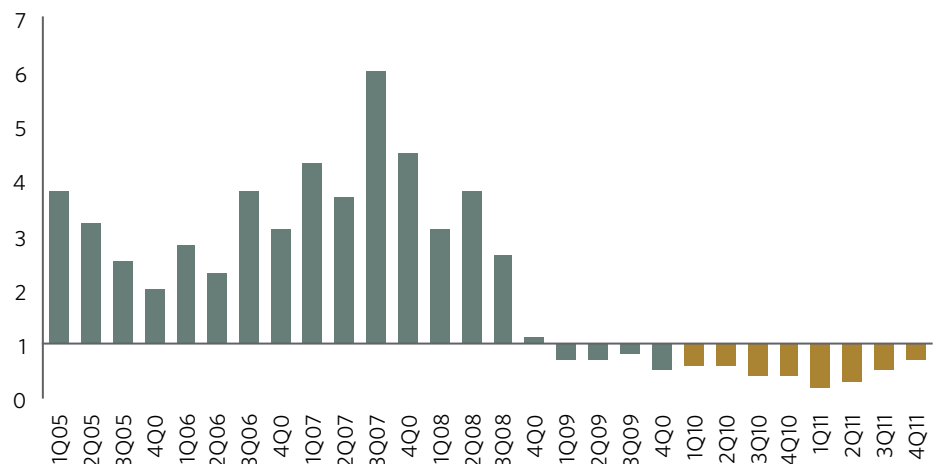
Source: Bond Buyer

Municipal Credit Quality Returns 2008 Year End vs. 2009 Year End



Source: Barclays Capital

Upgrade to Downgrade Ratios



Values greater than 1 denote more upgrades than downgrades. Values less than 1 denote more downgrades than upgrades. Sources: 2005 Q3- 2009 Q4 Moody's Investors Service, 2010 Q1- 2011 Q4 BNY Mellon estimates.

fiscal deterioration and the upgrade/downgrade ratio to reverse and reach 1:3. However, we are not predicting wide spread multi-notch downgrades (i.e., AA to BBB) across the nation but rather AA rated municipality deteriorating to an A rated municipality.

From a rating perspective, our outlook may actually be too pessimistic based on a bill in Congress that mandates rating agencies to treat municipal ratings consistent to all other fixed income ratings. Rating agencies may be forced to upgrade larger issuers, like state general obligations, which actually have been underrated for decades. Nevertheless, given the challenges municipalities will inevitably face regardless of the rating it is critical to employ a disciplined independent credit research process in creating a well diversified, high quality, investment grade municipal portfolio.

Bond Outlook 2010

Our bond outlook for 2010 hinges on the belief that the Federal Reserve will maintain an extremely accommodative monetary policy. We do not believe the Fed will raise the federal funds rate during the year and thus believe short-term yields will remain extremely low throughout 2010. Conversely, our outlook calls for continued pressure on long-dated Treasury yields, pushing them up some 50-75 basis points during the year. However, yields on long-dated securities within other fixed income sectors (i.e., corporate bonds, high yield bonds, asset-backed securities, and municipal bonds) will not increase nearly as much as long-dated Treasury securities. We expect the spreads will continue to compress throughout 2010,

though not as dramatically as they did in 2009. As a result, we expect continued strong demand for higher yielding securities as investors seek yields above money market funds. Consequently, we favor relatively safe sectors (i.e., corporates, mortgage-backed securities, asset-backed securities, and municipal bonds) that still offer attractive yields compared to Treasury bonds. Within the mortgage-backed security sub-sector, however, we recommend caution and seek to minimize the potential risk of maturity extension, which can occur in a rising rate environment.

We believe most states and localities will take appropriate actions to balance their budgets and act fiscally responsible. Nevertheless, some municipalities will be unable to overcome their fiscal hurdles, especially given the political nature of municipal finance. While we believe there will be only a limited number of bankruptcies, the potential exposure reinforces the importance of our bottom-up credit research process and in diversification within our clients' portfolios in order to mitigate risk. Through experience we recognize that in most circumstances preservation of capital is the prominent role of fixed income management. In that pursuit, we are committed to never forgetting these basic principles: stay diversified, stay intermediate, and stay the course.

About the Author

John F. Flahive

Director, Fixed Income Investments

John is the director of fixed income for BNY Mellon Wealth Management and is responsible for all fixed income strategy, policy and management. He is chairman of the Bond Strategy Committee, and is a member of the Investment Strategy Committee, Investment Policy Committee, and Asset Review Committee.

He has more than 20 years of investment experience and has been an investment manager with the firm since 1994. Prior to joining the firm, he was a senior portfolio manager and vice president with Neuberger & Berman, and a vice president and associate portfolio manager with T. Rowe Price.

John holds a bachelor's degree in business administration from Saint Michael's College and a master of business administration from Clarkson University, and attended New York University's Graduate School of Business Administration for Visiting Professionals. He is a CFA charterholder.