

Western Asset The Western View on the Municipal Bond Market

The U.S. economy started to recover during the summer of 2009, and it is estimated that fourth-quarter gross domestic product (GDP) will have expanded at a stronger rate than in the third quarter. However, the strength and sustainability of an economic recovery remains suspect, and forecasts need to be received with caution. For example, after an initially reported expansion of 3.5% in the third quarter, subsequent revisions lowered the pace of GDP growth to just a 2.2% annualized pace. While consumer spending has rebounded from very depressed crisis levels, high unemployment, job insecurity and restrained wage growth cloud the consumption outlook — and those factors are keeping consumer confidence suppressed. The manufacturing sector is expanding again as factory production ramps up to restore depleted inventories to more reasonable levels, but this recovery is far from firing on all cylinders, as overall business spending and the housing recovery remain very sluggish. Meanwhile, the prompt and extensive cost-cutting that corporate America engineered in response to the crisis has enabled a very impressive rebound in corporate profits, which is arguably the most promising development for future jobs growth and business spending.

On the other hand, government at all levels has been slower to react, with little reduction in spending in the face of significant declines in tax receipts. As a result, government budgets remain seriously strained, and continued concerns regarding the impact of future growth could further threaten the fiscal position of some states and municipalities. With continued budget shortfalls across the board, future tax rate increases are more probable. In fact, some states and localities have already imposed increases.

On another note, the Federal Reserve (Fed) is not presently concerned about a worrisome rise in inflation and plans to maintain its target fed funds rate in a range of 0%-0.25% until unemployment declines significantly and bank loan activity recovers. Of course, if conditions were to change, the Fed would likely alter policy accordingly.

All investments involve risk, including possible loss of principal.

Please refer to page 7 for definition of terms.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

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Municipal bond market held up better than the Treasury market during the fourth quarter

Most U.S. Treasury yields rose, with prices falling, during the fourth quarter, as marginally improving growth prospects prompted some investors to embrace more risk; evidenced by quarterly gains in corporate bonds and stocks. The benchmark 10-year Treasury yield ended the year at 3.85%, a 45 basis point (0.45%) increase for the quarter and up a noteworthy 143 basis points (1.43%) from the start of the year. Meanwhile, comparable maturity municipal yields generally rose less than their Treasury counterparts, or were little changed, during the quarter, providing more price stability than Treasuries for the final three months of 2009, albeit still losing ground. Nonetheless, municipal yields were significantly lower at the end of the year than at the beginning and posted strong overall gains for the calendar year. 10-year AAA municipal yields increased 38 basis points (0.38%) during the fourth quarter, but declined 82 basis points (0.82%) on the year. The yield differential between 10-year Treasury notes and 10-year municipal bonds was little changed during the quarter, but since municipal yields fell during 2009 while Treasury yields rose, municipals yielded less as a percentage of Treasuries at the end of the year than they did at the beginning.

The exceptionally strong investor demand for tax-exempt bonds that had been evident earlier in the year subsided in the fourth quarter as investors searched for higher yields elsewhere, but overall demand remained strong. The municipal yield curve steepened a little during the fourth quarter as longer-term yields rose more than shorter-term yields. (The yield curve is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.) As a result, and counter to the third quarter, longer-maturity municipal securities generally underperformed shorter-dated maturities during the fourth quarter, but longer-maturity securities significantly outperformed for all of 2009. A similar pattern holds across the quality spectrum, as higher-quality securities did better during the fourth quarter, but lower-quality securities outperformed on the year. However, revenue bonds posted another quarterly advantage to general obligation bonds and outperformed notably for the year as well.

While demand for tax-free municipal bonds began to cool from record levels, new tax-exempt issuance actually accelerated in the fourth quarter and eclipsed \$400 billion for 2009, for just the fourth year in history. Total tax-exempt issue volume for 2009 was \$406.9 billion, versus \$386.4 billion for 2008.¹ While robust supply could continue, with an expected pickup in new general obligation issuance next year, supply is not expected to overwhelm demand. One reason for this expectation: The Build America Bonds program, which could be extended beyond 2011, should continue to reduce the need for municipalities to issue long-maturity tax-exempt debt. The Build America Bonds program, designed by the Obama administration to remove a headwind to economic recovery by lowering longer-term borrowing costs for states and localities, has successfully transferred what would have been new tax-exempt supply to the taxable market by providing a 35% federal interest rate subsidy to issuers for the life of the issue.

Another factor that has impacted issuance is the changed dynamics of the variable rate market. A combination of reduced capacities to offer letters of credit to issuers of variable rate demand notes and issuers utilizing short duration securities to take advantage of a low interest rate environment

and to lock in lower long-term rates in lieu of variable rate demand notes resulted in a decline in issuance of these short-term financing instruments in 2009. Variable rate demand note issuance was just \$31.7 billion in 2009, compared to \$116.3 billion in 2008.² On the other hand, issuance of fixed-rate securities was \$360.7 billion in 2009, a 38.5% increase from 2008's \$260.4 billion.³

Overall, the best-performing municipal maturity range in the fourth quarter was the 3-year sector (2-4 year maturities), as it returned 0.80%. The worst performer was the 22+ year sector, which returned -2.39%. Within the municipal market, the best-performing sector during the fourth quarter was 5-year pre-refunded securities, which returned 0.79%. The worst-performing sector was long-term (17+ year maturities) general obligation (G.O.) securities, which returned -2.94%.

¹ Thomson Reuters, as of 12/31/09.

² Thomson Reuters, as of 12/31/09.

³ Thomson Reuters, as of 12/31/09.

Strategic highlights and our outlook for the municipal bond market

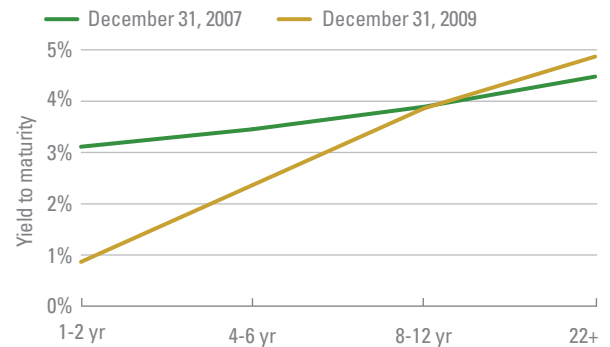
The yield curve steepened during the quarter

During the quarter, yields on 1-year municipal general obligation securities decreased modestly, while yields on longer-term municipal general obligation securities increased, resulting in a steeper yield curve at the end of the fourth quarter.

At the end of December 2009, 400 basis points (4.00%) separated the yield of the Merrill Lynch 1-2 year and 22+ year municipal bond indexes. Two years ago, just 137 basis points (1.37%) separated the same two indexes. As illustrated in the graph, the shift in the yield curve shows municipal investors are being better compensated today to assume extra duration risk by moving further out on the yield curve, or in other words, there is a big difference in the interest rate an investor receives today from a longer-maturity bond than from a shorter-maturity bond. (Duration is the measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points.) Two years ago, yields on longer-term municipals were not much higher than the yields on shorter-term municipals, providing little incentive for assuming additional risk.

We have been adding longer-dated, higher-yielding issues to our municipal portfolios, based on our opinion of the favorable risk/reward assessment that existed due to the steepness of the yield curve. At the end of the quarter, several strategies were long their respective duration benchmarks and several strategies were neutral or short their respective benchmark duration.

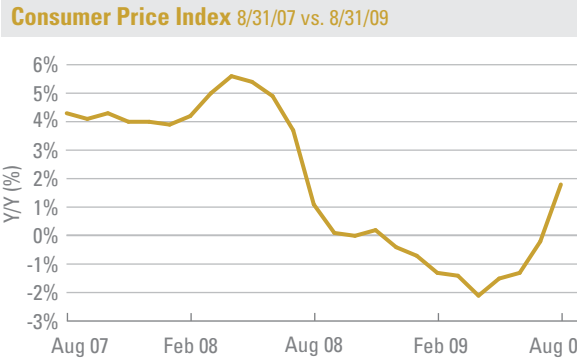
Municipal yield curve 12/31/07 vs. 12/31/09



Source: Merrill Lynch Municipal Bond Indexes, via Bloomberg, as of 12/31/09. Past performance is no guarantee of future results. For illustrative purposes only and does not represent the performance of any specific investment product. An investor cannot invest directly in an index.

Inflation is not a worry for now

Inflation, as measured by the Consumer Price Index (CPI), increased 1.8% in November 2009 relative to November 2008, and the Core Consumer Price Index, which excludes food and energy prices, was up 1.7% in November 2009 from a year earlier. While the recent pickup in inflation (illustrated in the first graph on page 5) suggests that crisis-induced deflation may have ended, it does not suggest that inflation is a near-term concern, in our opinion. Indeed, with a 10% national unemployment rate, there is little concern about strong consumption or wage demands leading to higher inflation. However, we would not be surprised to see the market push interest rates a little higher in anticipation of the removal of emergency measures, known as quantitative easing, implemented by the Fed in response to the financial crisis or for some inflation premium to be built into longer rates. But without a robust recovery in the American economy, which we don't expect, inflation is unlikely to be problematic for the markets in the near term. Therefore, we think that the Federal Reserve is likely to keep interest rates low for some time, but we also believe that it will act responsibly to deal with any unexpected emergence of inflationary pressures. For investors, low and stable inflation could translate into a relatively stable interest rate environment.



Source: Bureau of Labor Statistics, as reported 12/16/09.

Municipal yields, as a percentage of U.S. Treasury yields, have returned to average levels

Given the strong rally that has taken place in the municipal bond market, comparative yields to Treasuries reverted toward more average levels that existed prior to the crisis year of 2008, and at the end of the year they were actually below average. At the end of December, 10-year AAA municipal yields were 78.4% of U.S. 10-year Treasuries compared to 158.7% in December 2008 and a long-term pre-2008 average of 80%.

The municipal sector produced strong absolute returns in 2009, rebounding solidly from the liquidity crisis in 2008. Nonetheless, yields are historically low, especially at the short and intermediate segments of the yield curve, and the very attractive valuations relative to Treasuries have disappeared with the strong rally. Therefore, it would be highly improbable to replicate the results of the past year in 2010; in other words, the “easy money” has been made. Another note of caution concerns the importance of avoiding areas where budget conditions could deteriorate (tax receipts fall short of expenditures) to the point where credit rating downgrades result.

Despite potential challenges, there are reasons to be constructive on 2010:

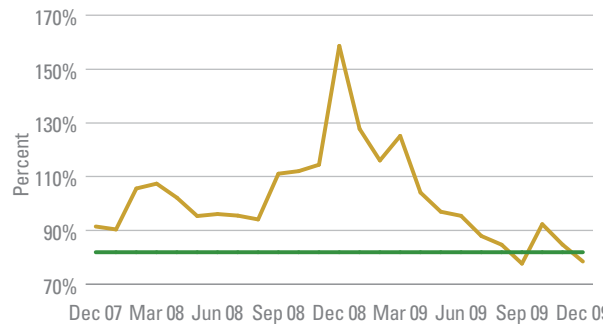
- A positive supply/demand situation, where supply does not overwhelm demand
- A relatively stable interest rate environment that could mean coupon-like returns for municipal bond investors
- Bush-era tax cuts are scheduled to “sunset” on 1/1/2011, which means the top federal tax rate for individual income will return to 39.6% from its current level of 35%. Some states and localities have already increased tax rates, and broader increases would not be surprising. These new higher tax rates could bolster demand for tax-exempt municipal bonds by making them even more attractive on a taxable equivalent basis than at the current rate.

The biggest threats to this outlook would be if yields were pressured by:

- A quick shift in Federal Reserve policy
- An unexpected drop in demand amid a bigger than expected increase in general obligation issuance
- A significant increase in negative news concerning credit downgrades

10-year AAA municipal yields

As a percentage of 10-year U.S. Treasury yields 12/31/07 through 12/31/09



Source: Bloomberg, as of 12/31/09. Past performance is no guarantee of future results. For illustrative purposes only and does not represent the performance of any specific investment product.

Essential service revenue bonds

We continue to allocate a significant amount of assets to Essential Service Revenue Bonds — such as water, sewer, electric, healthcare/hospital, industrial development revenue (IDR)/pollution control revenue (PCR), and education — amid this environment of ongoing uncertainty. Essential Service Revenue bonds are considered fundamental to the operation of government, but they are secured by the specific revenue streams and not by the general taxing power of the state or locality, as are General Obligation bonds (see “Definitions of terms” on back cover for more information). Therefore, with states and localities under pressure to cut expenditures to offset rising budget deficits, we think Essential Service Revenue bonds remain an attractive sector of the municipal market. However, given the general strong outperformance of revenue bonds this year, valuations are now less compelling than they were. This could create an opportunity to target select General Obligation bonds in the future, a sector where yields might become more compelling if new issuance increases and whose outlook could improve along with the broader economy.

Summary highlights

- The economic recovery is unlikely to be strong enough to create a worrisome near-term increase in inflation, which could allow the Fed to keep its target rate on hold for a considerable period.
- While tax-exempt issuance has increased, demand also remains quite robust, albeit below the exceptionally strong levels of earlier this year. We expect over \$400 billion of municipal issuance again in 2010, but some think that as much as 30% of this overall volume will be in the form of taxable Build America Bonds. This will reduce the supply of tax-exempt munis and should support the long end of the municipal curve, which is currently the most attractive part of the market relative to U.S. Treasuries.
- The municipal market performed very well during 2009, but with nominal yields low, it would be highly improbable to replicate that performance in 2010. As a percentage of Treasury yields, municipal yields have reverted to average levels.

- We continue to purchase longer-dated, higher-yielding issues due to the relative value inherent in the steepness of yield curve.
- We continue to favor Essential Service Revenue (ESR) bonds over state and local General Obligation bonds, but given the strong outperformance of revenue bonds during the year, valuations are not as compelling as they were.
- We believe that especially under present circumstances, our active management, independent credit analysis, and experience in sector rotation are crucial to avoid those areas at risk of correction or credit rating downgrades.

Investment Risks

Fixed income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Lower rated, high yield bonds possess greater price volatility, illiquidity, and possibility of default. Certain investors may be subject to the federal Alternative Minimum Tax (AMT), and state and local taxes will apply. Capital gains, if any, are fully taxable. Depends on individual tax situations.

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DEFINITIONS OF TERMS:

Gross domestic product, or **GDP**, is the total market value of all final goods and services produced in a country in a given year.

The **U.S. Federal Reserve**, or "**Fed**," is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

The **federal funds rate** is the interest rate that banks with excess reserves at a U.S. Federal Reserve district bank charge other banks that need overnight loans.

The **U.S. Treasury Department** is responsible for issuing all Treasury bonds, notes and bills; it is responsible for the revenue of the U.S. government.

Build America Bonds are taxable municipal bonds that carry special tax credits and federal subsidies for either the bond issuer or the bondholder. Build America Bonds were created under Section 1531 of Title I of Division B of the American Recovery and Reinvestment Act that U.S. President Barack Obama signed into law on February 17, 2009. The purpose of Build America Bonds is to reduce the cost of borrowing for state and local government issuers and governmental agencies.

AAA-rated bonds are of the highest credit quality, with exceptionally strong protection for the timely repayment of principal and interest.

The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

A **basis point** is one one-hundredth (1/100 or 0.01) of one percent.

The **Consumer Price Index** measures the average change in U.S. consumer prices over time in a fixed market basket of goods and services determined by the U.S. Bureau of Labor Statistics

Coupon refers to the amount of interest a bond pays per year expressed as a percentage of the face value of the bond.

Duration is the measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. Calculation is based on the weighted average of the present values for all cash flows.

General Obligation bonds are issued directly by state or local governments or their agencies to meet essential government functions, such as schools and highway construction. These bonds are backed by the issuer's pledge and its full faith, credit and taxing power to meet interest and principal payments.

Essential Service Revenue bonds are issued by entities considered fundamental to the operation of the government, which can include public universities, primary/secondary schools, water and sewer utilities, and state highway authorities. They are secured by a specific stream(s) of revenue(s) rather than the general taxing power of a municipality.

Revenue bonds are supported by the revenue from a specific project, such as a toll bridge, highway or local stadium.

A **pre-refunded bond** is a bond that originally may have been issued as a general obligation or revenue bond but is now secured by an escrow fund made entirely of direct U.S. government obligations that are sufficient for paying the bondholders.

U.S. Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

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