

## Market Review

After a very challenging 2008 in high yield (and most asset classes), this market has posted a very strong start to 2009. The rally that began in mid-December 2008 continued through January and resulted in one of the best monthly returns in history, at 5.99%. February eliminated much of what January provided by posting a -3.10% return, and March reversed the direction again by generating a return of 3.19%. Among the causes of these gyrations in the markets are poorly delivered federal government initiatives, continued housing price deflation, dismal consumer confidence, constrained credit markets, high and increasing unemployment, negative economic growth, weak consumer demand, and a continued overall uncertain economic outlook.

The high yield asset class posted a return of 5.98% in the quarter, lessening the losses that gained traction early in the third quarter of 2008 and, according to Barclays Capital, resulted in 2008 returns of -26.16%. Corporate spreads started 2009 at 1,796 basis points (bps), having peaked at 2,127 bps December 16, 2008, and rallied to close out the first quarter at 1,631 bps. Volatility remains elevated, and we expect this to continue, given the current economic environment. Since reaching a historical tight of 252 bps in June 2007, the high yield market widened 1,875 bps, until the contraction started in December 2008.

	1Q09	2008
Barclays U.S. Corporate High Yield	5.98%	-3.08%
Barclays U.S. Credit Index	-1.78%	-3.08%
Barclays U.S. Universal Index	.39%	2.38%
Barclays Euro High Yield Index	8.58%	-37.90%
Barclays Emerging Market Index	4.75%	-14.75%
S&P 500 Index	-11.01%	-37.00%

New-issuance volume continued at a depressed level, but it improved over last year, which we view positively. We saw \$13.1 billion of high yield issuance in the first quarter of 2009, versus \$8.1 billion in the first quarter of 2008. For the several years preceding 2008, annual new-issuance volume typically averaged \$150 billion. Looking at quality, no CCC or lower-rated company tapped the market in the quarter. The forward calendar continues to look extremely light. New supply via credits migrating from investment-grade to high yield in the quarter was \$36.6 billion, however, a tremendous increase from 2008, which saw \$56 billion for the entire year.

Higher-rated high yield continued to outperform lower-rated high yield, a trend that started during the second half of 2007. The month of March showed a reversal of this trend as investors sought higher

yielding assets. As a result, lower-quality high yield significantly outperformed higher-quality issues. According to the Barclays Capital High Yield Index:

	March 2009	1Q09	2008
BB	1.78%	9.02%	-17.53%
B	1.30%	4.65%	-26.65%
CCC	7.21%	4.78%	-44.35%

During the third quarter, the better-performing industries within high yield were Diversified Manufacturing (31.99%), Pharmaceutical (23.51%) and Supermarkets (20.53%). The stability and relatively defensive nature of these industries attracted investors seeking refuge from the more volatile areas of high yield. In March, however, higher beta sectors such as Autos (27.32%) and Banking (24.45%) strongly outperformed the overall market.

Conversely, the underperforming industries in the quarter were led by Gaming (-17.01%), with extreme pressure being experienced on the Las Vegas Strip and several companies struggling with over-leveraged balance sheets and massive capital expenditure programs in the face of sharp revenue declines. Finance Companies (-10.82%) also had a poor quarter as they continue to operate in an ever-changing landscape of regulation and uncertainty.

Default rates continue to accelerate, with the global speculative default rate at 5.23% as of the end of February, according to Moody's Investor Service. This is up from under 1% at the end of 2007 and from 4.13% at the end of 2008. The rate now exceeds the 20-year average of 4.33%. Moody's is forecasting the rate to peak at more than 15% in November and has a 12-month outlook of 13.8%. Year-to-date defaults already total \$35.8 billion in North America, compared to \$19.4 billion for all of 2008. As an alternative to a default, many companies are attempting to execute a debt exchange and therefore restructure their balance sheets outside the bankruptcy courts. They have seen mixed results so far. Bank loan covenant violations also are expected to continue their upward trend. Banks' willingness to provide relief for companies with sound business models appears favorable, however.

## Market Outlook and Strategy

We continue to recommend a moderate overweight on the high yield asset class. With a yield of approximately 18% and a coupon yield of roughly 13%, investors are receiving a large amount of income return to potentially cushion further negative price returns from defaults and spread widening. The average price of a high yield bond is about

64 cents on the dollar, with a spread in excess of 1,600 bps over Treasuries. Given the large carry, the math is stacked against further significant downside in the high yield market. We believe the market is setting up for strong returns over the next few years.

The technicals of the market appear favorable, as well. Cash balances relative to the size of the debt and equity markets are at their highest levels in five years. While many economists expect an increase in savings, cash returns are nearly zero. This cash will eventually need to be re-allocated into higher yielding investments. Indicators show that investors are allocating to high yield, as reflected in \$6.4 billion of inflows in the quarter into high yield mutual funds, according to Affiliated Managers Group. Further, April is seeing very strong inflows, as well.

While we view valuations and technicals positively, fundamentals will remain challenging. It is widely anticipated that economic and company fundamentals will continue to be weak in 2009. Visibility for economic stability and corporate earnings is lacking. The massive erosion in household wealth, combined with a lack of available credit, is causing corporations to conserve cash and reduce expenses. Additionally, U.S. unemployment stands at a 24-year high of 8.5%, with expectations for additional escalation. Further, rating agencies downgraded a record number of high yield bonds in the quarter: For every upgrade, they downgraded approximately 10 bonds. And, as previously indicated, we fully anticipate higher default rates and increased use of debt exchanges over the next 12 months.

While volatility is expected to stay high and fundamentals will decline, we believe valuations have overshot forecasted fundamentals. We see signs that demand is coming back into the market, as evidenced by inflows in the quarter. And the Federal Reserve and U.S. government have improved their vigilance. As we look back over the past 20 years, we see several periods in which high yield bonds staged rallies while default rates were increasing. In fact, spreads typically lead fundamentals by six to nine months. We believe that this period may be similar. It is important to emphasize, however, that while we cannot expect to time the eventual recovery perfectly, we are confident that we will look back five years from now and see this as a rare opportunity.

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