

Market Review

Gross Domestic Product (GDP) growth declined significantly in the first quarter of 2009, following a contraction of 6.3% in the fourth quarter of 2008. The ramifications of the financial crisis spread further into the real economy, which caused the labor market, housing, consumption, manufacturing and exports to deteriorate further. These effects highlighted the grim realization that the U.S. is likely experiencing the deepest recession since World War II.

As bad as the economic data has been throughout the first quarter, the environment has shown some signs of stabilization. Consumer spending has turned slightly positive; housing activity has begun to pick up; credit availability has improved modestly; equity markets have improved; and banks should benefit from first-quarter capital market activity. The markets also are benefiting from the implementation and announcement of additional stimulative programs, including Quantitative Easing (QE) and the Public-Private Investment Program. While we do not expect these developments to lead to significant near-term improvement in economic data, we do see signs of stabilization or at least a slowdown in the pace of decline.

The labor market continued to deteriorate, and the downward trend accelerated in the first quarter. Each month of the first quarter saw an average job loss of 685,000, which is significantly higher than the 425,000 monthly average in the fourth quarter. We have now experienced 15 consecutive months of job loss, bringing job loss to approximately two million in the first quarter and approximately five million since the recession began. The unemployment rate rose by 1.3% in the first quarter to 8.5%. This was the largest quarterly rise since the recession began and the highest unemployment rate since 1983. Initial jobless claims have continued to increase, with the most recent four-week moving average above 650,000, a level not seen since the 1970s. Continuing claims also increased to a record high in the first quarter, reiterating that people are unemployed longer as new jobs are more difficult to find. The weakness in labor markets has contributed to further declines in the outlook for consumers. We believe that consumer confidence will remain weak, and growth expectations will be subdued until labor markets begin to stabilize,

Personal spending rebounded in the first quarter of 2009, following a 4% annual rate of decline in the third and fourth quarters of 2008. Real consumer spending is likely to have increased at a 1.6% annual pace in the first quarter. The increase in spending was a surprising positive, given the continued weakness in labor markets, the further destruction of wealth and the increased savings rates. The increase was likely a result of one-time benefits, such as lower taxes paid, which could continue through April. As these benefits wear off, the weakening trends in the labor market are likely to reduce consumption.

Business spending has remained very weak, as companies hoard cash, which is a main driver of accelerated layoffs and the sharp inventory decline in the first quarter. The inventory decline is a key driver of declining growth in the first quarter. Through the first two months of the year, durable goods orders continue to point to a sharp decline in capital investment, with core capital goods orders down 45% and shipments down 35%. Other signs of stabilization are the Institute of Supply Management manufacturing index, which has increased four months in a row, and the March data showing strong increases in new orders and new export orders. While these readings are still well below a level that would provide sustainable growth, they are signs of improvement.

While home prices continue to fall, we see signs that activity in the housing market is increasing. Home prices continued to decline throughout the first quarter, with the most recent Standard & Poor's (S&P) Case-Shiller Composite 20 City Home Price Index down 19% year over year and 29% below its peak in 2006. The price index has now retraced back to 2003 levels. The declines in prices continue to reflect the tight credit environment and the continued rise in delinquencies and foreclosures. The U.S. Treasury and the Federal Reserve (Fed) increased their commitment to purchase mortgage-backed securities to \$1.25 trillion and have begun to purchase up to \$300 billion in U.S. Treasuries to lower mortgage rates and improve credit availability. The Home Affordable Refinancing Plan will greatly expand the ability of borrowers to refinance. Mortgage rates have declined to below 5%, and the government will continue to support lower mortgage rates to stabilize the housing market. These programs will enable a significant number of borrowers to lower their debt burden, and they will help slow the pace of foreclosures while enticing new homebuyers to reduce the overhang of housing inventory.

The lower mortgage rates have led to an increase in mortgage applications each week in March; an increase in new, existing and pending home sales in February; and an increase in building permits and housing starts. While prices will continue to decline over the near term, these are all signs that activity is increasing in the housing market.

Market volatility continued in the first quarter, but liquidity has improved as markets begin to stabilize. The S&P 500 Index fell further in the first quarter, ending down another 11.01%, but this was substantially higher than the lows hit in March. After reaching a low of 676 on March 9th, the S&P 500 rallied about 18% to end the quarter. The yield curve steepened by 42 basis points during the quarter, as the spread between two-year Treasuries and 10-year Treasuries ended the quarter at a positive 187 basis points (bps). The 10-year Treasury Note increased by 45 bps to end the quarter at 2.66%, while the two-year note increased just three bps to end the quarter at 0.79%.

We expect yields on the 10-year U.S. Treasury Note to trade between 2.50% and 3.00% during the second quarter of 2009 and trend toward 3.00% to 3.50% by year-end. The rise in interest rates was partially offset by the tightening of credit spreads, leading to modestly positive performance for higher-quality bonds. The Barclays Capital Aggregate Bond Index was up just 0.12% during the quarter, while the more credit sensitive Barclays Capital High Yield Bond Index was up 5.98%.

Market Outlook and Strategy

For the first quarter of 2009, the Barclays U.S. Treasury Index returned -1.32%. The Barclays U.S. Credit Index returned -1.78% for the same period. The Treasury yield curve steepened in the first quarter as the ten year Treasury yield increased by 45 basis points to 2.66% while the two year Treasury yield increased by 3 basis points to 0.79%.

The average spread to Treasuries for the Barclay Credit Index decreased 11 basis points to a level of 503 basis points at quarter end. For the quarter, the Barclay Credit A rated bond index returned -3.03% compared to 1.15% for the Barclay Credit Baa rated bond index. This return differential reflects the impact the financial sector had on the A rated portion of the index. The return of the financial sector was -7.2%

Barclays Bond Index Performance

Index	4Q08	YTD
U.S. Treasury	8.75%	13.74%
U.S. Credit	4.03%	-3.08%

Source: Barclays Capital

According to Aviva Investors data, approximately \$4 billion of traditional private fixed income was issued in the first quarter of 2009. Volume increased markedly, compared to the \$560 million of issuance in the fourth quarter of 2008. Companies in defensive sectors like electric utilities, defense and food represented a substantial portion of the new issuance volume. The average quality of issues placed was BBB+. Spread levels on the private bonds issued remained relatively wide but issuer specific.

Private debt issuance should continue to increase in the second quarter of 2009, as issuers adjust to the new financial and economic environment. While some private fixed income investors remain on the sidelines, due to internal cash flow constraints and capital preservation needs, Aviva Investors continues to actively pursue opportunities in this market. We expect new issuance to be weighted in more stable sectors, balanced between domestic and foreign issuers, with favorable terms and spreads.

We remain committed to our long-term, fundamental approach to private fixed income portfolio management, and will seek attractive investment opportunities in individual issues that are aligned with our strategy and consistently meet the objectives of our clients.

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