

## Market Review

After finishing a very strong first quarter, the global high yield market posted solid returns again in the second quarter (24.23%), making this the best quarter in the history of the Barclays Capital Global High Yield Constrained Index. The rally that began in mid-December 2008 continued through June and resulted in a six-month return of 32.52%. April was the best month on record, when the index soared 11.47%. The market has cooled down since then, but still managed to return 7.95% for May and 3.23% for June. We expect continued volatility in the market based on: slowing economic contraction, recent improvement of liquidity, decelerating labor market deterioration, continued housing price deflation, dismal consumer confidence, constrained credit markets, negative economic growth and weak consumer demand.

Global high yield corporate spreads started 2009 at 1,818 basis points (bps), having peaked at 2,082 bps December 16, 2008, and they rallied to close out the second quarter at 1,078 bps. Spread volatility has come down significantly but remains elevated, and we expect this to continue, given the current economic environment. Since reaching a historical low of 243 bps in June 2007, the global high yield market spread widened 1,839 bps, until the contraction started in December 2008.

We saw a strong primary market in the second quarter, with \$48 billion coming into the high yield market, versus \$11 billion in the first quarter of 2009, according to Barclays Capital. Year to date, companies have raised 39% more capital in the high yield market than they did in the first six months of 2008. Issuers able to tap the market have generally been higher quality and/or defensive in nature. We have seen some deterioration in credit quality, however. CCC issuers were responsible for 6.6% of new issuance in the second quarter versus 2.7% in the first quarter. April was the third largest month for fallen angel activity on record; more than \$34 billion of high grade bonds were downgraded to high yield. The credit migration has slowed down since then. The high yield market absorbed \$13.3 billion in May and only \$4.25 billion in June.

Reversing a trend that started from the second half of 2007 through 2008, CCC and lower rated securities significantly outperformed higher quality high yield, as investors' risk appetites continued to rise. As a result, CCC rated paper (at 42.22%) significantly outperformed BB (17.72%) and B (21.39%), for the quarter, according to the Barclays Capital Global High Yield Constrained Index.

During the second quarter, the better-performing industries within high yield were financial institutions (51.90%), transportation (38.67%), building materials (38.00%) and retailers (37.75%). Investors pulled away from the stable and defensive industries that

were attractive in 2008 and moved toward higher beta sectors that strongly outperformed the overall market recently. Conversely, the underperforming industries in the quarter were mainly coming from consumer non-cyclical sectors, such as supermarkets (2.08%), food & beverage (10.30%) and healthcare (10.29%), because many of their credits were trading at a high premium, forcing investors to seek better risk/return opportunities. Natural gas (at 11.89%) also had a poor quarter as price depression continued and demand remained subdued.

Default rates continued to accelerate; the global speculative default rate was at 9.23% at the end of May, according to Moody's Investor Service. This is up from under 1% at the end of 2007 and within 1% of the prior peak (10.12%) set in 2001. Moody's is currently forecasting that global default rates will rise to 13.8% by the end of 2009, then taper down to 7.98% in the 12-month outlook. After only 14 North American high yield defaults in all of 2007, May 2009 alone saw 23 defaults. The largest default in June was General Motors Corp., which had more than \$10 billion of bonds and loans outstanding prior to its default. The bankruptcies of Chrysler and GM took a toll on other auto suppliers: Lear Corp. and Cooper-Standard Automotive both missed payments in June. As an alternative to a default, many companies are attempting to execute a debt exchange so they can restructure their balance sheets outside the bankruptcy courts. 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.

## Outlook and Strategy

We continue to recommend a moderate overweight on the high yield asset class. With a yield to worst of approximately 12.91% and a current yield of roughly 10.64%, investors are receiving a large amount of income return to potentially cushion negative price returns from defaults and spread widening. The average price of a high yield bond is approximately 75 cents on the dollar, with a spread in excess of 1,078 bps over Treasuries. While we recognize that returns year-to-date have been strong, current valuations are still compelling on an historical basis and can continue to provide compelling returns going forward.

The technicals of the market remain 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, creating a strong technical bid for the secondary market. Indicators show that investors are allocating to high yield, as reflected in \$21.3 billion of inflows into high yield mutual funds year to date, according to Affiliated Managers

Group. We recommend a cautious approach however, because the last week of June saw the first mutual fund outflow – a modest \$110 million – after 15 consecutive weeks of inflows.

While we view valuations and technicals positively, fundamentals will remain challenging. Despite recent signs of improvement in market conditions and optimism that the worst is over, our economic view remains conservative. Visibility for economic stability and corporate earnings is missing. The reduction in monthly payroll losses and increase in consumer confidence still lack consistency. 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 26-year high of 9.5%, with expectations for additional escalation. Further, according to Barclays Capital, one of the rating agencies announced 101 high yield downgrades in 2009 and only five upgrades. We fully anticipate elevated default rates and increased use of debt exchanges over the next 12 months.

While we expect volatility to stay high and fundamentals to decline, we believe valuations have overshot forecasted fundamental deterioration. 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.

## Fund Performance

The FSITC Global High Yield Bond Fund returned -0.46% for the month of June, underperforming the Barclays Capital Global High Yield Constrained Index, which returned 2.45% for the same period. A large cash position, transaction costs and short-term volatility all negatively affected the fund. Most notably, initial transaction costs contributed -174.8bps to the underperformance. We expect these issues to improve significantly once we are fully invested.

Source: Unless otherwise stated, market data is quoted from Barclays Capital.

	2Q09	YTD
Barclays U.S. Corporate High Yield	23.07%	30.43%
Barclays U.S. Credit Index	8.81%	6.87%
Barclays U.S. Universal Index	2.94%	3.35%
Barclays Pan-European High Yield Index	31.91%	43.42%
Barclays Global Emerging Market Index	12.37%	17.92%
S&P 500 Index	15.93%	3.16%

Barclays U.S. High Yield 2% Capped	June 2009	2Q09	YTD
BB	2.51%	15.00%	25.36%
B	2.26%	19.71%	25.29%
CCC	5.79%	40.71%	48.50%

Source: Barclays Capital; Global indices are fully hedged to USD; Data as of 6/30/09

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