

Market Review

Gross Domestic Product growth declined another 5.5% in the first quarter of 2009 – the third quarter in a row of negative growth. Economic data began showing signs of a recovery throughout the second quarter. Growth is expected to turn positive in the second half of 2009 with a boost from inventory restocking, which was drawn down considerably in the first half of the year. Weakness continues in the housing and labor markets, but consumer confidence and spending stabilized and began to turn higher. Many of these increases will likely be short lived, however, because they were spurred by one-time stimulus payments.

The labor market continued to deteriorate, but the downward trend decelerated in the second quarter. The weakness in labor markets has contributed to further declines in the outlook for consumers, and we believe the collapse in wage growth will surely have a negative effect on consumer spending.

One-time stimulus measures supported personal spending, as they did in the first quarter. Retail sales increased by 0.5% in May, as an increase in automobile sales and gasoline drove sales higher. This is in line with other consumer spending measures that increased in May. They were likely a result of one-time benefits, such as additional social security payments distributed in the second quarter. As these benefits wear off, consumers will continue to save more and spend less going forward, which will ultimately keep growth slow.

The need to restock inventories in the second half of 2009 will be a positive growth driver for business spending. Durable goods orders were up 1.8% in May and 1.4% in April. The Institute of Supply Management manufacturing index increased for the sixth month in a row, and the non-manufacturing index increased for the third month in a row. Companies continue to work through inventories and inventory levels are now lower than any period since the early 1980s.

Home prices continue to fall. While activity may be increasing, higher mortgage rates will keep the housing market subdued. The most recent Standard & Poor's (S&P) Case-Shiller Composite 20 City Home Price Index was down 18% year over year and more than 32% below the 2006 peak. The price index has now retracted to 2003 levels. The decline in prices reflects the tight credit environment and the continued rise in delinquencies and foreclosures.

Capital markets stabilized in the second quarter, as the economic outlook and liquidity improved. The S&P 500 Index increased by 15.93% in the second quarter, bringing year-to-date returns into positive territory at 3.16%. The yield curve steepened by 55 basis points (bps) during the quarter, as the spread between two-

year Treasuries and 10-year Treasuries ended the quarter at a positive 242 bps. The 10-year Treasury note increased by 87 bps to end the quarter at 3.53%, while the two-year note increased 31 bps to end the quarter at 1.11%.

The rise in interest rates was more than offset by the tightening of credit spreads, leading to positive performance for all fixed income asset classes. The Barclays Aggregate Bond Index was up just 1.78% during the quarter, while the more credit sensitive Barclays High Yield Bond Index was up 23.07%.

We expect yields on the 10-year U.S. Treasury note to trade between 3.25% and 3.75% during the third quarter of 2009 and trend toward 3.50% to 4.00% by year end.

Credit Market Review

The Barclays U.S. Credit Index turned in excess return of 1,187 bps for the quarter, with all sectors ending on a positive note. Some of the best performance came from financial industries, specifically the life insurance, non-captive consumer finance and REIT sectors. The worst performers were high-quality non-corporate sectors such as foreign local governments, foreign agencies, supranationals and sovereigns, and higher-quality defensive sectors such as aerospace/defense and consumer products. The OAS closed out the month at 275 basis points. Thanks in part to investors' increasing appetite for risk, lower-quality BBBs have performed best, while higher-quality issues underperformed the index, even though they delivered positive excess returns. New issuance was steadily strong throughout the quarter, and investors responded with solid demand. The quarter saw consistent increases in flows from mutual funds and insurance companies into investment grade credit

April saw the Barclays U.S. Credit Index experience a healthy rebound from the first quarter. It outperformed Treasuries by 460 bps, resulting from 87 bps of tightening during the month. The OAS ended the quarter at 395 bps. Financials were the best-performing sector; REITs, life insurance and finance companies all posted strong excess returns. Despite enduring concern about their stress tests, banks also performed relatively well. In addition, a few banks tested the temperature of the market by issuing non-Troubled Asset Relief Program fixed income securities. Industrials were the next-best-performing sector, with gains in the relatively smaller lodging and paper sectors. Nearly every sector had positive excess return. The worst-performing sectors were the high quality buckets of foreign local governments and foreign agencies and most defensive sectors of aerospace/defense and consumer products. New issue supply in April remained strong.

The rally in the U.S. credit markets extended through May. This was the second-best month on record, following April, for excess return. The Barclays U.S. Credit Index outperformed Treasuries by 450 bps, resulting from 76 bps of tightening. The OAS ended the month at 319 bps. Again, financials were the best-performing sector. Sentiment for the financial sector improved in the wake of the banking stress test releases, and many major financial companies became anxious to validate their ability to access the debt market outside of the Temporary Liquidity Guarantee Program issuance. Sentiment improved across all sectors of the credit market, as every sector had positive excess returns. Life insurance, brokerage, finance companies and REITs were the leading outperformers once again. Genworth was the shining star, with more than 4,000 bps of excess return, followed by ING, Lincoln National, Prudential and AIG. Natural gas subsectors helped utilities generate the next-best sector returns. The worst-performing sectors were the high quality buckets of supranationals and foreign agencies and the defensive sectors of aerospace/defense. New issue supply in May remained strong, with most issues coming in the five-year and shorter bucket.

June helped cap off the best quarterly excess return on record for the Barclays U.S. Credit Index. The index tightened 44 bps, producing 254 bps of excess return. The life insurance sector contributed the best performance, with 710 bps of excess return, fueled by ING Bank and Genworth. Pipelines, packaging, non-captive consumer finance and independent energy also performed strongly. The higher-quality sectors of sovereigns, foreign agency and local government were the worst-performing sectors. In addition, General Electric's marginal excess return caused the non-captive diversified sector to underperform the credit market. June was another big month for supply, which investors matched with strong demand. New issue concessions have diminished compared to the start of the year, but new bonds have tended to perform well. Issuers continued to take advantage of relatively low all-in yields, while investors welcomed the new supply.

Outlook and Strategy

Fundamentals: While investors may be looking for a recovery in fundamentals soon, we do not expect it to occur until later this year or early in 2010. Because companies focused so strongly on cost cutting in the last few quarters, many were able to beat the lower expectations they had predicted in their revisions. In evaluating third-quarter earnings, investors will be looking for true top-line growth fueled by revenue increases and watching closely to see if companies can hit their new, higher estimates. Investors also are focused on the timing of a broader economic recovery. Most believe it will not arrive until the end of 2009 and into 2010.

Technical: Technical factors have been leading the way for investment grade credit spreads. Investors are looking to invest new cash, and demand is strong. We have seen heavy inflows to investment grade mutual funds and increased allocations to investment grade credit by insurance companies. The secondary supply is limited, and dealer inventory is light. Dealers, too, have been trying to increase their positions to investment grade credit. The new issue calendar has been heavy through the first half of the year, as companies have pre-funded financing needs, financed merger and acquisition (M&A) transactions and come to the market opportunistically. Financials are returning to the market to prove their access to liquidity. Interest in new issues is high, and they have generally performed well. We expect the supply to slow down somewhat based on reduced refinancing needs. New issuance will likely come from any M&A transactions or opportunistic moves to take advantage of low yields. Given the current environment, we anticipate M&A activity to continue muted. Demand is likely to remain strong due to the amount of investable cash available for investment grade credit.

Valuations: In spite of a strong second-quarter rally, valuations still look attractive on a historical basis. Spreads are likely to move tighter over the next quarter, but we don't expect a smooth one-way progression; the ride may be choppy, with both forward surges and intermittent pullbacks. Some of the defensive, higher quality sectors are reaching normal trading levels. While most of the tightening has been systematic, we still see opportunities in higher beta sectors and securities. Fundamental credit research will be critical in identifying these opportunities. Spreads continue to provide a decent cushion against implied default rates.

We continue to take a constructive view of investment grade credit and remain confident that it will outperform Treasuries over the next six months. The magnitude of performance may be muted, however, compared to the massive outperformance in the first half of the year. We expect outperformance to come from the finance sectors of insurance, banking and REITs and from some of the high-cash-flow sectors such as media/cable, pipelines and tobacco. We believe the consumer-oriented and energy sectors will underperform in the coming quarter.

Aviva Investors is committed to disciplined analysis in credit selection and sector allocation and will continue to seek performance based primarily on the outlook for fundamental strength.