

Market Review

The U.S. should benefit heavily from fiscal stimulus and inventory rebuilding in the first half of 2010, resulting in a short-lived V-shaped recovery. We expect slower growth in the second half, however, as the impact of fiscal stimulus fades and small businesses and households continue to suffer from a lack of credit availability.

The Fed met two times in the fourth quarter and held the federal funds rate steady at 0 to 0.25%, continuing to state that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." While the Federal Reserve (Fed) will need to increase its attention on intermediate-term inflationary pressures as the economic recovery matures, we expect it to retain its policy of supporting growth in the near term.

The capital markets have improved substantially from the depths of the worst credit crisis in 50 years, as the recovery in risk appetites led to a strong reversal of the severe flight-to-quality conditions experienced in late 2008 and early 2009. U.S. bond markets sold off appreciably in the fourth quarter, as further evidence of an economic recovery led to significantly higher yields. The 10-year U.S. Treasury bond yield increased by more than 50 basis points (bps) to 3.84% in the quarter. The spread between 10-year and two-year Treasuries ended the year near historic wides, at 270 bps.

Continued strong signs of economic recovery led to further tightening of spread assets in the fourth quarter. The tightening of spread assets led the Barclays Capital U.S. Aggregated Index to outperform duration-adjusted treasuries by 105 bps in the fourth quarter and by 746 bps for the year.

The best-performing asset classes relative to duration adjusted treasuries were high yield (up 690 bps for the quarter and 5,955 bps for the year), CMBS (up 374 bps for the quarter and 2,960 bps for the year), ABS (up 168 bps for the quarter and 2,496 bps for the year) and investment grade credit (at +267 bps for the quarter and 1,990 bps for the year).

Market Outlook and Strategy

The early phase of the cyclical recovery, which includes signs of economic growth, stimulative policies and increased risk appetite, is an ideal environment for the performance of risk-based assets. We expect this environment to continue contributing to positive excess returns for investment grade, high yield and other non-government, fixed income securities. Increasing supply, the economic recovery and the lack of Fed purchases will pressure Treasury yields higher.

The yield curve remains at an extremely steep level, essentially forecasting an economic recovery. The yield curve is likely to flatten in 2010, however, and rates probably will increase as the markets anticipate interest rate hikes by the central bank and heavy U.S. Treasury bond issuance. While we expect long-term rates to rise, we expect them to be constrained by the slow economic recovery, moderate inflation expectations and demand from long-duration investors.

While fixed income credit spreads have tightened from record wide levels, they remain wide relative to long-term averages. We continue to see opportunities to profit from tighter spreads in credit and securitized markets, but we expect returns to increasingly be driven by security selection and industry allocation as opposed to broad systematic market movements.

Past performance is not indicative of future results. This commentary contains the current opinions of Aviva Investors and is not intended to be, and should not be interpreted as, a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This commentary is distributed for informational purposes only and is not a recommendation or investment advice. The information herein is based on sources which Aviva Investors believes to be reliable but is not guaranteed to be accurate or complete.

No part of this commentary may be reproduced in any form, or referred to in any other publication, without the express written permission of Aviva Investors North America, Inc.(AINA). This material was produced by AINA and no part of this material may be reproduced in any form, or referred to in any other publication, without advance written permission from AINA.