

## Economic Review

### **Recession ends, weak growth expectations translate to a jobless recovery**

The healing of the global economy and the stabilization of financial markets continued in the fourth quarter of 2009, as unprecedented monetary and fiscal stimulus helped pull the North American economy out of a deep recession. Economic growth turned positive, with a 2.2% increase in GDP, following four consecutive quarters of decline. Increases in personal spending, investments in residential housing and federal government spending drove growth. Declines in commercial real estate and an increase in imports hurt GDP growth, however. Expectations for inventory rebuilding to contribute to growth have not yet materialized; inventories continued to shrink. We believe the economy will continue expanding in 2010.

The Index of Leading Economic Indicators also is showing signs of improvement. It recorded a monthly increase of 0.9% in November, the eighth consecutive month of positive change. Outlooks for the next three to six months have improved, with positive expectations for labor markets and residential construction.

Labor market conditions remain weak, but leading employment indicators are showing signs of improvement, and we expect modest job growth to emerge in the coming months. Despite a three-decade-high U.S. unemployment rate of more than 10%, initial jobless claims have declined to a 17-month low of 432,000. Additionally, temporary employment and average hours worked have increased. These are strong indications that the worst of the employment downturn is likely behind us. Structural changes in the labor market, however, such as permanent layoffs and weaker expected economic growth, drive our expectations for another slow employment recovery.

Canada's downturn in employment was not nearly as pronounced, although the unemployment rate reached an 11-year high of more than 8.5% late in the year. Canada has already begun to experience positive employment growth, however, and even the hard-hit Canadian manufacturing base has begun to stabilize.

### **Manufacturing and service sectors deliver mixed messages**

The Institute for Supply Management (ISM) manufacturing index has reported five months of readings above 50, indicating that manufacturing growth is expanding. The index was 55.9 in December, a large improvement from a 28-year low of 32.9 a year ago. Inventory levels have fallen throughout the recession, so production is expected to grow as manufacturers work to meet demand and fill new orders.

The ISM non-manufacturing index increased only slightly to 50.1 in December, indicating that the services sector has been slow to improve. It has had a difficult time breaking above 50 since the start of the recession. The gauge for business activity increased in December, but new orders declined, and employment conditions and

export orders remained below 50. We expect the services sector to remain weak until consumer spending and the labor market improve.

### **Housing has likely bottomed**

U.S. home prices have stabilized, and sales activity has increased due to low mortgage rates and the housing-tax-credit program, which has been extended through April 2010. Existing home sales are up 44% from last year at this time, while home prices are up 5% from their lows earlier this year. Both building permits and new housing starts have seen increased activity. New and existing inventories have declined to 6.7 and 6.5 months from peaks of 11 months in 2008. Prior to 2006, the average supply of homes was around 4.5 months. While the housing market will continue suffering from excess supply and record mortgage delinquencies, we believe the worst of the crisis is behind us.

### **Consumer spending stabilizes**

Consumption has stabilized from the depths of the financial crisis, but consumers in both Canada and the U.S. continue to face headwinds because of high unemployment, tighter lending conditions, high debt levels and reduced wealth effects. Consumer spending was positive in the fourth quarter, as personal incomes increased slightly and retailers continued slashing prices to entice spending. Personal incomes increased 0.4% in November, the largest monthly increase in six months, while the savings rate remained steady at 4.7%. We expect the trends of increased saving and more moderate consumption to continue.

### **Inflation to remain contained**

The Personal Consumption Expenditures rate was unchanged year over year, at 1.4% in November, indicating that prices are remaining stable, and inflation is still well contained. We expect inflation to remain under control because excess capacity, including slack in the labor markets and low industrial capacity utilization levels, continue to prevent upward pressure on core inflation. The key risks to higher inflation include substantial further weakening of the U.S. Dollar and a sustained V-shaped economic recovery.

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 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". The Bank of Canada (BoC) held the overnight rate steady at 0.25%, while the Bank of England and the European Central Bank both held policy rates steady at 0.50% and 1.00% respectively in the fourth quarter. Australia, however, has begun a course of monetary tightening, raising its administered rate 75 basis points (bps) to 3.75%. Australia is the one major western country that escaped a recession, and it is now beginning to experience some evidence of inflation.

The Canadian Dollar continued its ascent in the fourth quarter, rallying from USD0.93 to USD0.95. The large and ever-increasing U.S. budget deficit, looming supply in the U.S. bond market and strong resource prices continue to power the loonie upward. The U.S. Dollar experienced this weakness versus all major currencies in the quarter.

## Capital Market Review

The capital markets have improved substantially from the depths of the worst credit crisis in 50 years, as the recovery in risk appetite leads to a strong reversal of the severe flight-to-quality conditions experienced in late 2008 and early 2009. North American 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 moved 50 bps higher to 3.84%, while the 10-year Canada bond yield increased 30 bps to 3.60% in the quarter. The spread between 10-year and 2-year Treasuries ended the year near historical wide at 270 bps. The market expects that the Fed will keep short-term rates low for an extended period and longer-term rates will increase as the economy recovers. The Standard & Poor's 500 Index was up 9.26% in the fourth quarter and up 65% from its low in March 2009.

Continued strong signs of economic recovery led to further spread tightening of corporate bond markets in the fourth quarter: Canadian corporate spreads tightened by 20 bps, while U.S. corporate spread compression was much more impressive, tightening close to 45 bps. As a result, the Canadian corporate market was once again the best performing sector in Canada for both the quarter and the year. Provincial bonds tightened marginally in the quarter, while federal bonds once again underperformed.

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, economic recovery and the lack of Fed purchases will pressure Treasury yields higher.

The systemic stability provided by global government and central bank actions has helped the transition from extreme illiquidity to more fluid capital markets. The reversal of investors' risk aversion during the credit crisis drove heavy outflows from money markets into investment grade and high yield fixed income investments. Issuance of investment grade and high yield bonds has exceeded previous annual records, while the heavy supply has been met with even stronger demand from institutional and retail investors, resulting in strong positive returns and substantially tighter credit spreads. U.S. investment grade credit rallied 48 bps in the fourth quarter and returned 16% for all of 2009. The financial sector was a lead performer for the quarter, with a total return of 2.6%. The U.S. high yield sector also rallied significantly and returned more than 6% for the fourth quarter and 58% for 2009.

New issuance in both the public and private credit markets was strong this quarter and is expected to continue into 2010, as investors have fresh capital to allocate. We see technical conditions remaining firm and keeping the tone of the marketplace positive. Corporate fundamentals have improved as a result of the economic recovery, cost-cutting efforts and improved access to capital. Companies' renewed access to the capital markets allowed them to retire debt and issue equity capital to reduce leverage and repair balance sheets. Significant cost-cutting efforts have positioned corporate earnings to benefit from top-line revenue growth.

## Summary

Monetary stimulus, including record low central bank rates, quantitative easing and liquidity-based programs aimed at stabilizing the financial system, has been unprecedented. While the Fed will need to increase its attention on intermediate-term inflationary pressures as the economic recovery matures, we expect it to favor supporting improving labor markets and growth over inflation in the near term. We expect the Fed and U.S. Treasury to cease quantitative easing and begin removing excess liquidity in the first half of 2010, but they will not begin tightening monetary policy until late 2010. The BoC is likely to initiate monetary policy tightening ahead of the Fed, because its economic fundamentals are more positive.

Market valuations of risky assets have increased substantially and are consistent with the position in the cycle. While fixed income credit spreads have tightened from record wide levels, they remain wide relative to long-term averages. We see opportunities to profit from tighter spreads in credit and securitized markets, but we expect returns to be driven increasingly by security selection and industry allocation as opposed to broad systemic market movements.

The yield curve in both the U.S. and Canada remains at an extremely steep level, essentially forecasting an economic recovery. The yield curve is likely to flatten in 2010, and rates probably will increase as the markets anticipate a hike in central bank rates and heavy U.S. Treasury and government of Canada 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.

**We expect a sustained but moderate economic recovery in North America in the upcoming year. In the first half of 2010, during the early stages of global economic recovery, the U.S. should benefit heavily from fiscal stimulus and inventory rebuilding, leading to a V-shaped recovery. We believe this strength will not be sustainable into the second half of the year, however, as the significant impact from fiscal and monetary stimulus begins to fade. As a result, the economic recovery in late 2010 and 2011 should be quite muted. In Canada, growth should be somewhat stronger in 2010 versus the U.S., due to stronger housing and labor markets and upward-trending resource prices.**

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