

Market Review

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.

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.

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.

Consumption has stabilized from the depths of the financial crisis, but consumers 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.

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 manufactures 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.

Capital Market Review

The capital markets have improved substantially from the bottom 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. The Standard & Poor's 500 Index was up 9.26% in the fourth quarter and up 65% from its low in March 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 yield curve remained steep, as the 10-year U.S. Treasury bond yield moved 50 bps higher to 3.84%, and the spread between 10-year and two-year Treasuries ended the year near historic 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 Barclays Capital U.S. Aggregated Index outperformed duration-adjusted treasuries by 105 bps in the fourth quarter and by 746 bps year to date.

Credit Market Review

The Barclays U.S. Credit Index delivered 267 bps of excess return for the quarter on 41 bps of spread tightening. The energy and finance sectors were the best-performing sectors, with energy led by refining and independent energy and non-captive consumer and life insurance topping the financial sector. Other notable performers in the industrial sectors were media non-cable, paper and building materials. The worst performers for the quarter were higher quality non-corporates, including supranationals and foreign local governments. The corporate sectors that underperformed were the high-quality, lower-volatility sectors and consumer non-cyclicals, including food and beverage, pharmaceuticals, supermarkets and healthcare. Lower-quality issues outperformed their higher-quality counterparts.

New issuance was heavy for the quarter, and the increase in supply was handily absorbed by high demand. Financials and taxable municipals were among the highest issuers. Investors are demonstrating concern about healthcare reform, commercial real estate and banking reform.

In its seventh consecutive month of outperformance, the Barclays U.S. Credit Index experienced 73 bps of excess return in October on 11 bps of tightening. Equities were down for the month, which supplied some pressure to spread tightening, so performance was muted compared to the past six months. Financials outperformed, led by non-captive consumer (Sally Mae) and non-captive diversified (GE Capital). REITs, banks and insurance also were notable positive performers. Paper (International Paper) and refining were strong, as well. The worst-performing sectors were non-corporates, specifically foreign local governments and sovereigns. Among industrials, railroads and healthcare also underperformed.

Investment grade mutual fund inflows were strong in October. We also saw pension funds increase their allocations to fixed income over equities. Dealer inventories remained relatively low, resulting in a limited supply, which added support to spread tightening and outperformance.

The Barclays U.S. Credit Index underperformed Treasuries for the first time since March, coming in at 2 bps under in November, as equities rallied 6% for the month. Demand for credit and technicals remained strong for the asset class, and investor demand exceeded the supply. Financials generally underperformed, primarily led by banks such as ABM AMRO, Citigroup and RBS. REITs posted positive performance, however. Industrials outperformed, led by entertainment – notably Time Warner, Inc. and Viacom – and by construction machinery and paper (International Paper). Basic materials and media also performed well. Underperformers included tobacco, non-captive diversified finance – led by GE Capital – and airlines.

In December, as flows and new issuance experienced their annual lightening, the Barclays U.S. Credit Index tightened by 30 bps, ending the year at 157 bps OAS. It outperformed Treasuries by 192 bps for the month. Life insurance was the best-performing sector, led by Genworth Financial and Nationwide. Non-captive consumer financials, including Sally Mae and Discover Financial Services also did well, joined by paper. Supranationals, foreign local governments and foreign agencies were among the worst performers, as were the high-quality defensive sectors of construction machinery (Deere and Caterpillar) and aerospace/defense (General Dynamics, Raytheon and Boeing). Lower-quality outperformed higher-quality sectors.

Fundamentals: Going forward, we expect to see stable margins as a result of past cost cutting. The outlook for revenue growth is gradually improving. Free cash flow is strong, and cash balances are high for individual companies. A pickup in mergers and acquisitions, share repurchases and dividends could represent a possible risk to the category, as managers focus on returning value to shareholders. We do not, however, see this reaching the point of extreme balance sheet deterioration as it has in past cycles.

Technicals: Demand remains strong, with a stable buyer base for investment grade corporates. Insurance companies remain active, and pension fund managers are shifting toward fixed income vs. equity investments in response to changing regulations. Interest from banks and foreign accounts also is growing. Offsetting this, we could see a decline in retail mutual fund flows, depending on equity market performance. The current overweight of many investment grade funds also represents a risk. Finally, any unexpected negative event could create a temporary pullback in the market.

Valuations: Current valuations are relatively cheap versus historic levels. Spread levels also are cheap relative to default forecasts and historic default rates.

For 2010, we recommend a moderate overweight to investment grade corporate bonds, and we expect spread tightening to continue due to improved fundamental conditions, supportive technical factors and attractive valuations. Since the peak of the credit cycle, average corporate balance sheet leverage has declined from three times to two times and is expected to continue declining as corporate profits and cash flows improve in 2010. New issue supply is expected to decline by 20% due to already-liquid corporate balance sheets and limited refinancing needs. The reduced new issue calendar and limited opportunities in other spread asset classes will create favorable supply/demand conditions that will support credit spread tightening. The investment grade credit market has retraced approximately two thirds of the recent cycle's spread widening. Given where we are in the current credit cycle, we anticipate additional retracement in 2010, which further supports current market valuations as being attractive.

Unlike 2009, when spread tightening and credit performance were broad based, we expect 2010 spread tightening to be more security specific. Financials, lower-rated issuers in improving sectors and taxable municipal Build America Bonds should see better performance during 2010 than high quality industrial names.

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