

Market Review

With a 5.6% increase, the fourth quarter was the second quarter in a row showing GDP growth. Increases in inventory investments, personal spending and exports were the primary drivers. Expectations for inventory rebuilding have finally materialized, and we believe the economy will continue expanding in 2010. The Index of Leading Economic Indicators also continues to show signs of improvement. With an increase of 0.1%, February marked the eleventh consecutive monthly gain, which is driving a positive outlook for the next three to six months.

Labor markets have shown signs of stabilizing, and leading employment indicators continue to improve, as well. March payroll numbers were positive for the first time since December 2007, reporting 162,000 additional jobs. The U.S. unemployment rate has declined from more than 10% to 9.7%, and initial jobless claims have been trending lower. These are strong leading indicators that the worst of the employment downturn is behind us.

The Institute for Supply Management (ISM) manufacturing index has remained above 50 for eight months, indicating that manufacturing growth is expanding. The ISM non-manufacturing index has remained above 50 in 2010 as well, indicating that the services sector is expanding, too.

Consumer spending has been positive for five straight months, as rising equity markets and home prices increase the wealth effect and support spending. Personal incomes were flat in February, decreasing the savings rate to 3.1%, the lowest level in more than a year. As the economy and labor markets recover, consumer confidence has improved.

The Core Personal Consumption Expenditures price index year over year was lower, at 1.3% in February, indicating that prices remain stable and inflation is still well contained. We expect inflation to remain under control, because of recent dollar strength, excess capacity, slack in the labor markets and low industrial capacity utilization levels. The key risks to higher inflation include substantial weakening of the U.S. Dollar and a sustained V-shaped economic recovery.

Lower mortgage rates, lower prices and the extension of the homebuyer tax credit have made homes more affordable, led to more activity and stabilized prices. Home prices have steadily increased on a seasonally adjusted basis for eight straight months, and they are now down only 0.7% year over year, the smallest decline in more than three years. Even as housing prices have stabilized, the economy continues to work through the large amount of inventory, and the new supply of foreclosed homes continues to increase.

Capital Market Review

The Federal Open Markets Committee (FOMC or the Fed) has met twice this year. Although the Fed recognizes that the economy is stabilizing, inflation expectations remain muted, and low resource utilization rates warrant keeping the federal funds rate low for an extended period. The rate remains at 0 to 0.25%, but the Fed has increased the discount rate to 0.50% and allowed various financial stimulative programs to expire in an effort to drain excess liquidity from the system.

The capital markets have continued to improve, as risk appetites have increased with signs of a sustained economic recovery. The reversal of investors' risk aversion following the credit crisis drove heavy investments into investment grade fixed income investments. Issuance has remained strong, and the heavy supply has been met with even stronger demand from institutional and retail investors, resulting in positive returns and substantially tighter credit spreads. U.S. investment grade credit rallied another 22 basis points (bps) in the first quarter and returned 2.27%.

We believe technical conditions and investor sentiment will remain firm and keep 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. According to the Commerce Department, fourth-quarter corporate profits increased by nearly \$109 billion from the prior quarter, and earnings posted a 31% annual increase.

Credit Market Review

U.S. Treasury yields remained relatively unchanged in the first quarter, as the FOMC reiterated its intentions to keep the target rate low for an extended period. The 10-year Treasury rate was lower by one bp to close the quarter at 3.83%. The spread between 10-year and 2-year Treasuries ended the quarter about 10 bps steeper at 280 bps.

The Barclays U.S. Credit Index outperformed duration-neutral Treasuries by 113 bps. In January, credit underperformed Treasuries by 16 bps, and credit spreads tightened one bp. The trend reversed in February, when credit outperformed Treasuries by one bp, and credit spreads widened two bps. Credit soared ahead of Treasuries in March, outperforming duration-neutral Treasuries by 125 bps, and with spreads tightening by 22 bps. All major credit sectors generated positive excess returns versus Treasuries. Financials led the way, with

171 bps of excess return. Non-corporates generated 106 bps of excess return, followed by utilities at 93 bps.

January started solid for both U.S. equities and corporate bonds. Liquidity conditions for active trading in bonds were generally favorable. The market tone deteriorated toward the end of the month, however, as policy- and event-risk concerns grew, including financial concerns about Europe and Greece, in particular. Domestic regulatory concerns also returned. Eventually, equities and credit spreads lost their gains. The Barclays Capital Credit Index tightened one bp but underperformed, with -16 bps of excess return. The best-performing sectors were REITS (Tanger and HRPT among many others), healthcare (Aetna, CIGNA and Humana) and P&C insurance (Arch Capital, Endurance and Munich Re), packaging and brokerage (Ameriprise, Lazard and Raymond James). The worst-performing sectors were sovereigns (Peru and Brazil), metals and mining (Rio Tinto), independent and integrated energy (Nexen, Talisman, Devon, Eni S.p.A., Hess and ConocoPhillips) and retailers (Target, Wal-Mart and Lowe's). Banks marginally underperformed the index, but U.S. senior bonds underperformed, while Yankee and subordinated securities outperformed.

February started where January left off, with concerns surrounding sovereigns. The Barclays Capital Credit Index outperformed Treasuries by a single basis point for the month as a result of the index widening two bps during the month to end at 158 OAS. Sectors with European credits tended to underperform the most, while higher quality sectors outperformed. In addition to sovereign uncertainty, domestic regulatory concerns around financials and healthcare remained at the forefront. The best-performing sectors were oil field services (Smith International, Weatherford and Baker Hughes), independent energy (particularly rebounds by Nexen, Anadarko and EOG Resources), a rebound in retailers from January (Costco, Wal-Mart and CVS) and select sovereign rebounds (Peru, Mexico and Brazil). The higher-quality non-corporate bucket was the best performer after being the worst sector for all of 2009. The worst-performing sectors were life insurance (MetLife, Hartford and AEGON), banking (ABBEY, Bank of America and UBS) and wirelines (Telecom Italia, British Telecommunications, and Deutsche Telekom). Banking and telecom sectors were predominantly affected by the European credits, which spread to peers in the sector.

As a recovery in the European sovereign crisis appeared to take shape, liquidity returned to the U.S. credit market in March. The U. S Credit Index tightened 22 bps, outperforming Treasuries by 125 bps. This level of excess return illustrated the strong demand for U.S. credit even in light of relatively heavy supply. Financials outperformed, led by life insurance (namely AIG and Genworth). Other strong performing finance sectors were off-the-run finance companies and banks. Peru and Mexico helped lead

the sovereign sector to positive performance, and Alcoa, Vale and Freeport McMoran contributed positively to metals and mining. Low-beta sectors underperformed, including some of the university-issued debt and supranationals. Railroads, health insurance, aerospace/defense and food and beverage also underperformed.

Fixed income flows were strong in the quarter, as mutual funds, insurance companies and pensions continued buying investment grade corporates, absorbing the heavy supply we witnessed in March. Consequently, average new issue concessions have been very small, with select issuers pricing on top of – if not through – where outstanding secondary issues were trading. Supporting this positive supply/demand technical is the relatively low level of dealer inventory.

Valuations are no longer discernibly cheap versus a year ago. Spreads have retraced roughly 75% of the wide point of 2008. Comparing to historical levels, however, we still see upside potential for investment grade corporates.

Also in the quarter, we have seen a renewed concern over LBO speculation. Although we've had no LBO transactions in the investment grade asset class so far this year, several lists of 2005-2007 LBO candidates have been dusted off. This attention could keep spreads in check on some specific industrial credits, based on the risk premium associated with potential LBOs. We don't expect major LBO activity to heat up, but this overhang could drag performance down for some credits.

Many companies are carrying high cash balances and generating significant free cash flow as a result of past balance sheet repair and a focus on improving margins through cost containment. Rather than using this position to engage in full-fledged leveraging transactions, we expect companies to return the excess cash to shareholders through share repurchases or special dividends. We don't see this as a major threat to spread widening, however, because most companies are generating enough free cash flow and profits to generally reduce their net debt.

The effects of regulatory reform on financials and healthcare also continue to cause concerns for their sectors.

We continue to maintain our overweight view toward this asset class. For the first quarter, lower-quality credits have compressed to higher-quality credits, and financials have compressed to industrials – both trends that we expect to continue. As a result, we will maintain overweights to financials, particularly banks and insurance. We also continue to overweight BBBs versus As or AAs.

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