

## Market Review

The U.S. continued to benefit from fiscal and monetary stimulus as well as inventory rebuilding in the second quarter of 2010. We expect moderate growth of 2.0% to 3.0% in the second half, as the impact of fiscal and monetary stimulus fades and small businesses and households suffer from lack of credit availability.

The Fed has continued to leave the federal funds rate unchanged at 0 to 0.25% through 2010. We believe it will remain on hold until late 2011 or 2012, due to excess capacity, low core inflation and inflation expectations, stubbornly high unemployment and slower expected economic growth. The committee recognizes that some metrics are gradually improving but that financial concerns abroad could weigh on domestic growth. The Fed also has reiterated that muted inflation expectations and low resource utilization rates warrant keeping rates low for an extended period. A flight-to-quality trade has led investors to sell stocks and other risky assets and instead purchase government securities and high-quality bonds.

Treasury rates declined, as expectations for a rate increase in 2010 have dissipated and inflation concerns remain contained. Ten-year Treasury rates declined by 88 bps to close the second quarter at 2.95%. The spread between 10-year and 2-year Treasuries narrowed approximately 48 bps to 233 bps. The Standard & Poor's 500 Index declined 11.86% and is down 7.56% year to date. The Barclays Capital U.S. Aggregated Index underperformed duration-adjusted Treasuries by 55 bps in the quarter, with 63 bps of the underperformance coming in May.

Spreads widened across all risk assets. U.S. investment grade corporate bonds widened by 43 bps; U.S. mortgage-backed securities (MBS), asset-backed securities (ABS) and commercial-asset-backed securities (CMBS) widened by 36, 21 and 43 bps, respectively; and U.S. high yield corporate bonds widened by 131 bps. The best-performing asset classes vs. duration-adjusted Treasuries for the quarter were MBS (-1 bp) ABS (-8 bps) and CMBS (-67 bps). Worst were investment grade (-223 bps) and high yield (-386 bps).

## Market Outlook

With heightened volatility and continued uncertainty in Europe, we expect waters to remain choppy. The fundamental environment remains supportive of future credit performance, while technical market conditions warrant conservative positioning in the short term. We believe strong fundamentals and more-attractive valuations will

begin to win out in investors' minds over the coming months, when the technical- and sentiment-driven dust settles.

The yield curve is likely to flatten, and we expect rates to remain low and range bound, as inflation remains well contained and Treasuries benefit from the flight to quality in an uncertain and higher- volatility investment environment.

Credit fundamentals remain strong. Balance sheets are in good shape, and earnings are improving due to recent cost-cutting efforts. This should help support moderate economic growth. The environment for credit remains positive, distinguished by solid earnings growth, stimulative policy, and low borrowing costs.

Technical market conditions for risky assets have been negative, however, as risk appetites have turned downward and various measures of risk – including equity market volatility and credit spread volatility – have moved higher. The uncertainty surrounding the timing and ultimate resolution of European sovereign fiscal issues will likely keep overall levels of risk elevated over the near term.

Demand has declined for risk assets and has been very strong for high-quality government asset classes. As a flight to quality trade has developed, spreads have widened. As strong fundamentals and more-attractive valuations begin to influence investors, however, we expect demand for risk assets to increase again in the intermediate term.

We expect the 10-year treasury to range between 2.75% and 3.50% over the coming quarters. While the issuance of treasuries is expected to remain at historically high levels, interest rates are expected to remain low over the intermediate term. Inflation remains well contained, the timing of FOMC rate increases continue to be pushed further into the future, and treasuries should benefit from the flight to quality trade in a higher volatility environment.

**The risks to the economic and investment outlook are focused on:**

1. The impact of proposed financial reform regulation.
2. Fixing global sovereign fiscal issues and the related spillover risks into the global economy.
3. The timing and magnitude of unwinding monetary and fiscal stimulus.

The outcome of these events will have a material impact on investment performance in the second half of 2010.

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