

Economic Review

Economy recovers, though growth is muted

The massive coordinated policy stimulus of the past two years has resulted in a post-recession global economic recovery. U.S. economic growth has benefited heavily from government stimulus spending and re-stocking of business inventories that were depleted during the recession. The expectation for continued economic growth of 2.0% to 3.0% is rather muted, given the depth of the recent recession and relative to historical early-cycle recoveries. This is primarily due to subdued consumer spending, borrowing and consumption, which normally lead a recovery.

GDP expanded by 2.7% in the first quarter of 2010 following a 5.6% increase in the fourth quarter of 2009. Positive growth was attributed to increases in personal consumption and exports. This was partially offset by a deceleration in residential investments and negative growth in government spending. Inventories have continued to increase as expected, but the state of the consumer remains weak.

Leading economic indicators increased 0.4% in May and were up 7.9% on a six-month basis. Month-over-month increases have moderated from the end of 2009 but still indicate a modestly positive outlook for the next three to six months.

Job growth stalls

June payrolls reported a loss of 125,000 jobs compared to a gain of 431,000 in May. This can be attributed largely to temporary hiring for the 2010 Census. Additionally, the market has been focused on using private-sector unemployment as an indicator for the economy. The private sector has been slow to add new jobs, with only 116,000 the last two months. This reinforces our expectations of a jobless recovery. The unemployment rate trended down to 9.5% in June, mostly due to falloff from the unemployed who've given up on the job search. Aviva Investors expects a slow, grinding improvement in the employment picture, as businesses remain reluctant to hire.

Manufacturing, service growth slower than expected

Manufacturing data released during the second quarter shows growth for the industry expanding at a slower pace than expected. The Institute for Supply Management (ISM) manufacturing index has trended down from 60.4 in April to 56.2 in June. Any reading above 50 indicates expansion, but the recent trend illustrates that the economy is slowing from its initial post-recession pace. Underlying data shows a slowdown of growth in most of the major components, including production and new orders.

Growth in the service sector also appears to be stalling out. The June ISM non-manufacturing report declined slightly to 53.8 from 55.4 from the March report. The service sector is not expected to

substantially rebound until we see further improvement for the consumer and employment.

Housing activity metrics draw back

The end of the new-homebuyer tax credit has led to a drawback in several housing activity metrics. We believe the consumer will struggle to invest in the residential market until employment begins to rebound. Additionally, lending standards remain tight, making it extremely difficult for many consumers to qualify for a new mortgage. For May, existing home sales were down 2.2%, new-home sales were down 32.7%, housing starts were down 10%, and housing permits were down 5.9%. The supply of unsold homes also has increased from recent lows. It reached 8.3 months in May, after government tax credits helped to clear some inventory, resulting in a 6.5-month supply in November 2009. With the expiration of the housing tax credit and the continued record levels of mortgage delinquencies and foreclosures, Aviva Investors expects the housing market to continue bumping along the bottom though avoiding a double dip.

Consumer plays smaller role

Consumers have played a smaller role relative to past recoveries for three reasons: They were heavily over leveraged heading into the recession, they've experienced significantly tighter credit conditions following the credit crisis, and they've suffered continued weakness in the labor markets. Consumption has improved, but it remains well below previous cyclical recoveries, which were heavily fueled by borrowing and consumption.

Consumer confidence dropped by about 10 points in June to 52.9, after rising for three consecutive months. This reflects a worsening outlook for business conditions and employment over the next six months. After rising for eight consecutive months, retail sales for May dropped by 1.2%. Underlying data indicates the decline was caused by a large decrease in spending on building materials following a dramatic rise in March and April. We expect retail sales activity to remain modestly positive over the next several months.

In summary, our outlook for U.S. economic growth calls for a moderate recovery of 2% to 3% over the next 12 to 18 months, with an increase to downside risk due to weakness surrounding the consumer, spillover impacts from the European sovereign debt crisis and related equity market correction. We are intently watching the European sovereign crisis unfold, with a particularly close eye turned toward Spain. Greece, Portugal and Ireland represent less than 3% of total European Union GDP each, so their risks appear manageable. If Spain were to require a bailout, however, it would pose a bigger systemic problem for risk assets and would further affect the political problems facing the European Union.

Inflation and inflation expectations continue to be very well contained due to excess industrial capacity and slack in the labor markets, which reduces upward pricing pressure. We believe that inflation will remain well contained in the short to intermediate term, with risks beginning to tilt toward lower vs. higher inflation.

Capital Market Outlook

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. The Bank of Canada raised its overnight rate in May by 25 basis points (bps) to 0.5%, while the Bank of England and the European Central Banks have left policy rates unchanged from last quarter.

We are currently experiencing a healthy correction in credit fixed income markets as risk appetites have turned negative based on sovereign debt fears, concern over the effects of U.S. financial regulatory reform, equity market correction and rising volatility measures.

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. Within the fixed income markets, higher-quality and government bonds outperformed credit fixed income as investment grade and high yield credit spreads widened 43 and 131 bps, respectively.

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.

Investment View

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 intermediate term, when the technical- and sentiment-driven dust settles.

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 as inflation remains well contained, the timing of any FOMC rate increases continues to be pushed further into the future and treasuries 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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