

Market Review

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.

Job growth has stalled, with June payrolls reporting 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.

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. Growth in the service sector also appears to be stalling out. The ISM non-manufacturing report has remained unchanged, at 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.

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 high, making it extremely difficult for many consumers to qualify for a new mortgage. Aviva Investors expects the housing market to continue bumping along the bottom though avoiding a double dip.

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.

In summary, our outlook for U.S. economic growth calls for a moderate recovery of 2.0% to 3.0% 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.

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 Review

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.

Credit Market Review

The capital markets have deteriorated, and risk appetites have decreased with the development of fiscal problems in Europe, a correction in equity markets and the financial regulatory reform bill.

U.S. Treasury yields declined significantly in the second quarter, as investors pushed out the timing of the first rate hike, inflation expectations declined, and a flight to quality trade all led to stronger demand for U.S. Treasuries.

The 10-year Treasury rate was lower by 88 basis points (bps) to close the quarter at 2.95%. The spread between 10-year and 2-year Treasuries ended the quarter about 48 bps flatter, at 233 bps.

The Barclays U. S. Credit Index underperformed duration-neutral Treasuries for the quarter by 233 basis points. Credit outperformed Treasuries by 41 bps in the first month of the quarter, and credit spreads tightened 4 bps. The trend reversed dramatically in May, however, when credit underperformed Treasuries by 237 bps, and spreads widened by 40 bps. The trend continued, though moderating, in June, when credit underperformed Treasuries by 19 bps, and spreads widened 7 bps further.

The Barclays Capital U.S. Credit market tightened by 4 bps in April, ending the month at 132 OAS.

This resulted in outperformance of 41 bps versus Treasuries. On a total return basis, investment grade credit outperformed Treasuries and the Standard

& Poor's 500 Equity Index (S&P 500), while high yield outperformed investment grade. The same themes continue to affect the credit markets, including concerns over the sovereign crisis, notably worries over Portugal, Ireland, Italy, Greece, Spain and the UK. Domestic financial regulatory reform concerns also remain elevated. Both themes resulted in a choppy second half of the month. Higher-beta, lower-quality sectors outperformed, while the non-corporate bucket tended to be the worst performer due to higher quality and select sovereign concerns. Sectors with European credits, notably telecommunications and banking, tended to underperform, as well. The best-performing sectors were refining (Valero Energy, Sunoco), REITs (Mack-Cali Realty, Realty Income, HRPT Properties) and packaging and paper (Pactiv, Bemis, International Paper). The worst-performing sectors were sovereigns (Italy), foreign agencies, supranationals, oil field services and banking (ABBIEY, Goldman Sachs).

May was a tough month for credit-risk-related asset classes.

The Barclays Capital U.S. Credit market widened by 40 bps, ending the month at 172 OAS. This resulted in underperformance of 237 bps versus Treasuries. On a total return basis, investment grade credit outperformed other risk asset classes of the S&P 500 and high yield fixed income. In addition to concerns over the European sovereign crisis and U.S. financial regulatory reform, worries around the Gulf of Mexico oil spill escalated. A couple of technical factors also influenced credit spread movements this month. As equity volatility continued to increase during the month, spreads widened in connection. Similarly, Treasury rates dropped roughly 30 bps during the month. This prompted the yield bogey buyer to require higher spreads to compensate. As a result, the higher-beta, lower-quality sectors, which had outperformed leading up to May, underperformed during the month. The biggest negative influence on the credit market, however, was the Gulf of Mexico oil spill. The energy-related sectors of oil field services, refining, pipelines and independent energy were the foremost underperformers. The life insurance sector (mainly hybrid securities), basic industries, and European banks and telecom also underperformed. Offsetting these was good performance coming from the higher-quality, low-beta sectors of aerospace/defense, healthcare, diversified manufacturing and supranationals.

Market themes from May continued during the month of June.

Concerns around European sovereigns and the Gulf of Mexico oil spill dominated the headlines and performance. These negative events prompted a flight-to-quality trade throughout June. U.S. investment grade credit posted negative excess returns versus Treasuries but outperformed high yield fixed income and the S&P 500. The Barclays Capital U.S. Credit market widened by 7 bps, ending at 179 OAS. This resulted in underperformance of 19 bps vs. Treasuries. The flight-to-quality theme drove performance at the sector and asset class levels. AA and A credits outperformed BBBs and crossovers. Most of June's performance was a repeat of May, as lower Treasury rates and lower all-in yields affected relative performance. Treasury rates again dropped roughly 30 bps. Offsetting underperformance of the oil-

related sectors this month were higher-quality, low-beta sectors in the cyclical and non cyclical industries of retailers, restaurants, tobacco, entertainment and cable.

Concerns over the sovereign crisis are likely to be the biggest catalyst for spread movement in the third quarter.

We are keeping a particularly close eye turned toward Spain. Because Greece, Portugal and Ireland represent less than 3% of total European Union GDP each, 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.

We believe technical conditions and investor sentiment will generally remain constructive for investment grade credit (aside from the specific themes previously mentioned).

Dealer inventory levels are relatively low, affording room for balance sheet risk at the dealers. By contrast, investor cash balances are average to high, so investors have the need and ability to put their money to work. The new issue backlog remains healthy, supported by low all-in yields, which are generally a positive for investment grade credit. Mutual fund flows also have been strong year to date, which is another positive for investment grade credit. More recently, however, we have witnessed a couple of weeks of outflow. Because these flows are a good sentiment indicator, we will be watching the trend closely.

We expect credit spreads to remain choppy for the third quarter.

With limited liquidity and European headwinds, spreads will drift wider on macro global outlook themes. Valuations look relatively attractive on a historical basis vs. other asset classes. Liquidity is somewhat limited, though not terrible, and we don't expect it to materially improve in the foreseeable future. New issues will likely be absorbed by market demand. Credit spreads continue to be wide of historical norms and are biased to tighten as U.S. financial reform is finalized. We expect to have more transparency into the details of U.S. financial reform in the third quarter, which may help us better understand the expected effects of the new regulation. Individual company credit fundamentals continue to improve.

Despite solid credit fundamentals, we expect demand for investment grade credit to be muted by risk aversion due to European contagion fears, low Treasury rates and low absolute credit yields.

Lower demand will restrict spread tightening, as consumers hold their credit exposure steady rather than increasing it over the next several months.

Given the current market uncertainty, outperformance in the near term will be driven by higher-quality credit names with limited European exposure.

As solutions to the European debt crisis become clearer, risk aversion will subside, and outperformance will once again be driven by sector and security selection that is supported by improving credit fundamentals.

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