Core Aggregate Commentary

Third Quarter 2010

AVIVA INVESTORS

Market Review

Economic and political uncertainty dominated the financial markets during the third quarter. The slow-growth jobless economic recovery continued, as corporations remained reluctant to hire workers in the face of uncertainty regarding the global economy and political and regulatory changes. The slowdown in the global economy that started in the spring sparked fears of a double-dip recession in the U.S. Mid-cycle economic slowdowns are not unusual, however. They typically occur four to six quarters into an economic recovery.

The latest FOMC statement recognized the weakness in economic data since the last meeting, acknowledged that inflation is too low for comfort, and reiterated the Fed's commitment to support economic growth through another round of quantitative easing (QE). The Fed held the federal funds rate unchanged, at 0 to 0.25%, and committed to remain on hold for an extended period. We believe the Fed will hold until late 2011 or 2012, due to excess capacity, low core inflation and inflation expectations, stubbornly high unemployment and slow expected economic growth.

Treasury rates declined, as the Fed began purchasing Treasuries with the pay downs from its mortgage-backed securities (MBS) portfolio and as the market environment became more uncertain. Ten-year Treasury rates declined by 42 basis points (bps) to close the second quarter at 2.51%. The spread between 10-year and 2-year Treasuries narrowed approximately 24 bps to 209 bps. The Standard & Poor's 500 Index increased 11.27% and is now up 3.84% year to date. The Barclays Capital U.S. Aggregated Index outperformed duration-adjusted Treasuries by 36 bps in the quarter, with 68 bps of outperformance year to date.

Spreads narrowed across all risk assets except MBS. U.S. investment grade corporate bond spreads narrowed by 24 bps; asset-backed securities (ABS) and commercial-mortgage-backed securities (CMBS) spreads narrowed by 18 and 64 bps, respectively; and U.S. high yield corporate bond spreads narrowed by 131 bps, while U.S. MBS spreads widened by 60 bps. The best-performing asset classes vs. duration-adjusted Treasuries for the quarter were CMBS (+427 bps), high yield corporate bonds (+426 bps) and investment grade corporate bonds (+144 bps), while MBS underperformed duration-adjusted Treasuries by 31 bps.

Market Outlook

We believe the Fed will launch another QE program of asset purchases aimed at lowering long-term rates. We are skeptical, however, that QE alone will have much of a sustainable effect on the economy. Lower rates will not fix the problem of lack of demand in the economy or the inability of "underwater" homeowners to refinance. In addition to monetary policy, we believe that targeted fiscal policy actions will be required to close the output gap and generate sustained economic growth.

Credit fundamentals remain strong. Balance sheets are in good shape, corporations are flush with cash, and earnings are improving due to improved efficiencies and increased productivity. The slow- growth environment supports future credit performance, as businesses remain reluctant to increase leverage, corporate borrowing rates are at the lowest levels since the 1950s, and Fed policy reduces the likelihood of a double-dip recession.

Technical market conditions for risky assets have improved over the last quarter, as risk appetites have become more balanced and investor demand for yield in a low-rate environment has buoyed demand for corporate bonds. While uncertainty surrounding the timing and ultimate resolution of European sovereign fiscal issues remains outstanding, U.S. credit markets were less correlated with European sovereign credit spread volatility. Corporations have taken advantage of low rates and investor demand by issuing more than $600 billion in investment grade bonds and an annual record of $190 billion in high yield debt in 2010. The demand for fixed income continues to outstrip supply, however, as heavy investor demand and bond fund inflows combine with the lower relative supply of non-Treasury fixed income assets, primarily issuance of AAA structured assets that have declined significantly since the market downturn.

The fundamental environment remains supportive of future credit performance, but market volatility and uncertainty warrant conservative positioning in the short term. We believe strong fundamentals, attractive valuations and investor demand for yield will lead to modest positive performance for fixed income risk assets over the intermediate term. The current market environment remains highly uncertain, however, given risks to economic growth and European sovereign debt, as well as uncertainty about U.S. policy changes and upcoming elections. This leads to a lower level of conviction and warrants reduced portfolio risk positioning heading into late 2010 and early 2011.

We expect rates to stay low, with the 10-year Treasury ranging between 2.25% and 3.25% over the coming quarters. Interest rates over the intermediate term are expected to drift higher but remain relatively low, as the Fed sustains its hold, inflation remains well contained, bank demand for Treasuries continues strong, and additional QE puts downward pressure on rates.

The risks to our economic and investment outlook are focused on:

1. The impact of financial reform regulation, tax law changes and political uncertainties
2. European sovereign fiscal issues and the related spillover risks into the global economy
3. Potential monetary and fiscal policy errors

These risks will keep volatility elevated and conviction levels of investment views lower during late 2010 and heading into 2011.

Source: Barclays Capital; J.P. Morgan; AMG Data Services; Moody’s Investors Service