

## Economic Commentary

### Slow growth, jobless economic recovery to continue

Economic and political uncertainty dominated the financial markets during the third quarter. The slow-growth jobless economic recovery continued during the third quarter, 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.

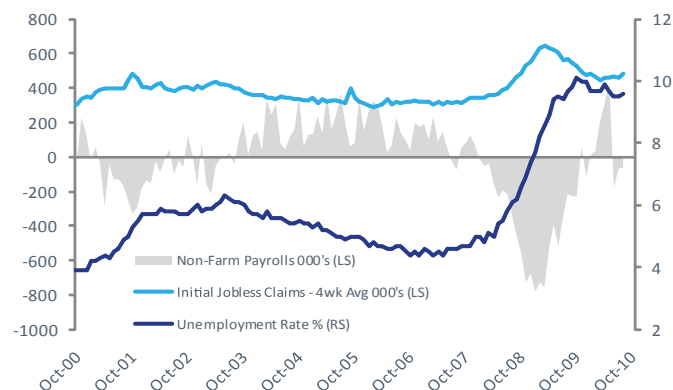
GDP expanded by 1.7% in the second quarter of 2010, following a 2.7% increase in the first quarter. The positive economic effects from fiscal stimulus and re-stocking of business inventories that were depleted during the recession began to fade during the second and third quarters. The trade balance also affected the slowdown in growth negatively, as the trade deficit subtracted 3.5% from GDP growth in the second quarter.

We expect the trend of sluggish, albeit positive, U.S. growth to continue due to economic headwinds, including the stubbornly high unemployment rate, weak consumer spending and the tight credit conditions that continue to challenge small business access to capital. We expect global growth to remain positive, buoyed by Asian growth and resource economies, including Canada.

### Job growth to remain sluggish

While the September labor market data has not yet been released, labor market statistics from the first two months of the third quarter show continued weakness. August payrolls reported a loss of 54,000 jobs, the same number as July. The total job loss was negatively affected by the reduction in census jobs, while private payrolls increased by 67,000 in August and 107,000 in July. The private sector is still reluctant to hire, but has added jobs every month in 2010. Small businesses, which employ more than 50% of U.S. workers, are unwilling to hire new workers in the face of economic uncertainty and the lack of credit to expand and start new businesses. The unemployment rate remains stubbornly high, at 9.6% as of August, and initial jobless claims have been stuck in a range of 420,000 to 500,000 all year. While year-to-date 2010 payroll growth has been modestly positive, cumulative job losses since the beginning of the recession remain near 8,000,000. These trends reinforce Aviva Investors' expectations of a slow, grinding improvement in employment, as businesses remain reluctant to hire permanent employees.

### Labor Markets



Source: Bloomberg

### Corporate sector remains resilient

Corporate earnings were largely positive during the second quarter, as businesses continued to benefit from improved efficiencies and high productivity. The Institute for Supply Management (ISM) manufacturing index trended down during the third quarter, from 56.2 in June to 54.4 in September. Any reading above 50 indicates expansion, but the recent trend illustrates that the economy is slowing from its early-cycle recovery.

Growth in the service sector also appears to be moderating. The September ISM non-manufacturing report declined to 53.2 from 53.8 in June. We expect the service sector to expand modestly unless we see a stronger employment recovery, which could lead to stronger consumption.

### Weak housing market to persist

The expiration of the new-homebuyer tax credit has led to a broad decline in housing market activity. The tax credit temporarily supported the housing market by front loading demand, which led to higher sales of new and existing homes in the first half of 2010. This temporary increase in demand has faded, however. New home sales have slid, and the supply of unsold homes remains elevated. 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.

### Weak consumption driven by sluggish employment

Consumption has improved, but it remains well below previous cyclical recoveries, which were heavily fueled by borrowing and consumption. While August retail sales, which were released in September, surprised on the upside, consumer spending continues mixed, similar to other economic indicators. We expect retail sales activity to remain modestly positive unless job market conditions show stronger improvement.

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 the risk of deflation remaining the focus of the markets and the Fed.

In summary, our outlook for the U.S. economy calls for slow growth – below 3% – for the remainder of 2010 and 2011. Alternative scenarios are tilted toward downside risk due to a weak consumer, European sovereign debt risks, and uncertainty about tax laws, financial reform regulation and upcoming elections.

## Investment Outlook

### Fed committed to additional quantitative easing

The latest FOMC statement recognized the weakness in economic data since the last meeting, acknowledged that inflation is too low for comfort, and reiterated its 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. The Bank of Canada raised its overnight rate an additional 50 basis points (bps) during the third quarter to 1.0%, while the Bank of England and the European Central Bank have left policy rates unchanged from last quarter.

We believe the Fed will likely 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.

### Risk assets exhibit strong performance

Despite economic and policy uncertainty, government bonds and risk assets experienced positive performance during the third quarter. Treasury rates declined, as expectations for additional QE drove 10-year Treasury rates to decline by 42 bps to close the third 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 returned 11.27% and is up 3.84% year to date. Within the fixed income markets, investment grade and high yield credit

outperformed Treasuries, with spreads tightening by 19 and 87 bps, respectively.

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.

### Strong demand for yield will support credit spreads and low Treasury rates

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.

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