

Market Review

Following a flat second quarter that reminded many investors of their doomsday concerns, the high yield market took a sharp turn and surged 3.52% in July, marking its best month in 2010. Despite the Fed's promises to keep rates at exceptionally low levels for an extended period and its announcement of a reinvestment plan, the high yield market was not able to live up to the record performance in July, recording a return of only 3 basis points (bps) in August. In September, investors were welcomed by a round of positive economic releases. Retail same-store sales increased by 3.6% for August, well above consensus, and initial jobless claims fell to 453,000 for the week ending September 25, the lowest level since July. The high yield market posted a 2.96% gain in September, bringing the year-to-date total to 11.35%.

U.S. high yield corporate spreads tightened by 85 bps from the end of the second quarter to 660 bps at the end of September. The 660-bps level is still approximately 80 bps higher than the lowest level of the year (576 bps on April 26) and is right around the 2009 yearend level of 662 bps. Current spreads remain attractive compared to the long-term average of around 550 bps. Most notably, BB and B spreads are 116 bps and 73 bps wider than their 17-year historical averages, while CCC spreads are 47 bps inside their historical average of 1,042 bps.

We saw a record \$70.1 billion of new issues priced in the third quarter. Most of the quarter's volume was recorded in September, when issuers raised \$32 billion, just \$3 billion short of the record issuance of March 2010. July and August contributed \$14.3 billion and \$23.8 billion, respectively. Year to date, new issuance totaled \$179.5 billion, which is the most the high yield market has raised annually for the past 15 years. The 2010 year-to-date number already surpassed the previous full-year record of \$152.6 billion achieved in 2009.

CCC paper issuance was fairly muted in the third quarter. Only \$7.7 billion of the new issues was rated CCC, making up 10% of the total new issuance volume, down from 20% in the second quarter. Higher-quality bonds (BB and B) continued to dominate the new issuance market, accounting for 85% of the new issuance year to date.

On the demand side, AMG has recorded 11 weeks of high yield mutual fund inflows of the total 13 weeks in the third quarter. The high yield market more than recovered from the \$2.7 billion of outflows it had in the second quarter and absorbed close to \$9 billion of inflows, bringing the year-to-date figure to \$8.9 billion. With only one quarter left in the year, however, 2010 is unlikely to match the \$32.7 billion inflows the high yield market experienced in 2009.

From a quality perspective, July had no clear winner. All quality tiers traded on top of each other, returning around the 3.5% area. As equities sold off in August, investors scrambled for higher qualities. BBs and Bs both posted positive monthly returns, at 0.72% and 0.17%, respectively, while CCCs lost ground, down 1.64% in August. September was clearly marked by a flight to risk. BBs and Bs performed largely in line with each other, returning 2.70% and 2.76%, respectively. CCCs outperformed higher qualities, posting a 3.69% gain. Year to date, higher qualities outperformed because they offer attractive yields and price appreciation potential with limited downside risks. BBs, Bs and CCCs returned 12.42%, 10.13% and 9.84%, respectively.

The financial sectors prevailed in the third quarter, returning more than 10% for the period. Life insurance, which was the best sector for the quarter (22.13%) and year-to-date period (38.04%), was mostly helped by the impressive performance of AIG. Other riskier sectors such as technology and communications also posted strong returns of close to 8% in the third quarter. Beta names such as Freescale Semiconductor, NXP and Clearwire were up more than 10%. Defensive sectors did not perform as well in the third quarter. Electric was up by only 2.62%, and aerospace/defense and pharmaceuticals returned around 4.6%. Consumer-oriented sectors such as restaurants (2.63%) and gaming (4.28%) also performed poorly. Year to date, the sector performance rankings have stayed largely unchanged, with financials being the best, at 21.48%, and utilities being the worst, at 5.01%.

The Moody's Investors Service U.S. issuer-weighted default rate reached 5% at the end of August, the lowest level since 2009 and down from the November 2009 peak of 13.48%. According to J.P. Morgan, default activity slowed significantly in 2010. Only seven issuers defaulted in the quarter, with a volume of \$4.4 billion in bonds and loans, bringing the year-to-date figure to 32 companies and \$12.9 billion. To compare, 118 issuers with \$184 billion defaulted in 2009. We expect default rates to continue decreasing as liquidity improves and bond issuers are able to negotiate for maturity extensions and covenant amendments. Moody's currently forecasts that the default rate will decline to 1.8% by the end of July 2011. Recovery rates returned to about 40% in 2010, which is in line with the historical level and up from the 2009 level of under 30%.

Following a year with a record volume of fallen angels, at \$150 billion, 2010 has seen a positive credit trend. According to J.P. Morgan, rising stars outpaced fallen angels year to date at 14 to 10 on an issuer basis and at \$26.7 billion to \$21.7 billion on a volume basis.

Outlook and Strategy

Following the roller coaster ride in the second quarter, investors were reminded again this quarter how quickly the market can turn. The Fed's promise to keep interest rates at extremely low levels has eased concerns over policy tightening and interest rate risks. Moreover, the Fed is widely expected to launch another round of quantitative easing to support these low levels of interest rates even into a slow recovery. Second quarter earnings mostly surprised investors on the upside, and balance sheet improvements continued. The European sovereign debt crisis is still far from over, but the worst is likely well behind us. China continued to produce a strong bid for commodity prices, and Beijing's announcement that it would un-peg the Yuan from the U.S. Dollar and tie it to a basket of currencies instead could help narrow the U.S.-China trade gap.

We maintain a positive U.S. economic outlook, although we expect a continued slow recovery. We believe fears of the "double dip" in the second quarter were overdone, and we see high yield bonds as an attractive asset class in the current environment. High yield bonds are well sought after by yield-hungry investors, and lower inflation expectations also present friendly conditions for the asset class. With yields at around 8% and spreads above historical levels, the high yield market provides investors with a nice coupon clip, plus the opportunity for capital appreciation. Default risk is minimal, with Moody's forecasted default rates dropping below 2% by July 2011, and the new issue market remaining open for virtually all issuers to refinance their debt. Due to the combination of mutual fund inflows and non-traditional high yield demand, liquidity risk also is minimal for the asset class in the next year. Thus, we continue to recommend a moderate overweight to high yield bonds.

The technicals aspect of the high yield market has improved, with the Chicago Board Options Exchange Volatility Index, which measures equity volatility, coming down to 23.7 at quarter end from its one-year high of 46 on May 20, 2010. The recent stream of high yield mutual fund inflows also supported a strong primary market, with private equity buyout and merger and acquisition activities picking up. Nevertheless, we believe valuations are not as attractive as they were three months ago. The high yield index was trading above par at quarter end, and CCC spreads have come within their long-term averages. Therefore, we rely on careful credit selection to drive performance.

Nonetheless, volatility remains, and economic and political headwinds prevail. Fears of European sovereign debt contagion, geo-political risks, worldwide macro-economic concerns and uncertainties in the U.S. regarding the election, healthcare costs and taxes can all put a dent on growth prospects. As a result, we recommend an overweight to higher quality tiers (BB and B rated bonds) vs. CCC rated bonds due to the relative risk/reward opportunity.

In all, we believe the rest of 2010 and early 2011 will be driven less by beta and more by idiosyncratic, security-specific risk. We would like to reiterate our recommendation of a moderate overweight to the high yield asset class – mainly BB and B rated bonds – and a focus on credit selection.

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