

Market Review

Despite economic and policy uncertainty, government bonds and risk assets experienced positive performance during the third quarter. The Barclays U.S. Credit Index outperformed duration-neutral Treasuries for the quarter by 144 basis points (bps). Treasury rates declined, as expectations for additional quantitative easing drove 10-year rates down 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.

Credit outperformed Treasuries by 123 bps in the first month of the quarter, and credit spreads tightened 18 bps. The trend reversed in August, and credit underperformed Treasuries by 55 bps, with spreads widening by 9 bps. In September, credit once again outperformed Treasuries by 72 bps, and credit spreads tightened by 10 bps.

Most major credit sectors generated positive excess returns vs. Treasuries for the quarter. Oil field services reversed its position from last quarter, reporting the best performance, with 562 bps of excess return. Packaging was the worst-performing sector, at 248 bps below Treasuries.

Refining, independent energy and oil field services led July's credit outperformance. The worst sectors for the month were retailers, healthcare and consumer products. By credit quality, the crossover sector was best, and high quality (AA+) was the worst sector. The credit market was once again affected by uncertainty regarding the European sovereign debt crisis, U.S. financial reform and upcoming elections.

As credit underperformed Treasuries in August, refining reversed positions, falling to the bottom of the performance list, along with packaging and paper. Oil field services, other industrials and supranationals were the best performers. High quality (AA+) was the best credit quality sector, and crossovers were worst.

Credit outperformed Treasuries again in September, led by non-captive consumer finance, tobacco and life insurance. Packaging, other industrials and pharmaceuticals were at the bottom of the pack. Crossovers returned to the top, while credits with qualities of AA and higher were the worst performers.

The investment grade credit market has been a favored asset class during the majority of 2010. A combination of very strong technical and fundamental factors provide support for the sector, but uncertain macro-economic outlooks for developed nations and global economies have increased overall spread volatility in investment grade credit. From

a technical perspective, negative net new issuance in spread sectors has continued to result in strong demand for new issue supply.

Fundamentally, the uncertain economic environment has continued to keep corporate balance sheets in check with high cash balances and conservative leverage. We also believe that macroeconomic uncertainty elevates overall credit market risk, however. From an asset allocation perspective, current macro economic uncertainty requires that risk be appropriately allocated toward sectors and securities that benefit from the growth of the emerging economies and away from high beta sectors or securities that will be negatively affected by the slow economic growth prospects in the developed economies. Looking forward, we believe that many of the same drivers will continue to favor the asset class. As a result, we are modestly constructive for credit spreads, with a slight preference for higher quality.

We believe demand for investment grade credit will continue to be a positive technical factor, and we expect to see new issue supply readily absorbed by the market. Net issuance across all spread products is expected to continue declining in 2011. All asset-backed markets (MBS, CMBS, ABS) are expected to have negative net issuance next year. As a result, we expect that principal and interest payments from those asset-backed markets will be reinvested in the credit markets. Lastly, current spreads relative to Treasury rates are a significant contributor to total yield. Investors searching for absolute yield will continue to find investment grade credit attractive.

From a "bottom up view," a number of fundamental and technical factors continue to support credit spread levels. First and foremost, we have the strong fundamental position of corporate balance sheets. Current cash balances remain near all-time highs, because corporate management teams have yet to deploy the cash to expand their businesses. The slow growth economic environment and increased regulatory costs from new legislation such as healthcare reform will continue to limit the reduction in cash balances. Until we see clear signs of hiring and capital investment spending, current cash balances plus generally positive cash flow will effectively continue to de-leverage corporate balance sheets. This reduces credit risk due to the high levels of liquidity and lower leverage that companies have as a result. We do anticipate a modest increase in shareholder-friendly activities such as share buybacks, dividend increases, mergers and acquisitions. We expect current capital market conditions to continue making highly leveraged transactions difficult to fund, however, compared to past credit cycles. As a result, we expect M&A activity to either be smaller in size, as firms bolt on strategic acquisitions, or to take the form of credit-friendly acquisitions that do not dramatically increase leverage.

Lastly, from a credit risk perspective, the banking sector will actually benefit from increased regulations and higher capital requirements.

The uncertain macro economic conditions will be affected by slow economic growth in the developed nations. Europe is of particular concern given large fiscal deficits, austerity measures and lack of certainty regarding the future of the European Union. In addition, the U.S. is expected to experience slow growth as a result of persistent unemployment, high fiscal deficits at the state level and increased regulatory activity. This high-level view dictates that risk exposures to the developed economies be allocated to more defensive sectors and names.

We expect continued higher economic growth rates for emerging economies. Companies that derive a large portion of their revenues from these economies should continue to benefit from their growth. In addition, asset rich sectors, such as metals and mining, which are tied to the emerging economies, will benefit.

We expect spreads to remain range bound, with a modest bias for tightening in the fourth quarter. Favorable U.S. credit fundamentals and technical indicators will support credit spreads. The market is susceptible, however, to spread widening due to macro-economic flare-ups. Valuations look relatively attractive on a historical basis versus other asset classes. Secondary market liquidity also is good; the market is generally well bid, and dealer inventories are at normal levels. We expect the market to absorb the supply of new issues easily. Financial spreads continue to be wide of historical norms and are biased to tighten due to gradual improvement in asset quality and improving tier-one capital ratios. Individual company credit fundamentals are solid due to strong and liquid balance sheets.

Solid credit fundamentals and technicals will continue to support demand for investment grade credit. In addition, the amount of cash available to be invested in the credit markets remains high and is supportive of spread tightening. High beta credit sectors are increasingly more susceptible to periods of spread widening due to macro-economic factors and compressed spread levels, however. As a result, we recommend a modest overweight to credit. To moderate overall credit risk, however, we recommend a reduction in exposure to high beta names. In addition, we believe that individual security selection will become a more important contributor to outperformance as credit spread dispersion narrows.

We expect credit to outperform Treasuries slightly in the fourth quarter. Strong company credit fundamentals coupled with continued demand for credit products will support spread tightening. Macro-economic risk factors have the potential for creating spread volatility, but we don't expect them to reduce risk appetites significantly. We don't expect Euro contagion concerns to be a factor again until 2011.

Important information

Past performance is not indicative of future results. This commentary contains the current opinions of Aviva Investors and is not intended to be, and should not be interpreted as, a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This commentary is distributed for informational purposes only and is not a recommendation or investment advice. The information herein is based on sources which Aviva Investors believes to be reliable, but it is not guaranteed to be accurate or complete.

Forward-looking statements, opinions and other information contained in this article are subject to change continually and without notice and may no longer be true after the date of publication. Any such statements speak only to the date they are made and Aviva Investors North America assumes no duty and does not undertake to update forward-looking statements. Such statements are subject to numerous assumptions, risks and uncertainties, which may change over time. Actual results may differ substantially from those anticipated in forward-looking statements. Past performance is not indicative of future results. There is potential for profit or loss with any investment.

No part of this commentary may be reproduced in any form, or referred to in any other publication, without the express written permission of Aviva Investors North America, Inc.

Performance is shown gross of fees and does not include the deduction of management fees and other expenses that may be incurred in managing an investment account. A portfolio's return will be reduced by advisory and other fees.

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