Core Aggregate Commentary

Fourth Quarter 2010

AVIVA INVESTORS

Market Review

U.S. economic growth is continuing on a path of recovery. The sustainability of growth has improved, and we see less risk to the downside. We expect U.S. growth to proceed at a sustainable yet moderate pace in 2011, based on better prospects for consumption and slowly improving labor markets. While the impact from restocking business inventories and fiscal stimulus is beginning to fade, we're encouraged by strong corporate profits; improving consumption, driven by auto and retail sales; and increased exports, led by strong growth from developing countries.

Since the last FOMC meeting, committee members have remained concerned about the sluggish nature of economic growth, potential deflation risks and stubbornly high unemployment. The Federal Reserve Committee (Fed) again left the federal funds rate at 0 to 0.25% at the December 14 meeting. The Fed has a dual mandate to seek maximum sustainable employment and price stability. The rate of core inflation – around 1% – is below the Fed's target zone of 1.75% to 2.0%, and unemployment, at 9.8%, is well above the 5.5% to 6.5% natural rate. So the Fed has chosen to implement another round of quantitative easing (QE2) to keep borrowing rates low and spur borrowing and economic growth. The Fed is expected to buy back $600 billion in Treasuries through June 2011, thereby pumping more liquidity into the system.

Treasury rates rose following the announcement of the Fed's Treasury purchases, as economic data improved and the likelihood of a double dip decreased. Ten-year Treasury rates increased by 78 basis points (bps) to close the fourth quarter at 3.29%, while the spread between 10-year and 2-year Treasuries widened by approximately 61 bps to 270 bps. The Standard & Poor's 500 Index increased 10.76% in the fourth quarter and ended the year up 15.06% year to date. The Barclays Capital U.S. Aggregated Index outperformed duration-adjusted Treasuries by 171 bps year to date, with 97 bps coming in the fourth quarter.

Spreads narrowed across all spread asset classes, as economic conditions improved and risk appetites returned. U.S. investment grade corporate bond spreads narrowed by 14 bps, commercial mortgage-backed securities (CMBS) spreads narrowed by 53 bps, U.S. mortgage-backed securities (MBS) spreads narrowed by 82 bps, and U.S. high yield corporate bond spreads narrowed by 78 bps. The best-performing asset classes vs. duration-adjusted Treasuries for the quarter were high yield corporate bonds (+519 bps), CMBS (+265 bps) and MBS (+176 bps). For the year, the best-performing asset classes vs. duration-adjusted Treasuries were CMBS (+1551 bps), high yield corporate bonds (+974 bps) and MBS (+225 bps).

Investment Outlook

Looking forward, we see credit fundamentals remaining strong and commercial real estate fundamentals bottoming. Balance sheets are in good shape, default rates are expected to continue to decline, and corporate earnings growth should remain positive. Commercial real estate will benefit from moderate economic growth and limited supply, which will help continue to stabilize delinquency rates across all property types.

The technical conditions for all spread asset classes have turned more positive. Market risk appetites have improved on the basis of more manageable global uncertainty, reduced fears of an economic soft patch, and asset price increases driven by the Fed's QE2 program. The uncertainty surrounding the timing and ultimate resolution of European sovereign debt, banking and fiscal issues will likely keep the markets on heightened alert over the next one to two years.

We believe strong fundamentals, improved technicals and relatively attractive valuations bode well for credit spread performance. The bias for spreads in 2011 is stable to modestly tighter. At current levels, we continue to believe that investors are being adequately compensated for the risks and that there is good value across all spread asset classes.

We expect overall bond yields to remain lower for longer, as the Fed continues its policy of supporting growth in the near term. We expect the 10-year Treasury to range between 2.75% and 3.75% in the first half of 2011. With the issuance of Treasuries expected to remain at historically high levels and continued improvement in economic conditions, however, we expect yields to increase only gradually over the intermediate term.

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

1. European sovereign fiscal issues and the related spillover risks into the global economy
1. The ability of China to successfully slow down overheated property markets and inflation
1. The impact of financial reform regulation on the financial industry and economy
1. The idiosyncratic risks associated with shareholder-friendly activities from corporations
1. Risks surrounding the Fed's ultimate exit from highly stimulative monetary policy