

# Economic Review and Market Outlook

## Commentary

### Fourth Quarter 2010



## Economic Review

### **Growth continues recovery, with improved sustainability**

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.

Gross Domestic Product (GDP) expanded by 2.6% in the third quarter, which is up from a 1.7% increase in the second quarter. We expect an annualized increase in GDP of 2.5% for 2011. 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.

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. We've seen the Fed step up its asset purchase program, an improvement in underlying economic indicators, the extension of the Bush-era tax cuts, and reduced concerns that European sovereign debt problems would lead to large credit problems for U.S. banks.

### **Labor market recovery remains slow**

The November payroll report reminds us that the road to recovery in the labor markets will remain slow and bumpy. The November report showed a gain of 39,000 jobs, which pushed the three-month average to a 62,000-job increase. Temporary employment within business services continues to add to payrolls, while a decline in retail jobs was a negative contributor. The jobs market has improved substantially from the recession in 2008 and 2009, with private sector payrolls adding 50,000 jobs in November and showing growth for the last 11 months.

The unemployment rate climbed from 9.6% to 9.8% in November because of an increase in the labor force as more people began to seek employment. We expect the unemployment rate to remain stubbornly high. Employers are likely to stay focused on productivity gains and remain reluctant to hire at a rapid pace. The unemployment rate should begin to gradually decline as we progress through 2011, and it should approach 8.5% to 9.0% by the end of the year.

Other labor market indicators, such as jobless claims, continue to point to a gradual improvement in the labor markets. Recent weekly claims – below 400,000 – are much lower than the 650,000 high in March 2009, and this measure appears to be breaking out of the 420,000 to 500,000-claims range, where it has been through all of 2010. We expect a moderate improvement in the employment picture.

### **Corporate earnings positive, service sector expands**

Corporate earnings growth should remain positive. Fundamentals are strong, balance sheets are in good shape, and default rates are expected to continue to decline. The Institute for Supply Management (ISM) manufacturing index trended up during the fourth quarter, from 54.4 in September to 57 by December. The manufacturing index has remained above 50 since July 2009, indicating that the sector continues to expand following the recession. The weakening U.S. Dollar has benefited U.S. manufacturers through improved global price competitiveness.

Growth within the service sector also indicates expanding trends. The ISM non-manufacturing index increased from 53.2 in September to 55.0 in November. Strong readings within new orders and employment have contributed to the expanding service sector and remain consistent with sustainable economic growth.

### **While housing affordability improves, weakness persists**

Housing has shown signs of stabilizing in the past 18 months. Declining home prices and low interest rates have greatly improved housing affordability. Several factors will cause the housing market to experience a bumpy recovery, however. The expiration of the housing tax credit has dampened demand, as new and existing home sales remain sluggish. High levels of delinquencies and new foreclosures keep housing inventory elevated and prices muted. The supply of new and existing homes remains up, at 8.2 and 9.5 months, respectively. This is much higher than the pre-financial-crisis levels, which averaged around 6 months for new homes and 4.6 months for existing homes. The Case-Shiller 20-City Price Index was down 0.9% year over year in October and remains 30% below the 2007 peak. The worst in the housing market seems to be behind us, but weakness will persist.

## Consumers spend cautiously

Consumers are spending at a relatively cautious pace due to high unemployment. Additionally, consumer confidence remains sluggish but has shown signs of improvement during the fourth quarter. The increase in auto sales, stronger holiday season retail sales and slowly improving labor markets provide confidence, while the recent increases in the savings rates have improved many individuals' balance sheets and put them in a better position to spend. We expect modest growth in consumer spending, which is in line with our moderate growth outlook.

# Market Outlook

## Fed implements new round of QE

Since the last FOMC meeting, the Federal Reserve Committee remains concerned about the sluggish nature of economic growth, potential deflation risks and stubbornly high unemployment. The 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.

## Wage inflation muted

We see very few signs of upward pressure on inflation. Low levels of capacity utilization and significant slack in the labor markets will keep wage inflation — the largest driver of overall inflation — muted. Core producer prices increased 0.8% in November versus one year ago, while core consumer prices rose 1.2% from last November. Breakeven inflation rates implied by 5-year Treasury Inflation Protected Securities (TIPS) increased approximately 60 basis points during the fourth quarter, indicating that the market is expecting inflation to rise over the intermediate term.

## Treasuries sell off, credit outperforms

Treasuries sold off in the fourth quarter, which we attribute to improvement in the economic outlook and a classic case of "buy the rumor, sell the fact," with Treasuries rallying strongly in late summer and early fall on the anticipation of QE2 and selling off when QE2 began to be implemented. The 10-year Treasury rate increased by 78 basis points (bps) to close the year at 3.29%. The spread between 10-year and 2-year Treasuries widened approximately 61

bps to 270 bps. The Standard & Poor's 500 Index returned 10.76% for the quarter and is up 15.06% year to date. Within the fixed income markets, investment grade and high yield credit outperformed Treasuries, with spreads tightening by 14 bps and 78 bps, respectively.

## Credit demand, fundamentals remain strong

Overall demand for credit remains very robust in this low-rate environment. The moderate spread widening experienced in the credit markets last summer was driven by technical sentiment, as risk appetites declined on the heels of rising European sovereign debt and bank uncertainty. During the fourth quarter, credit spread volatility has become more muted, as the markets have become more comfortable with U.S. banks' ability to manage exposure to European risk and as political and tax uncertainties have been clarified.

Looking forward, we see credit fundamentals remaining strong. Balance sheets are in good shape, default rates are expected to continue to decline, and corporate earnings growth should remain positive. High yield companies also have improved their liquidity profile by "termining out" near-term debt maturities, and record levels of high yield issuance continue to be met with strong demand. It's likely that we are beginning to experience the peak of the fundamental credit cycle, however. Businesses have begun to deploy the significant cash levels on their balance sheets through shareholder-friendly actions. Those include stock buybacks, dividend increases and mergers and acquisitions.

The technical conditions for credit and other risky assets 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.

## Investment Strategy

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

We expect overall bond yields to remain lower for longer, as the Fed continues to retain 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
2. The ability of China to successfully slow down overheated property markets and inflation
3. The impact of financial reform regulation on the financial industry and economy
4. The idiosyncratic risks associated with shareholder-friendly activities from corporations
5. Risks surrounding the Fed's ultimate exit from highly stimulative monetary policy

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