

## Market Review

Following a stellar third quarter for the high yield market, the fourth quarter produced a gain of 3.22%. October's return of 2.56% was boosted by a healthy third-quarter earnings season, while investors kept their eyes on the mid-term election and the Federal Open Market Committee meetings. The high yield market was strong going into November, with the Federal Reserve's (Fed's) announcement of a \$600 billion asset repurchase plan. The market took a turn mid-month, however, when concerns surrounding sovereign debt, especially the peripherals, returned; a second round of quantitative easing (QE) backload risk loomed; and worries arose around tighter policy out of China. The high yield market ended with a loss of 1.14% for November, the first negative return since May. With Treasury yields moving higher in December, risky assets outperformed again. Equities benefited most from the risk-on trade, with the Standard & Poor's 500 Index (S&P 500) returning 6.68%, and high yield assets followed suit, returning 1.81% for the month.

This makes high yield bonds one of the best performing credit asset classes for the year, returning 14.94%. According to Barclays Capital, high yield bond returns were in line with U.S. equities (S&P 500 returned 15.06%), and high yield bonds outperformed crossover credits (14.07%), emerging market bonds (12.84%), investment grade bonds (8.47%) and U.S. government bonds (5.52%).

Most of the year's spread tightening occurred in the fourth quarter. U.S. high yield corporate spreads were at 662 basis points (bps) and 660 bps, respectively at the end of 2009 and at the end of the third quarter of 2010. Spreads tightened further by 81 bps from the end of the third quarter to 579 bps on December 31, 2010. The 579-bps level is right around the lowest level of the year (576 bps on April 26). Current spreads are slightly above the long-term average of 550 bps. Most notably, BB spreads are still 63 bps wider than their 17-year historical average, and B spreads are at their historical average, while CCC spreads are 187 bps inside their historical average of 1,040 bps.

We saw a record \$83.4 billion of new issues priced in the fourth quarter, the most active quarter on record. Issuers raised around \$30 billion in both October and November and \$22 billion in December. For the full year, new issuance totaled \$262.7 billion, which is the most the high yield market has raised annually in the past 17 years and 72% more than the previous peak of \$152.6 billion in 2009.

Additionally, lower-quality companies have become more dominant issuers in the new issuance market. CCC issues made up 24% of the fourth-quarter issuance volume, vs. 11% a quarter ago.

Most of the increase in CCC issuance came from the decrease in BB issuance. BB issuance only accounted for 19% of total issuance, down from 31% in the third quarter. B issuance was largely unchanged, at 56%.

On the demand side, fund flows were strong in the last quarter of the year. AMG Data Services recorded \$4 billion of inflows in the fourth quarter, bringing the year-to-date figure to \$13 billion, though less than half of the \$32.7 billion 2009 absorbed. Throughout the year, high yield assets grew by 8%.

From a quality perspective, the fourth quarter reversed the risk-off trade we had seen until the third quarter. Lower-quality bonds outperformed higher-quality bonds consistently in the last three months of the year. Investors scrambled for higher yields, as QE2 served as a catalyst for risky assets. BB credits were hurt the most by the rotation away from bonds into stocks, returning only 1.7% in the fourth quarter, while B's and the more equity-like CCCs and below returned 3.23% and 6.18%, respectively. For the full year, CCCs and below, returning 18.08%, outperformed higher qualities. BBs, thanks to their earlier run this year, outperformed B's by a small margin. BBs registered a 12-month return of 14.34%, while B's returned 13.69%.

All sectors produced positive returns for the year. The financial sectors were among the best performers throughout the year, returning 25.5%. Insurance companies even posted a remarkable 38% full-year return, mostly helped by the largest issuer and the best performer in the industry, AIG, which returned 67.8%. Cyclical sectors such as gaming and autos returned 20.5% and 17.2%, respectively. Technology, despite its strong run in the last quarter with a gain of 7.1%, only returned 14.8% for the full year, in line with the overall market. Electric, the underperformer in previous quarters, unsurprisingly finished at the bottom on the return ranking, with only a 2.98% gain.

The Moody's Investors Service U.S. issuer-weighted default rate continued its downward trend and reached 3.3% at the end of November, its lowest level since the end of 2008 and down from the November 2009 peak of 13.48%. According to J.P. Morgan, default activity slowed significantly in 2010. Only 44 companies and \$19.8 billion of bonds and loans defaulted during the year. To compare, 118 issuers with \$184 billion defaulted in 2009. We expect default rates to continue trending lower, despite being below historical averages, as liquidity improves and the new issuance market remains strong, allowing bond issuers to negotiate for maturity extensions and covenant amendments. Moody's currently forecasts

that the default rate will decline to 2.1% by the end of November 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%. Senior secured bonds were able to recover 48.5 cents on the dollar on average, while senior and senior subordinated bonds recovered 36.5 cents and 22.2 cents in 2010, as reported by J.P. Morgan.

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 20 to 13 on an issuer basis and at \$32.9 billion to \$28.0 billion on a volume basis. The upgrade to downgrade ratio is at its highest level since 2002 on both an issuer and a volume basis.

## Outlook and Strategy

The year 2010 should be remembered as a time when macroeconomic improvements, healthy corporate balance sheets, strong retail inflows and accommodative Fed policies placed a strong bid on risky assets. Following its highest return in history of 58.76% in 2009, the high yield asset class returned 14.94% in 2010, the fifth highest annual return ever.

We expect fundamentals to continue improving in the coming year, but do not expect the high yield asset class to achieve double-digit returns again. At the end of November, we lowered our recommendation on the high yield asset class from moderate overweight to marketweight. While we continue to recommend a strategic allocation to the high yield asset class, we believe current price levels are pointing toward a fair valuation. With the majority of the high yield assets trading above par, half of the callable bonds trading within 2 points of call price or above, yields and default rates at historical lows, and spreads slightly above historical averages, we see limited price appreciation opportunity for the high yield asset class in 2011. In our opinion, most of the coming year's return will derive from "carry," or coupon return.

Nevertheless, we still consider the high yield asset class as a favorable credit asset class. While any further spread tightening will likely be squeezed by rising Treasury yields for the other credit asset classes, the high yield market will continue to benefit from its usually low, and currently negative, correlation to Treasuries. The demand

for high yield is expected to remain strong, given its advantageous yields compared to other fixed income assets. The strong primary market of 2010 has helped push out the great maturity walls to 2013 to 2016. According to Barclays Capital, only \$180 billion is coming due in 2011 and 2012. The new-issuance-friendly market also allowed many companies to obtain lower-cost financing and improve their capital structure. Corporate cash balances spiked to an all-time high of \$1.93 trillion. The recent largest leveraged buyouts were not as heavily levered as those in 2009. Default risk going forward is minimal. Based on these factors, we believe high yield bonds remain appealing to investors who prefer an asset class with a high current yield, but with less dependency on economic recovery and earnings growth than equities have.

On the economic front, 2010 ended on a good note. The Institute for Supply Management non-manufacturing index, at 57 in December, was better than expected and at its highest since May 2006. The Chicago Purchasing Managers Index also came in at its highest level in 20 years. Initial jobless claims were reported at 400,000, the lowest level since the summer of 2008. ADP private payrolls reported a gain of 297,000, significantly above expectations of 100,000. Holiday sales mostly surprised investors to the upside. Last but not least, many investors increased their 2011 economic growth forecasts after President Obama enacted a tax-cut extension.

Investors should remain cautious going into 2011, however, as volatility remains. The Ireland debt crisis did not affect the market as much as Greece's did in March, but the situation in Europe is still alarming. The Chinese government put aggressive tightening policies in place recently to combat inflation and rising asset prices. The large flows into emerging market funds could be seen as the first sign of a bubble. The U.S. unemployment rate is still close to 10% and is unlikely to experience large improvements in the near future. Domestic municipal governments face their worst budget situation ever, with record defaults in municipal debt. Lastly, it is still unclear whether the economy can sustain its recovery after QE2 ends in June 2011.

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

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