

# Investment Grade Commentary

Fourth Quarter 2010



## Market Review

Risk assets experienced positive performance during the fourth quarter. The Barclays U.S. Credit Index outperformed duration-neutral Treasuries by 138 basis points (bps). 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.

Credit outperformed duration-matched Treasuries by 7 bps in the first month of the quarter, and credit spreads tightened 7 bps. The trend reversed in November, with spreads widening 6 bps and the index underperforming duration-matched Treasuries by 19 bps. In the last month of the year, the index tightened by 13 bps, outperforming duration-matched Treasuries by 107 bps.

The majority of the major credit sectors generated positive excess returns versus Treasuries. Airlines were the best performers, with 469 bps of excess return for the quarter. The supranational sector performed worst, at -19 bps.

Most September themes continued into October, but concerns over economic growth began to subside. The bid for risk product continued, resulting in spread tightening. Other, higher-risk asset classes also performed well, especially equities and high yield corporates. Higher-beta sectors outperformed lower-beta sectors during the month. Crossovers and BBBs outperformed the higher-quality buckets. Because of the mortgage put-back issue weighing on the sector, banks performed relatively in line with the market, despite the higher-beta nature of the sector. The best performing sectors were packaging (Pactiv rebound from last month's lows), airlines, paper (International Paper), tobacco (Altria, Lorillard), life insurance (AIG) and REITS (ProLogis). The worst performing sectors were foreign local governments, other industrials (includes many low-beta university bonds), consumer products, restaurants and diversified manufacturing.

In November, the resurgence of the European credit crisis especially affected non-corporates, banks and telecom. Treasuries had a big move during the month; rates increased around 20 bps. Aside from the Treasury move, equities were flat for the month. All qualities underperformed Treasuries, with BBBs slightly outperforming other qualities. The best performing sectors were airlines (new issuance of enhanced equipment trust certificates helped liquidity), home construction, health insurance (Humana, Aetna, United Health), environmental (Waste Management, Republic Services), and REITS (ProLogis). The worst performing sectors were sovereigns, wirelines

(Telefonica, Telecom Italia, France Tel all underperformed), foreign local governments, foreign agencies and wireless.

In December, financials was the best performing major sector (+165 bps excess return). Within finance, financial companies (SLM Corp, General Electric, Block Financial) generated +233 bps of excess return, life insurance (AIG, Axa, Lincoln National) generated +219 bps, and Health Insurance (Cigna, Wellpoint, United Health) generated +177 bps. By quality, crossovers had the highest outperformance (+274 bps) followed by A's (+125 bps). The best performing sectors were finance companies, life insurance, refining (Valero, Sunoco), health insurance and entertainment (Time Warner, Viacom). The worst performing sectors were packaging (Pactiv), other industrials (Cintas, Timken, Yale University), supranationals (Asia, European Investment Bank), other financials and foreign agencies.

## Fundamentals

Fundamental factors support tighter spreads going forward. Credit metrics, such as profit margins and revenues, are up, and we should see continued growth as the economy improves. Free cash flow and cash flow generation are strong. We do expect some of that cash to go back to shareholders, but most companies have a cushion and should be able to engage in shareholder-friendly activities without significantly affecting their balance sheets and credit ratings. Solid balance sheets should stay that way, but we don't foresee the major improvements that were in evidence over the last couple of years. The exception would be banks, whose capital ratios are significantly better than they were before the recent crisis and should get even better as new banking regulations, including Basel III, take effect. We expect leveraged buyouts to be infrequent, be smaller and use less leverage than in previous credit cycles. Headline risk will be a factor in contributing to spread volatility, however. One-off events and mergers and acquisitions will drive any systemic rating trends. Otherwise, we expect credit ratings trends to be stable or improving.

## Technicals

The overall limited investment grade credit supply will continue in 2011. We do expect some money to return to equities, because the absolute expected return for fixed income will be lower than it has been in the last two years. But the need for yield and duration by

traditional fixed income investors will support the interest in corporate debt. The reach for yield will drive spreads tighter. While we expect retail demand to shift toward equities, institutional demand should remain solid, with pension plans continuing to allocate out of equities, life insurance companies still seeking long duration and yield and Asia maintaining its strong demand. Concerns based on the continued European sovereign crisis, shareholder-friendly announcements and potential LBOs, uncertainty around banking and financial regulation reform and municipal solvency issues will create some spread volatility.

## Valuations

We don't expect any major deterioration in credit fundamentals to re-price risk and widen credit spreads. Spreads continue to look attractive relative to credit metrics and from a historical perspective.

## Sector Views

We expect to be overweight to banks. We believe that financial regulatory reform, including Basel III, will make banks fundamentally stronger, but the headlines will drag the spread recovery out over some time. Spreads on banks remain historically cheap. We also like other higher-beta sectors, especially those that are commodities based, including metals and mining and energy.

We will be underweight to low-beta, tight-spread sectors that are susceptible to spread-widening risks from mergers and acquisitions and leveraging events. We'll also remain underweight to European credits based on sovereign risk, awaiting a better entry point.

Overall sector spread tightening will be limited compared to prior years. As a result, managing idiosyncratic risk via good security selection will be a large factor in generating positive outperformance in 2011.

Both 2009 and 2010 have been very strong for investment credit performance. We still see room for credit spreads to tighten in 2011, but they will be volatile, and we don't expect absolute returns to be as high as observed over the past two years. We do expect investment grade credit to generate excess return relative to Treasuries in 2011

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