

Market Review

U.S. economic data suggest the economy is on a path of self-sustaining recovery. The growth prospects have improved since the Federal Reserve's (Fed's) November start to the second round of quantitative easing (QE2), and there is less risk to a material economic slowdown. We expect U.S. growth to proceed at a sustainable yet moderate pace in 2011, based on improving labor markets, healthier business confidence and merger and acquisition activity, and continued expansion in consumption. The impact of QE2, strong investor risk appetites, improved corporate profits and confidence in the economic recovery have continued to increase investor demand for risk and result in outperformance of higher-beta, risky asset classes, including credit fixed income.

The Fed again left the Federal Funds rate at 0 to 0.25% at the March 15 meeting, while implementing QE2. The Fed has a dual mandate to seek maximum sustainable employment and price stability. The rate of core inflation remains at 1.1%, and inflation expectations remain below the Fed's target zone of 1.75% to 2.0%. The unemployment rate has improved significantly to 8.8% but remains elevated and well above the 5.5% to 6.5% natural rate. Fiscal and monetary policy will be debated heavily over the next several months. Aviva Investors expects marginally more restrictive fiscal policy into 2011. We also expect the federal funds target rate to remain unchanged through the end of 2011, as Chairman Ben Bernanke and the Fed move in measured steps to exit policy accommodation.

The U.S. markets are awash in liquidity due to highly stimulative monetary and fiscal policies, which have led to continued strong relative performance of risky asset classes at the expense of modest negative performance by U.S. Treasuries. Ten-year Treasury rates increased by 16 basis points (bps) to close the first quarter at 3.45%, while the spread between 10-year and 2-year Treasuries narrowed by approximately 3 bps to 267 bps. The Standard & Poor's 500 Index increased 5.92% in the first quarter. The Barclays Capital U.S. Aggregate Index outperformed duration-adjusted Treasuries by 50 bps.

Spreads narrowed across all 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 44 bps; U.S. mortgage-backed securities (MBS) spreads narrowed by 23 bps; and U.S. high yield corporate bond spreads narrowed by 62 bps. The best-performing asset classes vs. duration-adjusted Treasuries for the quarter were high yield corporate bonds (+387 bps), CMBS (+237 bps) and investment grade corporate bonds (+105 bps).

Investment Outlook

Looking forward, we see credit fundamentals remaining strong and supportive of future credit performance for investment grade and high yield credit. Balance sheets are in good shape, default rates are expected to continue declining, and corporate earnings growth should remain positive. Business confidence is growing, merger and acquisition activity continues to pick up, and companies are beginning look for alternatives to deploy record levels of cash from their balance sheets.

Overall demand for credit remains robust in this low-rate environment. The moderate spread widening and subsequent spread tightening experienced following Japan's earthquake and tsunami indicate the strength of technical demand from credit fixed income investors. Investment grade and high yield issuance continues to be met with strong investor demand, as fixed income investors continue to allocate away from U.S. Treasuries for fear of rising rates.

We believe strong fundamentals, positive technicals and relatively attractive valuations bode well for future credit and securitized performance. We expect default rates to continue declining, and we remain constructive on high yield companies, given the positive credit metrics, supportive levels of economic growth, limited exposure these issuers have to the European region, and lower correlations to Treasuries in a rising-rate environment.

We expect overall bond yields to remain relatively low as the Fed completes its large-scale asset purchase program by the end of the second quarter. We expect the 10-year Treasury to range between 3.25% and 4.0% during most of 2011. With the issuance of Treasuries expected to remain at historically high levels, continued improvement in economic conditions, and the potential for the Fed to begin preparing for removing policy accommodation before yearend, however, we expect yields to increase gradually over the intermediate term.

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

1. Geopolitical risks and uncertainty surrounding Middle East tensions
2. Ongoing European sovereign fiscal issues and potential spill-over risks into the global economy
3. Energy and commodity price increases and their negative impact on disposable income and growth
4. The ability of China to successfully slow down overheated property markets and inflation
5. The impact of Dodd-Frank regulatory reform on the financial industry and economy
6. Potential policy errors, as highly stimulative fiscal and monetary policy begins to unwind

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