

Economic Review and Market Outlook Commentary

First Quarter 2011



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. GDP expanded by 3.1% in the fourth quarter, which is up from a 2.8% increase in the third quarter. We expect annualized GDP in the range of 2.5% to 3.0% for 2011. While the economy continues to be supported by highly stimulative monetary and fiscal policy, we are encouraged by strong corporate profits, improving labor markets, solid expansion in manufacturing activity, stable 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 improving labor markets, growing business confidence, expanding manufacturing, continued expansion in consumption, and exports led by global growth. 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.

Economic Review

Labor markets show signs of recovery

The March payroll report showed solid signs of recovery in the labor markets. It showed a gain of 216,000 jobs, which pushed the three-month average to an increase of 159,000 jobs. The job market recovery is underpinned by the strength of private payrolls, which increased by 230,000 in March and 188,000 over the last three months. Private sector payrolls have experienced growth for the last 15 months.

The unemployment rate declined to 8.8% in March from a high of 9.8% in November because of a recent drop in the labor force, as fewer people were seeking employment. We expect the recent pace of improvement to level off, as improvements in the labor markets and the expiration of extended unemployment benefits begin to lure workers back into the labor force. Employers are becoming more confident in the economic recovery, which should support continued positive hiring trends and overall improvement in the labor markets. The unemployment rate should continue to decline gradually as we progress through 2011, approaching 8.0% by the end of the year.

Other labor market indicators, such as jobless claims, continue to point to an improvement, as well. The four-week moving average of jobless claims is 394,250 as of March 31, which is consistent

with monthly payroll gains of 150,000 to 200,000 per month. Aviva Investors expects the improving employment landscape to support economic growth.

Corporate and service sector growth remain solid

Corporate earnings growth remains solid due to improving business fundamentals, strong manufacturing activity supported by a weaker U.S. Dollar (USD) and improving financial sector profits. The Institute for Supply Management (ISM) manufacturing index trended higher during the first quarter, from 58.5 in December to 61.2 by March. The manufacturing index has remained above 60 each month in 2011 and remains at a multi-year high last seen in 2004. The broad, trade-weighted USD has declined by 4.0% over the last six months, benefiting the manufacturing sector through increased global competitiveness.

Growth within the service sector also has continued to support overall economic growth, with the ISM non-manufacturing index remaining relatively flat from 57.1 in December to 57.3 in March. Solid readings within new orders, employment and business activity remain consistent with sustainable economic growth.

Housing activity levels retreat

Housing was a sore spot for the economy during the first quarter. Despite falling prices and improved affordability, housing activity levels retreated during the first quarter. Housing sales, starts and permits have all recently come in below consensus expectations, and distressed sales still make up approximately 30.0% of total sales. The demand for housing continues to be weak, as the home ownership rate trends lower, recently at 66.5%, down from the 69.2% peak in the fourth quarter of 2004. High levels of delinquencies and new foreclosures keep housing inventory elevated, and prices have resumed their downward path. The new and existing supply of homes remains elevated at 8.9 and 8.6 months, respectively. This is much higher than the pre-financial-crisis levels that averaged around six months for new homes and 4.6 months for existing homes. The Case-Shiller 20-City Price Index was down 3.0% year over year in January and has declined to its lowest level since 2002. The weakening housing market trends are likely to continue, with a long, slow, bumpy road to recovery.

Consumer confidence improves, spending remains cautious

Consumers are spending at a relatively cautious pace due to continued elevated levels of unemployment. Consumer confidence has improved, averaging 67 during the first quarter, as compared

to 54.5 for 2010. While improving labor markets are a positive for consumption, recent increases in food and energy prices, driven by oil and commodity price increases, will provide headwinds to future growth in consumer spending. Improvements in many individuals' balance sheets have put them in a better position to spend, but tight credit conditions and savings trends continue to result in a much more muted recovery in consumption relative to previous economic recoveries. We expect modest growth in consumer spending, which is in line with our moderate growth outlook.

Investment Outlook

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. During the first quarter, Treasuries generated a -0.16% return, while the Standard & Poor's 500 Index returned 5.9192%. The spread between 10-year and 2-year Treasuries was relatively unchanged and remained historically steep, at 267 basis points (bps). Within the fixed income markets, high yield, commercial mortgage-backed securities (CMBS) and investment grade credit outperformed Treasuries, with excess returns of approximately 400, 250 and 100 bps, respectively.

Monetary and fiscal policy influence markets heavily

Monetary and fiscal policy will continue to influence the capital markets heavily during the second quarter and beyond. During the first quarter, the Fed continued to implement its \$600 billion QE2 Treasury purchase program, which is on track to be completed by the end of the second quarter. Fiscal stimulus increased as a result of the payroll tax holiday implemented for 2011, which has helped to offset the negative impact of rising food and energy prices on disposable income and consumption. The Federal Open Market Committee (FOMC) has acknowledged the improvement in economic conditions and sees the economy exhibiting more self-sustaining characteristics; it still sees the recovery as moderate, however, and remains concerned with the elevated level of unemployment.

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. While headline inflation has increased to 2.1% year over year, 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. Overall, upward pressure on inflation has increased with the recent spike in oil and other commodity prices, but low levels of capacity utilization and a significant slack in the labor markets will keep wage inflation – the largest driver of overall inflation – muted.

We expect the FOMC to debate monetary policy heavily over the next several months. Recent commentary by regional Federal Reserve bank presidents indicates a growing difference of opinion between the hawks, who are posturing for the Fed to hike rates in the last half of 2011, and those who see the economic recovery as fragile and requiring a slow and steady approach to removing policy accommodation.

Fiscal policy also is being debated heavily as pressure grows on the Treasury Department and policy makers to begin fixing the federal budget deficit and deal with entitlement programs (Social Security, Medicare and Medicaid), which account for approximately half of the U.S. budget. The impact of marginally more restrictive fiscal policy through reducing spending and/or raising taxes over the coming quarters and years could affect the sustainability of the economic recovery. With all else being equal, any tightening of fiscal policy will affect the likelihood and timing of Fed policy tightening. 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.

Credit demand, fundamentals remain strong

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 credit spreads tightened approximately 13-14 bps during the quarter, while high yield and CMBS spreads tightened by approximately 65 and 45 bps, respectively. 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.

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. We are likely beginning to experience the peak of the fundamental credit cycle, however, as businesses begin to deploy cash from their balance sheets through shareholder-friendly actions including stock buybacks, dividend increases and mergers and acquisitions.

Valuations for credit have remained neutral to modestly positive as spreads have tightened, reflecting positive fundamental and technical factors. Valuations are more consistent with expected risks in the market, but we still see opportunities to generate excess returns from active security selection and sector allocation. We expect spreads to grind modestly tighter and investment grade and high yield credit to moderately outperform Treasuries over the next six to 12 months.

Dodd-Frank regulatory reform to affect markets

The regulatory landscape is undergoing major changes, as policy makers and government agencies scramble to write policy rules to enact the post-crisis Dodd-Frank legislation. Requiring approximately 300 rules to be written and implemented under aggressive time restrictions creates a growing risk of policy error, which has caught the attention of most market participants. While the implementation of specific rules aimed at derivative and financial institution reform remains uncertain, the new legislation promises to affect the markets for many years.

Investment Strategy

We believe strong fundamentals, positive technicals and relatively attractive valuations will 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. Additionally, with the balance sheet repair and cost cutting that has occurred over the past year and a half, investment grade and high yield companies are benefitting from the upturn in the economy and are better positioned to withstand moderate economic weakness.

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 gradually increase 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 spillover 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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