

## Market Review

The high yield market produced a stellar first quarter return of 3.89% (Barclays Capital U.S. High Yield Constrained Index), outperforming all other credit asset classes including crossovers (3.42%), emerging market bonds (1.57%), investment grade bonds (0.89%) and U.S. government bonds (-0.08%), trailing only U.S. equities (5.92%).

The high yield market started the year with a strong January, returning 2.21%, unscathed by the turmoil in Egypt. In fact, returns were positive every day, from the beginning of the protest, January 25, through the end of the month. Total return for high yield during this unstable time was 0.44%, while the Standard and Poor's 500 Index (S&P 500) fell 0.38%.

The protests eventually spread throughout the Middle East and North Africa in February, and oil prices spiked above \$100 per barrel for the first time since October 2008. The high yield market again proved its resilience during volatile times, returning 1.32% for the month.

Going into March, investors became more cautious about risky assets in response to the continued tensions in the Middle East and North Africa. The high yield market slowed its pace, clipping just a coupon return in the first two weeks. On March 15, following the Japanese earthquake, the high yield market recorded its worst daily return year to date of -0.51%. At the end of the month, Standard & Poor's downgraded Portugal to a notch away from high yield and downgraded Greece to BB-. The high yield market seems to have looked past these macro overhangs, however, and more than recouped the earthquake-related declines, producing a positive 33 basis point (bps) return in March.

U.S. high yield corporate spreads tightened from the year-end level of 579 bps to 493 bps February 16, the tightest level since November of 2007, before widening to 554 bps after the Japanese earthquake. Throughout the first quarter, spreads tightened by 62 bps to finish at 517 bps March 31. Current spreads are inside the long-term average of 550 bps but still are significantly above historical lows of below 300 bps in mid 2007. By quality, BB spreads of 377 bps are at their 17-year historical average, and B spreads of 512 bps are about 50 bps inside their historical average, while CCC spreads of 784 bps are 253 bps inside their historical average of 1,037 bps.

Spreads may still have additional room to compress as Treasury yields rise. High yield yield-to-worst is around its historical low. The high yield market had a yield of 7.03% March 31, compressed from

7.91% at year end. The historical low was recorded December 15, 2004, at 6.74%.

The first quarter saw \$83.8 billion of new issues priced, topping the previous record issuance of \$83.4 billion in the fourth quarter of 2010. January's issuance of \$29.5 billion and February's \$21 billion are the largest January and largest February on record. March's \$33.3 billion also is the second largest month and March on record, slightly short of the \$35.4 billion recorded in March 2010. If the current pace continues, 2011 will price \$335.4 billion of new issuance, 25% more than the current record of \$262.7 billion in 2010.

CCC rated bonds made up about 17% of new issuance in the first quarter of 2011. Although this ratio is significantly lower than the 24% in fourth quarter of 2010, it is still higher than the low teens seen in late 2009 and early 2010. We view the current level of CCC issuance as healthy. The peak of CCC issuance was in 2007, when a quarter of the new issues were rated CCC. Bs made up majority of the new issuance (58%) with BBs taking the remaining 23%.

About two-thirds of the new issuance proceeds were used toward refinancing, 18% went toward mergers and acquisitions (M&As), and 12% were used for general corporate purposes or capital expenditures, according to Barclays Capital. The large portion allocated toward refinancing should be viewed positively, because it signals that companies are more focused on improving their balance sheets than leveraging up. M&A activities have picked up. We saw several mega deals announced in the first quarter, including AT&T's \$39 billion deal for T-Mobile, Duke Energy's \$13.7 billion acquisition of Progressive Energy, and Sanofi-aventis's \$20.1 billion bid for Genzyme. The current level is still nowhere close to the excessive level seen in 2007, when half of new issuance proceeds were used to fund M&A deals.

On the demand side, the high yield market absorbed \$8.9 billion of inflows in the first quarter, despite a couple of weeks of outflows in March. To compare, AMG Data Services recorded \$13 billion of inflows in 2010 and \$32.7 billion in 2009, a record year. Most of the first-quarter inflows came from money markets and municipal funds, as money continued flowing into risky assets.

From a quality perspective, lower qualities again outperformed higher qualities, as investors chased higher-yielding and riskier assets. CCCs returned 4.90% while Bs returned 3.72% and BBs returned 3.43%. CCCs had the worst pullback during the market turmoil, however, down 100 bps during the first half of March, whereas BBs were about flat, down 3 bps for the same period. Risk

appetites improved later in March, and lower qualities again outgained higher qualities.

All sectors produced positive returns for the quarter. Technology was the best sector, with a return of 5.68%. The largest technology issuer, First Data, which recently extended maturities of \$1.2 billion revolvers and \$5.3 billion term loans, was up 11.82%. Utilities, the biggest underperformer in 2010, had the second-best quarterly return of 5.22%. The strong performance was largely boosted by El Paso, a natural gas company, which returned 10.17% during the quarter. The energy sector followed closely, with a 4.89% return, thanks to the strong performance of oil field services (5.8%) and the run up in oil prices. Consumer cyclicals had the worst return (2.94%) during the quarter, as investors worried that rising commodity prices would compress margins. Communications also performed poorly, with a return of only 3.5%.

The Moody's Investors Service U.S. issuer-weighted default rate continued its downward trend and reached 2.8% at the end of February, its lowest level since the third quarter of 2008 and down from the November 2009 peak of 13.48%. According to J.P. Morgan, default activity slowed significantly in 2010. Only seven companies and \$1.5 billion of bonds and loans defaulted during the year. 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 1.6% by the end of February 2012. According to Moody's, recovery rates returned to about 50% in 2010, which is in line with the historical level and up from the 2009 level of 34%. Senior secured bonds were able to recover 62.5 cents on the dollar on average, while senior secured and senior subordinated bonds recovered 49.6 cents and 33.5 cents, respectively, in 2010.

The high yield credit trend remains positive. Year to date, rising stars have tripled fallen angels at 9 to 3. The number of upgrades also has outpaced the number of downgrades for 19 consecutive months. According to J.P. Morgan, upgrades surpassed downgrades year to date at 118 to 75 on an issuer basis and at \$154.2 billion to \$58.2 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 first quarter of 2011 was filled with macro headline news. The political turmoil in Egypt, unrest in the Middle East and North Africa, Portugal and Greece downgrades, and a devastating Japanese earthquake and tsunami all threatened to reverse the market's positive trajectory. The negative headlines gave the market a much-needed pullback. The S&P 500 was down as much as 6.0% from the two-year high February 18 to the trough of the selloff March 16. The market reversal was transitory, however. By the end of March, the index had recovered to within 1.0% of the two-year high. High yield bonds sold off in sympathy with risky assets but at a much smaller magnitude, down only 7 bps for the period. During the

first quarter, the high yield market returned 3.89%, outperforming all other credit asset classes and yielding only to U.S. equities. The recent volatility again confirmed the resilience of the high yield market, and we reiterate our recommendation of a marketweight to the asset class.

### We attribute the strong high yield performance to the following drivers:

1. **Attractive spreads coupled with low default rates:** Although high yield bonds' yield-to-worst of 7.0% is near the historical low, it compares favorably to other credit asset classes. Spreads have further room to compress, mostly from a potential rise in Treasury yields. The high yield market will continue to benefit from its usually low, and currently negative, correlation to Treasuries. Additionally, we view the downside risk to high yield credits as limited, given that the Moody's 12-month forecasted default rate of 1.6% by the end of February 2012 is significantly lower than the historical average default rate of 4.0%. Many of the poorly run high yield companies were eliminated during the credit crisis, when default rates peaked at 13.48%, and high yield corporations now have a much stronger credit profile.
2. **Strong high yield technicals:** The robust primary market has significantly pushed out the maturity wall, one of the biggest obstacles the high yield market was facing. According to J.P. Morgan, a manageable amount of \$87 billion in high yield bonds is due in 2011 and 2012 (data as of January 31, 2011). On the supply side, although fund cash levels have come down slightly, fund flows keep coming into the high yield market, as investor risk appetite increases. Given that most new issuance has been used toward refinancing instead of adding new debt to the high yield market, the continued inflows will keep high yield bonds well bid.
3. **Positive U.S. fundamentals and limited impact from macro overhangs:** The positive economic news at the end of March further boosted investor sentiments. The unemployment rate fell to 8.8%, as reported April 1, and manufacturing surveys continue to surprise on the upside. U.S. corporations continue to produce healthy profits and raise earnings guidance. Political unrest in the Middle East and North Africa region, developments from the nuclear plants in Japan, and further downgrades of some peripheral European countries now seem to have minimal impact on prices and are unlikely to reverse the expansion path of world economies.

Valuation is the biggest obstacle to a bullish view on high yield credits. With an average index price of \$103.4 and the optionality embedded in many high yield bonds, we see limited price appreciation opportunity for the high yield market and expect a coupon return for the rest of the year. We ask investors to remain cautious throughout 2011, however. As we witnessed in the first quarter, unexpected shocks could considerably derail the market, despite positive fundamentals. Rising commodity prices remain our biggest concern. The prices of crude oil have returned to a level not seen since the end of 2008, and high oil prices could significantly hurt consumer confidence. The consumer confidence level fell to 63.4 in March from 72.0 in February. With earnings season starting

next week, we also will watch closely for any signs of corporate margin compression resulting from the rise in commodity prices. The second round of quantitative easing is projected to end by June 30, and we still question whether the market can sustain its rally without the Federal Reserve's help.

As a result, we believe that the best risk and return profiles are not from an outright add to the riskiest and highest yielding credits, but from fundamentally strong companies that can realize the earnings from an economic recovery and weather any macro volatility should the market pull back. We continue to recommend an overweight to BB and B rated bonds over CCC credits. 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.

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