Investment Grade Commentary

First Quarter 2011

AVIVA INVESTORS

Market Review

Risk assets experienced positive performance during the first quarter. The Barclays U.S. Credit Index outperformed duration-neutral Treasuries by 105 basis points (bps). The 10-year Treasury rate increased by 15 bps to close the year at 3.45%. The spread between 10-year and 2-year Treasuries was relatively unchanged and remained historically steep, at 267 bps.

Credit tightened by 6 bps in the first month of the year, outperforming duration-neutral Treasuries by 39 bps. Again in February, the Barclays U.S. Credit Index tightened by 9 bps, exceeding duration- matched Treasuries by 62 bps. The index widened by 1 bp in March but still managed to outperform Treasuries by 3 bps.

Most of the major credit sectors generated positive excess returns vs. Treasuries for the quarter. The best performer was textiles, with 457 bps of excess return. The worst was pharmaceuticals, at -17 bps.

January

Factors contributing to the overall market tightening n January include an improved economic outlook, continuation of improved corporate revenue and earnings, and a view that the European Union will work hard to solve sovereign risk concerns. The uprising in Egypt did not affect U.S. credit markets. Inflows into investment grade mutual funds turned positive in January, supporting the strong technical picture. The best performing quality bucket was crossovers, thanks to a few specific credits (SLM, Discover Card, Entertainment Properties) performing very well. The best performing sectors were refiners (Valero), finance companies (SLM Corp, Discover Card), life insurance (AIG, AXA, Nationwide), packaging and REITs (Entertainment Properties, ProLogis). The worst performing sectors were tobacco (Lorillard, Altria), restaurants and entertainment.

February

Better-than-expected earnings and positive sentiment about the economy helped early in February, and the turmoil in Libya caused concerns toward the end of the month. We still had positive flows into investment grade mutual funds, which continued to support technicals. For the most part, higher-beta sectors outperformed lower-beta, defensive sectors. Crossovers were once again the best performing quality bucket, with a few specific credits – SLM, Discover Card and Toll Brothers – performing very well. The best performing sectors were paper (International Paper); tobacco (Lorillard, Altria, Reynolds), rebounding from last month; banking (mainly off-the-run issuers); finance (SLM, Discover Card); and home builders (Toll Brothers). The worst performing sectors were entertainment, cable, integrated energy, pharmaceuticals and non-cable.

March

Spread volatility increased during the month, due to uncertainty surrounding the Japanese earthquake and tsunami and tensions in the Middle East and North Africa. The market was able to shrug off these headlines after widening inter-month. In addition, a record volume of new issuance weighed a little on the market, and investors absorbed the new bonds. Accordingly, new issuance concessions increased during the month to entice investors, but they remain relatively low. Despite the volatility, lower-quality credits still managed to outperform. The best performing sectors were non-captive finance (SLM), sovereigns, building materials, tobacco and pipelines. The worst performing sectors were airlines, entertainment, packaging (limited impact due to small scale), paper (specifically International Paper) and life insurance.

Fundamentals

Fundamental factors support tighter spreads going forward. Credit metrics are solid; profit margins are very good, and revenues are up. 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. Individual company credit fundamentals are solid. Balance sheets have low leverage and high liquidity. We expect leverage to increase and liquidity to decline in 2011, however, as companies use their balance sheets to grow revenues and earnings for shareholders. Balance sheets are solid, but we don't expect them to get any better. Bank capital ratios are stronger and significantly better than pre-crisis levels, and we should see continued improvement with banking regulations and Basel III. We expect leveraged buyouts to be smaller and spottier, using less leverage than in previous credit cycles. Headline risk will be a factor in contributing to spread volatility, however. Event risk is likely to increase during the year, which will be a negative factor for the investment grade credit market.

Technicals

Secondary market liquidity is good. The market continues to be well bid, and dealer inventories are at normal to low levels. The market will easily absorb new supply, though issuance is expected to be lower than it was in the record-setting first quarter. Total 2011 issuance is likely to be similar to last year. We expect investors to drive spreads tighter as they reach for yield. Due to the limited fixed income alternatives, we continue to expect supportive cash flows into the asset class. Retail investors looking for higher absolute returns are likely to re-allocate some cash to equities, but we expect institutional demand for investment grade credit to remain solid. Pension plans should continue allocating out of equities, life insurance companies are still seeking long duration and yield, and overseas demand remains strong, especially from Asia. We expect volatility to be higher, based on risks and absolute returns. Those risks include the continued European sovereign crisis, political volatility in the Middle East and Africa, shareholder-friendly announcements and potential leveraged buyouts, uncertainty around banking and financial regulation reform and municipal solvency issues. Credit sectors are increasingly more susceptible to periods of spread widening and volatility due to macroeconomic factors and compressed spread levels.

Valuations

Spreads relative to credit metrics look attractive, and we don't expect any major deterioration in credit fundamentals. Spreads continue to look attractive relative to credit metrics and from a historical perspective. They also are attractive relative to volatility. Although we expect volatility to go up (which usually implies higher spreads), spreads won't necessarily widen on increased volatility in this case.

Risk

The market continues to be susceptible to periods of spread widening and greater volatility. We are cautious about the effects of macroeconomic flare-ups. Tensions in the Middle East and North Africa will reduce risk appetites and pressure energy prices. Eurozone countries will continue being challenged by high debt levels and poor economic growth in the weaker nations, along with slow progress in implementing permanent solutions. We expect low all-in yields; absolute returns may be better in other asset classes. We aren't seeing the next marginal buyer of credit risk; investors can still recall the lessons from past financial crises, when risk control measures were tightened. Finally, we're concerned about the risk associated with regulatory reforms.

Summary

In summary, we have a positive outlook for investment grade credit spreads, supported by strong fundamentals in the form of income statements and balance sheets and strong technicals, meaning supply vs. demand. We expect increased periods of volatility based on headlines and event risks. And we believe spread performance will be muted by risks such as the European sovereign crisis, shareholder-friendly activity and policy and regulatory actions, along with the resulting increases in volatility. Individual security selection will be important to performance.