

## Market Review

The U.S. economy has experienced sluggish growth during the first half of 2011. The slowdown can be attributed partially to temporary factors, including Japanese supply chain disruptions, weather-related issues and the oil price shock and its impact on consumer discretionary income. The slowdown in growth relative to late 2010 also is a function of another leg down in the housing market, continued private sector deleveraging, slowing global growth affected by tighter monetary policies and the reluctance of businesses to hire and spend in the face of significant regulatory uncertainty. We do not believe this is a severe slowdown, because the economy commonly experiences a period of slower growth in the middle of an economic cycle.

With unemployment remaining at heightened levels and inflation expectations moving away from deflation risk, we expect the Federal Reserve (Fed) to maintain its current policy stance well into 2012. The Fed continues to note headwinds facing stronger economic growth and remains disappointed with the slow recovery in unemployment. We expect the Federal Open Market Committee to continue debating monetary policy over the coming quarters, with the hawks posturing for the Fed to begin reducing its balance sheet and hiking rates earlier. The fragile economic recovery argues for continued patience, however, and a slow and steady approach to removing policy accommodation.

In April, Standard & Poor's downgraded the outlook on U.S. government debt from "stable" to "negative." Moody's also has noted the risk to the rating of U.S. government debt if it doesn't make progress toward fiscal cuts in the near future. While the standalone risk of a downgrade is unlikely, a failure to reach consensus on the upcoming U.S. debt ceiling issue and subsequent plan to address the fiscal deficit would substantially increase the likelihood of a downgrade.

They seem to have consensus on the need to reduce the budget deficit, but Democrats and Republicans do not agree on the methods. U.S. government credit ratings, a potential technical default and substantially higher borrowing costs are at stake. Aviva Investors expects legislators to enact a "two-part approach," temporarily extending the debt ceiling to avoid a technical default, while agreeing to future spending cuts to address the unsustainable growth of entitlement programs and to avoid a downgrade of U.S. government debt credit ratings.

Overall demand for credit and other risky assets turned negative during the second quarter, as the number of unresolved macro risks

facing the markets resulted in a "risk off" trade, causing credit spreads to widen. These macro risks included geopolitical Middle East tensions, Greek debt restructuring, U.S. economic growth, U.S. fiscal and debt ceiling issues and emerging economy inflation concerns. While the underlying strength of demand from credit fixed income investors remains in place, the spread widening experienced in the second quarter reminds investors of the impact shorter-term technical sentiment can have on the markets. Investment grade credit spreads widened approximately 8 basis points (bps) during the quarter, while high yield and commercial mortgage-backed securities (CMBS) spreads widened by approximately 54 and 13 bps, respectively.

The markets experienced rising volatility and relative underperformance of risky asset classes during the second quarter, as the economy slowed, European sovereign debt restructuring fears flared, the U.S. debt ceiling and fiscal policy issues received heightened attention, and the Fed completed its second round of Quantitative Easing (QE2).

U.S. Treasuries outperformed most other asset classes during the second quarter, as reduced risk appetite resulted in "flight to quality" demand, driving rates lower. During the quarter, Treasuries generated a 2.39% return, while the Standard & Poor's 500 Index returned 0.10%. The 10-year Treasury yield declined 31 bps, while the spread between 10-year and 2-year Treasuries remained historically steep, at 270 bps. Within the fixed income markets, investment grade credit, high yield and CMBS underperformed Treasuries, with excess returns of approximately -7, -110 and -43 bps, respectively.

## Investment Outlook

We believe solid fundamentals, improving technicals and relatively attractive valuations bode well for future credit and securitized fixed income performance. We remain constructive on investment grade and high yield credit, given the positive credit metrics, supportive levels of economic growth, the 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 two years, investment grade and high yield companies are benefitting from the improvement in the economy and are better positioned to withstand future moderate economic weakness.

We expect overall bond yields to remain relatively low following the Fed's recent completion of its \$600 billion large-scale asset purchase program, due to moderate economic growth and relatively contained inflation expectations. We expect the 10-year Treasury to range between 3% and 3.75% during the second half of 2011. With the issuance of Treasuries expected to remain at historically high levels, a moderate second-half rebound in the economy, and fixed income markets adjusting to the end of QE2 and continued reinvestment by the Fed, we expect yields to move gradually higher.

**The key risks to our economic and market outlook are focused on:**

1. European sovereign debt restructuring fears and the potential spillover risks into European banks, the financial industry and the global economy
2. U.S. debt ceiling and fiscal policy issues and potential U.S. government debt rating implications
3. Geopolitical risks and political instability in the Middle East and North Africa
4. China's ability to successfully slow down overheated property markets and contain inflation
5. Global monetary and fiscal policy tightening
6. The impact of Dodd-Frank regulatory reform on the financial industry and economy

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