Economic Review and Market Outlook
Commentary

Second Quarter 2011

AVIVA INVESTORS

Economic Commentary

U.S. economy experiences soft patch

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. Finally, it's common for the economy to experience a period of slower growth in the middle of an economic cycle. We expect the U.S. economy to resume its moderate growth path during the second half of 2011.

Hiring trends downshift with economy

The April and May payroll reports showed moderate gains, consistent with the slower-growing economy. The job gains of 232,000 and 54,000 reported in April and May reduced the three-month average to an increase of 168,000 jobs. The job market recovery also slowed within private payrolls, which increased by 251,000 and 83,000 in April and May, respectively, and 184,000 over the last three months. Private sector payrolls have experienced growth for the last 15 months.

The unemployment rate ticked back up to 9.1% in May, from 8.8% at the end of the first quarter. This was consistent with our expectations that the rapid pace of improvement during the first quarter would level off and the unemployment rate would decline only gradually as we progress through 2011.

Other labor market indicators, such as jobless claims, also pulled back during the quarter. The four-week moving average of jobless claims was 427,000 as of June 30, which is up from 395,000 at the end of the first quarter. The labor markets will continue to have significant excess capacity unless jobless claims remain solidly below the 400,000 level and monthly payrolls generate consistent gains of 200,000 or more.

Manufacturing and service sector indicators slide

The Institute for Supply Management (ISM) manufacturing index shifted lower during the second quarter, from 61.2 in March to 55.3 in June. The manufacturing index has remained above 50 each month in 2011, which continues to indicate broad-based growth. U.S. manufacturing continues to benefit from a weak U.S. Dollar (USD) through increased global competitiveness, which helped offset the temporary weakness resulting from the Japanese supply chain disruption.

Growth within the service sector also ticked down, with the ISM non-manufacturing index falling from 57.3 in March to 53.3 in June. Readings in the low 50s are consistent with the moderate economic growth environment Aviva Investors expects over the coming quarters.

Housing prices continue downtrend

Housing continued to affect the economy negatively during the second quarter. Despite falling prices and improved affordability, housing activity remained at depressed levels. Housing sales, starts and permits all remain depressed, and distressed sales continued to make up approximately 30% of total sales. 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 6.2 and 9.3 months, respectively. This is much higher than the pre-financial-crisis levels, which averaged around six months for new homes and 4.6 months for existing homes. The Case-Shiller 20-City Price Index was down 3.96% year over year in April and has declined to its lowest level since 2002. We expect the weakening housing market trends to continue, with a long, slow, bumpy road to recovery.

Consumer spending affected by rising gas prices

Consumers are spending at a cautious pace due to elevated unemployment. Consumer confidence has improved from several quarters ago, averaging 62 during the second quarter, as compared to 54.5 for 2010. Late 2010 and early 2011 increases in food and energy prices, driven by hikes in oil and other commodities, have provided headwinds to growth and consumer spending. These headwinds should begin receding now, thanks to an 11% decline in oil prices during the second quarter. 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 rebound in consumption relative to previous economic recoveries. We expect modest growth in consumer spending, which is in line with our moderate growth outlook.

Market Outlook

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 Federal Reserve (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 basis points (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 commercial mortgage-backed securities (CMBS) underperformed Treasuries, with excess returns of approximately -7, -110 and -43 bps, respectively.

Fed ends QE2, no indication of further monetary easing

The Fed ended its $600 billion government debt purchase program June 30, 2011. While some question whether QE2 was necessary, the market data strongly suggests that QE, along with other policies, was successful in easing financial conditions, raising asset prices, reducing longer-term borrowing costs and lowering the value of the USD, thereby increasing exports via more competitive pricing of U.S. goods. On the other hand, real economic improvement, including job and economic growth, is less evident.

We expect the Fed to maintain record stimulus following the end of QE2, which is consistent with its dual mandate to seek maximum sustainable employment and price stability. The Fed gave no indication of considering further expansion of monetary policy (i.e. QE3) or plans to reduce the Fed's balance sheet or raise short-term rates in the near term. Fed Chairman Ben Bernanke said, "The current outlook is significantly different than what we were facing in August of last year. We no longer have a deflation risk." Headline inflation has increased to 3.6% year over year, and the rate of core inflation is at 1.5%. The Fed also increased its core inflation expectations for 2011 from 1.3% - 1.6% to 1.5 - 1.8% and for 2012 from 1.3 - 1.8% to 1.4 - 2.0%.

With unemployment remaining at heightened levels and inflation expectations moving away from deflation risk, we expect the 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.

U.S. fiscal policy takes center stage

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.

Fiscal policy is a politically charged issue, and President Obama, policy makers and the Treasury Department are being further pressured 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 deficit, which is approaching 10% of gross domestic product, is unsustainable. The Republicans are using the debt ceiling issue as leverage to secure meaningful reductions in government spending, and they have resisted the Democrats' push for higher taxes. The Democrats have little appetite to agree to material immediate spending cuts that would jeopardize the fragile U.S. economic recovery and could prove costly ahead of the elections.

While they seem to have consensus on the need to reduce the budget deficit, 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.

Market technicals weaken, fundamentals remain strong

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 most of the quarter before staging a recovery late in June. 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 bps during the quarter, while high yield and CMBS spreads widened by approximately 54 and 13 bps, respectively.

Looking forward, we see credit fundamentals remaining stable and supportive of moderate outperformance for investment grade and high yield credit. Balance sheets are in good shape, and corporate earnings growth should remain positive, even as margins are likely beginning to peak. Business confidence is growing modestly, merger and acquisition activity has picked up, and companies are beginning to look for alternatives to deploy record levels of cash from their balance sheets. We believe we are 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 are neutral to modestly positive, as spreads have recently widened, reflecting macro fundamental and technical risk factors. Valuations are 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.

Regulatory reform continues 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 market participants. While the implementation of specific rules aimed at derivative and financial institution reform remains uncertain, the new legislation, which will be rolled out over coming quarters, promises to affect the markets for many years.

Summary

We believe stable 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.

We also expect volatility to remain elevated and portfolio risk positioning to be increasingly important, due to the number of key macro risks affecting the markets and the magnitude of their potential effects on financial institutions, the global economy and investors' risk appetites. 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