

Market Review

Following a stellar first quarter, the high yield market returned a small gain of 1.05% in the second quarter (Barclays Capital US High Yield Constrained Index), bringing the year-to-date return to 4.98%. As risky assets underperformed in the second quarter, the high yield market performed better than only U.S. equities (0.10%), trailing all other credit asset classes, including crossovers (1.97%), emerging market bonds (3.37%), investment grade bonds (2.50%) and U.S. government bonds (2.22%).

The high yield market carried the first quarter rally on into April, returning 1.55%, boosted by a positive first-quarter earnings season. Weak economic data, rising commodity prices and European sovereign risks all weighed on equity prices in May, pushing the Standard & Poor's 500 Index down 1.13%. High yield bonds remained resilient, however, returning 0.49% for the month. The market turned sour quickly in June, as investors worried about the situation in Greece and an extended soft patch in the economy. The high yield market was down as much as 1.66% until the last week of June, when it regained some ground, ending the month with a return of -0.97%.

High yield corporate spreads widen 54 basis points (bps), from 517 bps March 31 to 571 bps June 30. The high yield market reached its tightest level of 498 bps since the end of 2007 on April 11. Spreads are hovering around the long-term average of 550 bps but still are significantly above their historical lows of under 300 bps in mid 2007.

High yield yield to worst ended the second quarter at 7.33%, contracted 19 bps from the yearend level of 7.52%. The historical low of 6.76% was recorded December 31, 2004. The lowest yield recorded in 2011 was 6.63% on May 16.

The second quarter saw \$110.3 billion of new issues priced, a record high quarter. About \$18 billion was non-U.S.-Dollar (USD) issuance, according to J.P. Morgan. Year-to-date, \$219.8 billion of new issues came to the market.

CCC rated bonds made up about 15% of new issuance in the second quarter of 2011, a slight increase from the first quarter's 11%. BBs and Bs shared the rest of the new issuance about evenly. We view the current level of CCC issuance as healthy compared to the peak of issuance in 2007, when almost one-third of the new issues were rated CCC.

On the demand side, the high yield market had consecutive weeks of outflows in June, bringing the year-to-date inflows down from \$8.9 billion at the end of the first quarter to \$5 billion at the end of second quarter.

During the quarter, higher quality bonds outperformed lower qualities, as investors peeled back their risky positions. BBs returned 1.59%, while Bs and CCCs returned 0.78% and 0.79% respectively.

Utilities had the best return in the second quarter, at 2.29% and 7.63% year to date. The largest issuer in the utility space, TXU Energy, was up 6.78% in the second quarter. Banking, the best sector in first quarter, was one of the worst sectors in second quarter, with a return of 1.16%.

The Moody's Investors Service U.S. issuer-weighted default rate continued its downward trend and reached 2.4% at the end of May, its lowest level since the third quarter of 2008 and down from the November 2009 peak of 13.48%. Moody's forecasts the default rate to decline to 1.7% by the end of May 2012, saying expansion by business sales, corporate borrowing restraint and sufficient liquidity will limit defaults.

The high yield credit trend remains positive. The number of upgrades also has outpaced the number of downgrades for 22 consecutive months. According to J.P. Morgan, upgrades surpassed downgrades year to date at 231 to 147 on an issuer basis and at \$303.5 billion to \$139.5 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 end of the second round of quantitative easing (QE2), weak economic data, Chinese company accounting scandals, uncertainty around the Greek austerity package and rising inflation all overshadowed a strong first-quarter earnings season. The high yield market ended the first half of 2011 at levels close to where it started the year. The yield to worst and spreads tightened by 19 bps and 8 bps year to date, respectively, finishing at 7.33% and 571 bps midyear. Nevertheless, the high yield market turned in 4.98% in the first six months, 3.98% of which came from coupon return. Going into the second half of 2011, a post-Fed asset purchasing program

period, we expect the market to be driven less by macro headlines, and we will focus more on fundamentals and idiosyncratic risk selection. We do not expect the market to experience another significant pullback, given that investor concerns have been eased by the Greek Parliament's approval of an austerity package, the recent drop in commodity prices and the Fed's slow exit of QE2. We do not think the U.S. economy will reverse its positive trajectory, but we are cautious of tail risks as we await decisions on the U.S. budget deficit and debt ceiling. We would like to reiterate our recommendation of a marketweight to the high yield asset class due to the following reasons:

1. Attractive spreads coupled with low default rates: High yield bonds' yield to worst of 7.33% compares favorably to other credit asset classes, and its spread of 571 bps is still far from historical lows. With QE2 ending, we expect rates to rise slowly, a negative in general for fixed income credits. The high yield market benefits from a usually low, and currently negative, correlation to Treasuries, however. Additionally, a 12-month default rate forecast of 1.7% by the end of May 2012 shows the limited fundamental downside risk of high yield credits. High yield bond prices also have dropped from the peak of \$104.5 one and a half months ago to around \$102.3 at the end of June.
2. Strong high yield technicals: Despite recent mutual fund outflows and slower activity in the primary market, we believe high yield technicals remain positive. We found that liquidity

became scarce when the market was selling off, because investors were reluctant to liquidate positions. Bond prices also were bid up quickly when the market recovered, showing optimistic investor sentiment.

3. Strong corporate fundamentals: Although washed out by the macro headline news, the first-quarter earnings season reported strong numbers. According to Barclays Capital, the aggregate earnings beat was 7.3% for the first quarter and S&P 500 2011 EPS estimates increased \$2.05 since end of first quarter. We are seeing strength in top-line growth, and ratings momentum is more positive than ever. Given the idiosyncratic nature of high yield bonds, we think the positive fundamentals should outweigh macro uncertainties.

In all, 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 the rest of 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.

Important information

Past performance is not indicative of future results. This commentary contains the current opinions of Aviva Investors and is not intended to be, and should not be interpreted as, a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This commentary is distributed for informational purposes only and is not a recommendation or investment advice. The information herein is based on sources which Aviva Investors believes to be reliable, but it is not guaranteed to be accurate or complete.

Forward-looking statements, opinions and other information contained in this article are subject to change continually and without notice and may no longer be true after the date of publication. Any such statements speak only to the date they are made and Aviva Investors North America assumes no duty and does not undertake to update forward-looking statements. Such statements are subject to numerous assumptions, risks and uncertainties, which may change over time. Actual results may differ substantially from those anticipated in forward-looking statements. Past performance is not indicative of future results. There is potential for profit or loss with any investment.

No part of this commentary may be reproduced in any form, or referred to in any other publication, without the express written permission of Aviva Investors North America, Inc.