Economic Review and Market Outlook
Commentary

Third Quarter 2011

AVIVA INVESTORS

Economic Review

U.S. economic growth remains sluggish

The U.S. economy appeared to improve modestly during the third quarter, following the second quarter's sluggish 1.3% annualized growth rate. The temporary factors affecting growth during the second quarter — Japanese supply chain disruptions, weather-related issues and the oil price shock — began to fade, giving a modest boost to growth during the third quarter. Economic data continues to support our view that U.S. economic growth will remain tepid for the foreseeable future.

Standard and Poor's downgrade of U.S. government debt and an intensification of the European government debt problems also contributed to the slowing economy. While we expect U.S. growth to improve modestly in the next one to two quarters, the economy remains very fragile. We expect growth to remain sluggish over the next 12 to 24 months, constrained by the stubbornly high unemployment rate, tighter financial conditions triggered by Europe, and low confidence from consumers and businesses.

Job creation remains stagnant

The July and August payroll reports reinforced the slowing economy and lack of improvement in the labor markets. The job gains of 85,000 reported in July and zero in August reduced the three-month average to an increase of 35,000 jobs. The job market recovery also slowed within private payrolls, which increased by 156,000 and 17,000 in July and August, respectively, and averaged 83,000 over the last three months. Overall, private sector payrolls have experienced growth for the last 18 months.

The unemployment rate ticked down to 9.1% in August, from 9.2% at the end of the second quarter. This was consistent with our continued expectations that the rapid pace of improvement during the first quarter would level off and the unemployment rate would remain stubbornly high due to the economy experiencing tepid growth.

Other labor market indicators also remained weak during the quarter. Jobless claims continued to hover above 400,000. The labor markets also have been affected by businesses' reluctance to hire in the face of large macro uncertainties. The labor markets will continue to have significant excess capacity unless jobless claims shift solidly below the 400,000 level and monthly payrolls generate consistent gains of 200,000 or more.

Manufacturing and service sectors predict slow growth

The ISM manufacturing index shifted lower during the third quarter, from 55.3 in June to 51.6 in September. The index has remained above 50 each month in 2011, which continues to indicate modest growth. U.S. manufacturing has experienced a slight pickup recently, with auto production rebounding from second-quarter Japanese supply chain disruptions.

Growth within the service sector remained flat during the third quarter, with the ISM non-manufacturing index unchanged from 53.3 in June to 53.0 in September. 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 also continued to affect the economy negatively. Despite falling prices and improved affordability, housing activity remained at depressed levels throughout the quarter. Housing sales, starts and permits remain lower, and distressed sales continued to make up almost a third of total sales. High levels of delinquencies and new foreclosures keep housing inventory elevated, and prices have resumed their downward path. The Case-Shiller Home Price Index decreased 4% year over year in July. The new and existing supply of homes remains elevated, at 6.6 and 8.5 months, respectively, and the shadow home inventory of properties in foreclosure is approximately 2 million. 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. We expect the weakening housing market trends to continue, with a long, slow, bumpy road to recovery.

Consumer spending remains cautious

Consumers continued spending at a cautious pace due to elevated unemployment and tighter financial conditions caused by volatility in the financial markets. Consumer and business confidence declined during the third quarter, following the downgrade of U.S. government debt and the escalating European sovereign debt crisis. Declining energy prices have removed some of the headwind to consumer spending. Stagnant labor markets, falling asset values and rising uncertainty led to further declines in consumer confidence, however. We are experiencing a negative feedback loop, where macro risks, such as the European debt crisis, lead to weak consumer and business confidence, which causes weaker consumption and economic growth, and so on. We expect tight credit conditions, savings trends and the negative feedback loop to keep consumers spending at a cautious pace, which is in line with our sluggish growth outlook.

Market Outlook

The markets experienced rising volatility in the third quarter. Risky asset classes significantly underperformed, as Standard & Poor's downgraded its rating of U.S. government debt, fears of a U.S. double-dip recession increased, the European sovereign debt crisis intensified, and concerns rose about potential European bank failures.

U.S. Treasuries outperformed all other asset classes during the third quarter, as the risk-off environment and flight-to-quality demand drove rates lower. Treasuries generated a 6.48% return, while the S&P 500 returned -13.87%. The 10-year Treasury yield declined 123 bps to a 1.93% yield, while the spread between 10-year and 30-year Treasuries flattened to 100 bps from 121 bps in June. Within the fixed income markets, investment grade credit, high yield and CMBS substantially underperformed Treasuries, with excess returns of approximately -4.75%, -10.35% and -3.6%, respectively.

U.S. credit rating downgrade contributes to market volatility

Standard & Poor's August downgrade of U.S. government debt to AA+ followed the April announcement of its outlook being reduced from "stable" to "negative." The U.S. economy's sizeable budget deficit, approaching 10% of GDP, the federal government's inability to proactively address it in previous quarters, and the lack of coordination during the budget ceiling debate led to this action. While the country's access to capital has never been in jeopardy, the downgrade intensified the uncertainty in markets and did little for consumer and business confidence.

The deficit remains unsustainable. Following the debt ceiling debate, a congressional "super committee," made up of Republicans and Democrats, was formed and charged with agreeing on $1.2 trillion of deficit reduction by November to avoid prescribed automatic spending cuts. While they seem to have consensus on the need to reduce the budget deficit, the parties do not yet agree on the methods, and the deficit reduction issue will be highly debated. Policy makers are under significant pressure to reach agreement following the poor handling of the debt ceiling debate and the growing public perception of the budget deficit as a primary political concern. This increases the likelihood of the committee reaching an agreement by the deadline, but Aviva Investors expects the debate to continue adding to market uncertainty and volatility over the near term.

Fed announces Operation Twist and rates on hold until mid-2013

At its August 9 meeting, the FOMC announced plans to "hold rates steady until at least mid-2013." The Fed understands and communicated the limited ability of monetary policy action to directly improve job creation and economic growth. Chairman Ben Bernanke's Jackson Hole speech focused heavily on the need for fiscal policy to support economic growth and job creation in the near term, while also fixing the long-term deficit problem and negative drag on growth over the intermediate term. In essence, Bernanke put pressure on policy makers and the administration to fix the current fiscal policy issues.

The FOMC followed up by announcing plans to implement Operation Twist at its September meeting. This involves selling $400 billion in three-month to three-year Treasuries and purchasing $400 billion in six- to 30-year Treasuries over the next nine months. In addition, the FOMC attempted to support the housing market and mortgage financing by announcing that all agency and agency MBS maturities on the balance sheet will be reinvested into agency MBS. The objective of Operation Twist is to drive longer rates lower and ease financial conditions by removing duration from the market. The announcement resulted in lower rates and a flatter yield curve but did not provide a boost to asset prices.

Instead, risky assets reacted negatively to the dire tone of the FOMC's economic outlook. The September meeting statement highlighted the fragile environment for growth and job creation. It also indicated that downside risks to growth and financial market turmoil have increased and are being affected heavily by the lack of policy coordination and the absence of a credible solution to the European sovereign debt crisis.

With unemployment remaining at heightened levels and inflation expectations moving lower, we expect the Fed to maintain record levels of stimulus for the foreseeable future, which is consistent with its dual mandate to seek maximum sustainable employment and price stability. The Fed continues to note headwinds facing stronger economic growth; it remains disappointed with the slow recovery in unemployment; and it is concerned with the downside potential posed by heightened macro risks.

Credit performance deteriorates due to heightened macro risks

Demand for credit and other risky assets turned significantly negative during the third quarter, as the number of unresolved macro risks facing the markets intensified and resulted in a flight-to-quality, risk-off environment, causing credit spreads to widen significantly.

Investors' risk conviction and risk appetite dropped precipitously with the heightened volatility surrounding the macro risks and the likely outcomes being heavily influenced by politics. This elevated uncertainty negatively affects investors' fundamental economic outlook and their technical sentiment.

The credit spread widening experienced in the third quarter reminds investors of the 2008/2009 credit crisis and the potential systemic financial crisis that could result from European sovereign debt defaults. Investment grade credit spreads widened approximately 80 bps during the quarter, while high yield and CMBS spreads widened by approximately 280 and 110 bps, respectively. Liquidity also has deteriorated, with bid/ask spreads widening, new issuance volumes down, and new issuance premiums rising to attract capital from investors. Also, financial spreads in Europe are now trading beyond their 2008 highs, and investment grade financial spreads are nearing their 2008/2009 peaks. High yield and investment grade financial spreads are beginning to price in a recession scenario.

Looking forward, we see credit fundamentals remaining stable but declining modestly, and profit margins are expected to top out. We expect third-quarter earnings to be OK, but in many cases guidance will likely be conservative or withdrawn altogether, given the economic and policy uncertainty and depressed consumer and business confidence. Stable fundamentals, including strong balance sheets and low inventory levels, remain supportive of moderate outperformance for investment grade and high yield credit. We expect companies to remain patient in deploying the record levels of cash on their balance sheets.

Valuations for credit are becoming attractive in the long term, as spreads have widened materially, reflecting heightened macro uncertainty and technical sentiment factors. We expect spreads to move tighter in the event of a coordinated resolution of the European sovereign debt crisis, with heighted credit spread and return volatility to continue over the near term. While valuations have become incrementally more attractive, and credit spreads are already pricing in very adverse economic scenarios, we continue to view lower levels of active risk positioning in client portfolios as prudent. This is particularly true in the current macro-risk-dominated environment, which is highly dependent on political coordination to resolve important market risks. We see the attractive long-term valuations and volatility creating opportunities to generate excess returns from active security selection and sector allocation when the European political uncertainties begin to subside.

Summary

We expect U.S. economic growth to remain sluggish but avoid a double-dip recession, because consumers and businesses are better prepared to deal with the slower-growth environment. We believe heightened uncertainty surrounding the resolution of the European sovereign debt crisis and domestic fiscal policies will continue to create a risk-off environment favoring lower levels of active risk in client portfolios. We remain constructive longer term on investment grade and high yield credit, given the stable credit fundamentals and relatively attractive valuations. Tactically, however, we remain patient for signs of political and macro uncertainties beginning to subside. We also expect the markets to continue pushing the ECB and Euro-area policy makers to coordinate and act decisively to avoid a systemic financial crisis.

We expect overall bond yields to remain relatively low, consistent with steady rates through mid-2013, Operation Twist, sluggish economic growth and relatively contained inflation expectations. We expect the 10-year Treasury to range between 1.50% and 2.50% over the next six to 12 months.

We believe key risks to our economic and market outlook are focused on:

1. The European sovereign debt problem and potential systemic banking and financial crisis
2. The U.S. economy tipping into a double-dip recession due to negative feedback loop risks
3. The U.S. fiscal deficit reduction plan and political debate
4. China’s ability to manage a soft landing