

Market Review

Risk assets experienced slightly negative performance during the first quarter. The Barclays U.S. Credit Index underperformed duration-neutral Treasuries by 7 basis points (bps). The 10-year Treasury yield declined 31 bps, while the spread between 10-year and 2-year Treasuries remained historically steep, at 270 bps.

The Barclays U.S. Credit Index tightened by 4 bps in April, outperforming Treasuries by 42 bps. In May, the index widened by 7 bps, underperforming Treasuries by 27 bps. The index widened further in June by 5 bps, underperforming Treasuries by 22 bps.

Most of the major credit sectors underperformed Treasuries for the quarter, with the exception of utilities and non-corporates. Foreign local governments, specifically Build America Bonds, were the best performers, generating 210 bps of excess return for the quarter. Paper, explicitly International Paper, performed worst, at -180 bps.

April

March's spread volatility continued into early April, based primarily on higher oil prices and concerns about overall economic weakness, resulting in wider spreads. But the second half of the month was better, seeing spread tightening as companies reporting earnings impressed to the upside. New issuance concessions remained a little higher vs. recent history but still were relatively low. Money flows into investment grade mutual funds continued at an increasing pace during April, as well. The best performing sectors were refining; foreign local governments, where performance was dominated by Build America Bonds; life insurance; independent energy; and cable. The worst performing sectors were textiles, which is a very small sector, airlines, home construction, and industrial-other, predominantly university bonds. By credit quality, crossovers were the worst sector, and A/BBB rated issues were the best performers.

May

The trend reversed in May, as economic data weakened and concerns mounted over European sovereign debt issues. As a result, we saw a flight-to-quality, "risk-off" trade. The best performing sectors were foreign local governments (Build America Bonds), lodging, industrial-other (university bonds), natural gas distribution and supermarkets. The worst performing sectors were life insurance, metals and mining, media non-cable, and environmental. Crossovers performed worst, and AA+ rated issues performed best.

June

Continued U.S. economic weakness carried into June, fueling poor credit performance. Further deterioration in Greece and broader concerns on the uncertainty around the sovereign debt crisis also

kept pressure on spreads during the month. Credit spreads did improve in the last couple of days of the month, based on successful votes in Greece and some level of European support for bailout packages. A flight-to-quality, risk-off during the month was still the way to outperform, however. The best performing sectors were sovereigns, notably the non-European countries of Panama, Brazil and Columbia; entertainment; media cable; home construction (small sector/issuers); and media non-cable. The worst performing sectors were paper (International Paper), tobacco, refining, pipelines and wirelines. AA and BBB rated issues performed best, and crossovers were at the bottom.

Fundamentals

Fundamental factors support tighter spreads going forward. Credit metrics are solid, but we are watchful for changes in earnings guidance. Revenues are up marginally. Free cash flow and cash flow generation remain strong. We wouldn't be surprised to see 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 destroying their balance sheets. Individual company credit fundamentals are solid. Balance sheets are relatively low leveraged and have high liquidity. We expect leverage to increase marginally 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, but headline risk will be a factor. We don't expect any major systematic trends for ratings, but they will be driven by one-off events or mergers and acquisitions, which will be a negative factor for the investment-grade credit market.

Technicals

The technical bias has shifted along with the negative sentiment surrounding concerns about the Euro and sovereign debt issues, as well as financial reform legislation and investigations. Secondary market liquidity is poor. But dealer inventories are at low levels, and fund flows into the asset class remain strong, which is supportive to spread tightening. The market can easily absorb new supply. Low all-in yields are keeping pressure on any meaningful spread tightening, as marginal-yield buyers are sitting on the sidelines. 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 for U.S. credit product remains solid. We expect volatility to be higher, based on risks and absolute returns. Those risks include the continued European sovereign crisis, political unrest in the Middle East and Africa, shareholder-friendly announcements and potential leveraged buyouts, uncertainty around financial reform and banking regulation and investigations, and potential municipal solvency issues. Credit sectors are increasingly more susceptible to periods of spread widening and volatility due to macroeconomic factors and compressed yields. Spreads relative to credit metrics look attractive, however, and we don't expect any major deterioration in credit fundamentals.

Risk

We expect only modest spread tightening for the second half of the year, based on sovereign risk concerns, such as macro-economic flare-ups. 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; so 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 still have concerns surrounding risks associated with financial regulatory reforms.

Valuations

Spreads relative to credit metrics look attractive, and we don't expect any major deterioration in credit fundamentals. On a historical perspective, spreads still look cheap. Relative to volatility, spreads look attractive, although we expect volatility to potentially go up.

Sector Views

We expect to be overweight to banks going forward. We believe that financial regulatory reform, including Basel III, will make banks fundamentally stronger, but the headlines will drag the spread recovery out over some time. Spreads on banks remain historically cheap. Security selection will be important.

We also like other, higher beta sectors, predominantly those that are commodities-based, including metals and mining and energy, which should benefit from global expansion. Security selection will be important here, as well.

We expect to underweight low beta, tight spread sectors, to guard against risk from potential merger and acquisition activity and leverage events. We also will underweight consumer sectors that have limited revenue growth potential. Consumer products and food and beverage are likely to underperform due to event risk, increased shareholder-friendly activity and rising input costs, which pressure their margins. We'll also remain underweight to European credits based on sovereign risk, awaiting a better entry point.

We recommend maintaining a modest strategic overweight to credit with specific overweight allocations to finance (banking) and commodity-based sectors. We recommend underweights to sectors and issuers that have limited revenue growth potential and exposed to shareholder friendly activity and event risk. We recommend underweights to European credit credits, especially to the peripheral European countries. We suggest overweights to issuers with significant exposure to global growth. Tactically, we recommend a position in higher quality, defensive credits to start the third quarter, and we suggest increases to utilities and higher rated, select industrials.

Summary

In summary, from a strategic standpoint, we have a positive outlook for investment grade credit spreads, supported by bottom-up credit fundamentals and favorable supply vs. demand technicals, offset by negative sentiment surrounding global macro events, domestic economic growth and low all-in yields. Our tactical approach is more cautious, however, and we are positioned a little more defensively as we begin the third quarter. Our bias is for spread tightening, but we expect periods of increased volatility due to event-driven headline risk. We believe spread performance will be muted by risks such as the European sovereign crisis, shareholder-friendly activity and policy and regulatory actions. Company and industry-specific fundamentals and valuations take a back seat to macro events, but we still believe individual security selection will be important to outperforming.

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