

ECONOMIC REVIEW & MARKET OUTLOOK COMMENTARY

Fourth Quarter 2011



Economic Commentary

U.S. economy experiences modest uptick

The U.S. economy closed the year on a positive note, with fourth-quarter economic growth estimates of approximately 3.5%, following the third quarter's sluggish 1.8% annualized growth rate. The temporary factors affecting growth in the first half of 2011 continued to fade, while increased consumption provided a boost to growth during the fourth quarter. Economic data is experiencing a temporary strong patch, as increased consumption has come at the expense of a reduction in savings, and income growth remains subdued.

The European debt crisis continues to dominate the headlines, and Europe has likely entered into a recession. Growth in Asia and emerging markets also has begun to slow. While the U.S. economy has remained resilient and somewhat disconnected from the slowdown in global growth, we expect the continued global de-leveraging, slowing global economy and continued U.S. political gridlock to put downward pressure on growth in 2012. The economy remains very fragile and subject to heightened political and global systemic risks, particularly from Europe, where we are getting more questions than answers regarding a credible solution to the growing sovereign fiscal problems. We believe growth will remain sluggish over the next 12 to 24 months, constrained by the stubbornly high unemployment rate, slowing global growth triggered by fiscal austerity in Europe, and subdued real income growth.

Labor market improvements surprising to the upside

The labor market data has surprised the market to the upside over the last few months. Payroll gains in the fourth quarter averaged more than 135,000 per month including December's gain of 200,000. Average hours worked and small-company job growth numbers also have improved and are now close to the averages seen during the last expansion.

The unemployment rate ticked down to 8.5% in December, from 9.1% at the end of the third quarter, driven partially by a reduction in the number of unemployed individuals continuing to seek work. We believe the unemployment rate will remain stubbornly high, however, due to modest economic growth and cautious expansion from businesses.

Other labor market indicators also improved during the quarter. Jobless claims dropped below the key psychological 400,000 level and moved to a three-year low in December. The four-week moving average for jobless claims dropped to 375,000 in the last week of the year. The labor markets continue to be affected by businesses' reluctance to hire in the face of large macro uncertainties and modest economic growth projections. While we are encouraged by the recent improvement, the labor markets will continue to have significant excess capacity unless jobless claims can hold solidly below the 400,000 level and monthly payrolls can generate consistent gains of 200,000 or more.

Manufacturing and service sectors improve modestly

The ISM manufacturing index improved during the fourth quarter, increasing from 51.6 in September to 53.9 in December. The index remained above 50 each month in 2011, which continues to predict modest growth. U.S. manufacturing has experienced a slight improvement, with auto production continuing to rebound from second-quarter Japanese supply chain disruptions and overall business sentiment improving.

Growth within the service sector remained flat during the fourth quarter, with the ISM non-manufacturing index unchanged from 53.0 in September to 52.6 in December. Readings in the low 50s continue to be 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 improved affordability due to falling prices and record low mortgage rates, housing activity remained at depressed levels throughout the quarter. Single-family housing sales, starts and permits remained 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 remain on a downward path. The Case-Shiller Home Price Index decreased 3.4% year over year in October. Sales activity has picked up, however, and the new and existing supply of homes has started to decline, at six and seven months, respectively, which are the lowest levels in last two years. The shadow inventory of properties in foreclosure that still need to come to market remains substantial and will keep downward pressure on home prices in 2012. We expect the weakening housing market trends to continue until steps are taken to reduce the shadow inventory and increase the availability of mortgage-related credit. Absent these, the road to recovery will continue to be extended and uneven.

Consumer spending borrows from lower savings

An improvement in consumer sentiment has helped the recent uptick in consumption. Confidence among consumers rose to an eight-month high in December, thanks to gains in the labor market and a rebound in the equity markets. Declining energy prices also removed some of the headwinds to consumer spending from the first half of 2011. Households have run down their savings to support higher spending than what is justified by income growth, however, and we don't expect them to sustain higher levels of consumption without meaningful employment and wage expansion. Trends in the distribution of income toward the richest households don't support a broad-based rise in spending either.

We also have seen a reduction in the effect of the negative feedback loop, where macro risks, such as the European debt crisis, lead to weak consumer and business confidence, which causes lower consumption and economic growth, and so on. We expect global de-leveraging, tight credit conditions, savings trends and the negative feedback loop from European headlines to keep consumers spending at a cautious pace, however, which is in line with our moderate growth outlook.

ECONOMIC REVIEW & MARKET OUTLOOK COMMENTARY

Fourth Quarter 2011



Market Outlook

The markets improved but continued to experience heightened volatility in the fourth quarter, as risky asset classes outperformed. U.S. economic growth de-coupled from Europe; coordination among European politicians improved as markets pushed the European Union toward a coordinated solution; and fears of a systemic financial crisis declined, as the ECB and other global central banks took measures to increase liquidity for European banks.

Credit and securitized fixed income rebounded to outperform Treasuries during the fourth quarter, as the risk-off environment moderated and U.S. Treasuries remained relatively flat. Investment grade credit, high yield and CMBS outperformed Treasuries by 0.61%, 5.69% and 2.43%, respectively. Treasuries generated a 0.89% return, while the S&P 500 returned 11.15%. The 10-year Treasury yield declined 4 bps to 1.92%, while the yield curve remained relatively unchanged.

U.S. political gridlock continues

U.S. politicians under delivered yet again, as the bipartisan super committee charged with agreeing on \$1.2 trillion of deficit reduction by November failed to reach a compromise. We do not believe that this will affect the U.S. fiscal situation in 2012, but it will result in automatic spending cuts starting in January 2013. We expect the current political gridlock to continue until after the 2012 election, because the parties have no incentive to concede any ground before the elections.

This gridlock also is affecting the Bush-era tax cuts that were set to expire at the end of 2011. The Democrats and Republicans agreed on a two-month extension to the tax cuts and will continue discussions in early 2012 to extend them through the end of the year. We believe that they will resolve their differences and extend the tax cuts to avoid an estimated negative 1% impact on 2012 economic growth.

The sizeable U.S. budget deficit, approaching 10% of GDP, remains unsustainable. This will continue to keep the rating agencies focused on the worsening deficit picture, and we expect further risk of negative guidance from the rating agencies as we approach the sequestration effective date of 2013. With the markets squarely focused on resolution of the eurozone crisis and low investor expectations for resolving U.S. political gridlock in the near future, we do not expect this issue to be a major market mover during the first half of 2012.

Fed implements Operation Twist and moves to increase transparency

At its December 13 meeting, the FOMC continued to support the implementation of Operation Twist and repeated its view that economic conditions would warrant "exceptionally low levels for the federal funds rate at least through mid-2013." The Fed understands the limited ability of monetary policy action to directly improve job

creation and economic growth. Chairman Ben Bernanke also continues to pressure policy makers and has communicated 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.

The FOMC said that the economy "has been expanding moderately" while also referencing the slowing global growth and the downside economic risks posed by the strains in global financial markets. Additional quantitative easing appears to be on hold for the first half of 2012 as long as economic growth continues to improve and inflation expectations do not fall materially. The December meeting minutes indicated the FOMC's interest in continuing to enhance communication and increase transparency to the markets to reduce long rates and asset price volatility. We believe the increased transparency is a positive on the margin, but we do not believe it will have a material effect on the markets.

With unemployment remaining at heightened levels and inflation expectations moderating, we expect the Fed to maintain record levels of stimulus for the near 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.

European economy and sovereign crisis remains in the spotlight

Renewed recession in the eurozone starting in the fourth quarter and continuing throughout the first half of 2012 now looks inevitable. European economies are in austerity and de-leveraging mode, plagued by their continuing government- and bank-debt problems. The spotlight turned from Greece to Italy in the fourth quarter. With Italy's sheer size, its very large debt and 500 billion Euro of debt maturing in the next three years, markets became concerned that the country would soon face a liquidity crunch that was simply too large for the European Financial Stability Facility to bail out. This led to the resignation of Prime Minister Berlusconi and the assumption of the post by the well-respected Mario Monti. Monti prescribed a very significant 30 billion Euro austerity package, which was subsequently approved. Italy's bond yields continue to flirt with 7%, however, a level at which the country will have great difficulty financing its economy.

The fear of contagion remains, as French government bond yields also have moved higher; the rating agencies have put France's AAA credit rating on negative watch; and Spain, Italy and other European countries are likely to face further downgrades. The ECB has been extending liquidity to European banks at a significant rate in three-year loans, and it has virtually doubled its balance sheet over the last three months. The latest summit may succeed in European leaders presenting a more united front and beginning the march toward a stronger fiscal union. The details of a credible plan will

ECONOMIC REVIEW & MARKET OUTLOOK COMMENTARY

Fourth Quarter 2011



take a long time to work out, however. We expect financial market sentiment to continue to be driven extensively by future developments in the eurozone.

Credit performance improves as sentiment stabilizes

Demand for credit and other risky assets turned modestly positive during the fourth quarter, as investor sentiment stabilized and credit fundamentals remained solid. While the number of unresolved macro risks facing the markets stayed high, the fear of a systemic financial crisis moderated. Investors' level of risk conviction remains low, but risk appetites became more balanced following the precipitous decline in the third quarter. More positive U.S. economic fundamentals and continued solid corporate earnings helped U.S. credit markets modestly de-couple from Europe.

Credit spreads recovered from the significant spread widening experienced in the third quarter, but valuations continue to reflect heightened fears of a potential systemic financial crisis that could result from European sovereign debt defaults. Investment grade credit spreads tightened a modest 1 bp, while high yield and CMBS spreads tightened by 108 and 42 bps, respectively. Market liquidity continues to be at low levels, with bid/ask spreads widening, new issuance volumes down and new issuance premiums rising to attract capital from investors. High yield and investment grade financial spreads continue to price in recession-like scenarios.

Looking forward, we believe credit fundamentals will remain stable but decline modestly. We believe fourth-quarter earnings to be OK, with earnings guidance continuing to be conservative or withdrawn altogether, given the macroeconomic and policy uncertainty and the effects from a European recession and slowdown in Asia. Stable fundamentals, including strong balance sheets and low inventory levels, remain supportive of moderate outperformance for investment grade and high yield credit. We believe companies will remain patient in deploying the record levels of cash on their balance sheets.

Valuations for credit remain attractive in the long term, as spreads have widened materially, reflecting heightened macro uncertainty and technical sentiment factors. We believe spreads will move tighter in the event of a coordinated resolution of the European sovereign debt crisis, with heighten 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 modest 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 expect attractive long-term valuations and market volatility to create opportunities to generate excess returns from active security selection and sector allocation.

Summary

We believe U.S. economic growth will continue at a moderate pace of 2% to 2.5% during 2012, with downside risks resulting from the European recession and economic slowdown in Asia. We believe heightened uncertainty surrounding the resolution of the European sovereign debt crisis and domestic fiscal policies will continue to temper investors' risk appetites and favor lower levels of active risk in client portfolios. Our long-term view on longer-term investment grade and high yield credit remains constructive, 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 toward further coordination to avoid a systemic financial crisis and deal with the core solvency issues facing Europe.

We believe overall bond yields will remain relatively low, consistent with the Fed keeping rates exceptionally low through mid-2013, the continuation of Operation Twist, moderate economic growth and relatively contained inflation expectations. We believe the 10-year Treasury will range between 1.50% and 2.50% during 2012.

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. A more significant slowdown in Asia and emerging market growth
3. The U.S. economy's ability to withstand the European recession
4. The U.S. political gridlock and inability to reach agreement on extending Bush-era tax cuts

Important information

Past performance is not indicative of future results. There is potential for profit or loss with any investment.

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.

Benchmark (index) performance does not reflect the deduction of transaction costs, management fees, or other costs which would reduce returns. References to market or composite indexes, benchmarks or other measures of relative performance, over a specified period of time, are provided by your information only and do not imply that a portfolio will achieve similar returns, volatility or other results. An index is unmanaged and the composition of an index may not reflect the manner in which a portfolio is constructed in relation to expected or actual returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility or tracking error targets, all of which may change over time. An investor cannot invest directly in an index.

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.

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.