

Market Review

Following a record-breaking second quarter, the U.S. high yield market returned 14.21% for the third quarter, as reflected by the Barclays Capital U.S. High Yield 2% Issuer Capped Index. July gave the quarter a strong start, returning 6.00%. Despite August having the second lowest return for the year, it still managed to return 1.92%. The September return was uplifting at 5.71%, but it was only the fifth best performing month this year. The U.S. high yield market has more than recovered its 25.88% loss in 2008, returning close to 50% year to date. We expect continued volatility in the last quarter and into 2010, as the pace of economic recovery will be slow and drawn out, and consumer activity remains constrained by unemployment and increased savings.

According to the Barclays Capital U.S. High Yield 2% Issuer Capped Index, U.S. high yield spreads continued the tightening trend from their 2008 yearend level of 1,794 basis points (bps), tightening 990 bps year to date and finishing the third quarter at 804 bps. We expect the tightening trend to continue, as historical spreads are around 600 bps. The tightening magnitude will likely be smaller than in previous months, however.

The primary market is still strong, with the third quarter seeing \$42.98 billion of new issuance – nearly as much as the second quarter’s \$48 billion, according to Barclays Capital. Year-to-date new issuance volume for 2009 – at \$102 billion – is more than twice the 2008 total. September was the second most active month, with \$18.6 billion in new issues priced. While issuers have been concentrated in higher-quality names, we have seen a pickup in volume in the CCC space as well. CCC issuers were responsible for 14.4% of new issuance in September versus an average of 6.6% in the second quarter. In terms of rating transitions, we have seen 109 fallen angels versus seven rising stars in 2009. Credit trends are improving, however, as upgrades outpaced downgrades in two of the previous three months.

Investors’ flight to risk continued. According to the Barclays Capital U.S. High Yield 2% Issuer Capped Index, CCC and below rated issues, returning 87% year to date, continued to outperform higher quality credits. For the same period, BB and B rated credit was only able to generate a return of approximately 40%. Likewise, the more volatile names performed best in the third quarter, led by technology (24%), financials (19%), automotive (21%) and building materials (20%). Conversely, the underperforming sectors were mainly utilities and consumer non-cyclical sectors, both returning less than 10% for the quarter. The worst-performing sector for the quarter, supermarkets, still managed to generate a 6% return.

Meanwhile, default rates continued rising to record levels, and recovery rates remained below 2008 and historical levels. The Moody’s Investor Service global issuer-weighted default rates were at 11.48% at the end of August, comparing to a default rate of 2.75% one year ago. Moody’s forecasts a peak in default rates at 12.6% in the fourth quarter and a decline to 4.27% by August 31, 2010. Moody’s has been revising down its 12-month forward default rate forecast, confirming that the default outlook has been improving, and we are getting back to long-term historical levels faster than we have in previous cycles.

Outlook and Strategy

As in the last several quarters, we continue recommending a moderate overweight to high yield, despite the significant run-ups over the last several months. While these returns may discourage some investors, we believe today’s valuations offer good opportunities. Spreads are nearly 1,000 bps tighter year to date, but they are still roughly 750 bps more than Treasuries. This compares to previous peak spreads in 2002 of roughly 1,100 bps and a trough in 2007 of 260 bps. Today’s market yields 10.5%, and the current yield (cash coupon) is approximately 9%. Over a 12-month period, the cash yield can produce a 9% return, and spread tightening of 100 bps equates to returns over 4%. Therefore, if spreads tighten by 200 bps over the next year, total returns could exceed 17%, assuming no defaults.

Technicals are still quite strong, with year-to-date mutual fund flows of \$16.7 billion – the highest level since 2003, according to AMG Data Services. Fundamentals, however, remain challenging. While trends in consumer spending and confidence have improved, we believe they were driven by temporary stimulus programs. We have seen improvements in global manufacturing, housing and labor market data. We still see areas of pessimism, however, in the Institute for Supply Management survey of non-manufacturing and the National Federation of Independent Businesses survey of small businesses. Cash for Clunkers was the likely cause of increases in monthly consumer spending and retail sales in August. Higher home prices and gains in equity markets are helping to restore consumer net worth. Consumer credit remains constrained, however, dropping by \$25 billion in July, and lending standards are still tight. Back-to-school spending in August did not match the usual seasonal boost. This could foreshadow a lower-than-expected increase in holiday spending later this year. We expect consumers to continue struggling through the first half of 2010, as unemployment continues to rise and one-time stimulus measures end. Corporations have been cutting costs, and analysts have been lowering their earnings forecasts, which resulted in upside earnings surprises. Companies have been able to achieve their bottom-line targets, but we have yet to see an improvement in top-line revenues.

We expect volatility to remain high and fundamentals to be slow in recovering. Valuations have overrun forecasted fundamental deterioration. Spreads have historically led fundamentals by two to three quarters, however, and we foresee buying opportunities for high yield. Going forward, we will focus on idiosyncratic risk, as returns driven by beta have largely played out. We plan to maintain a higher-quality credit bias and expect lower-rated high yield bonds to have lower returns and higher defaults than higher-quality high yield bonds.

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