Investment Grade Commentary

Third Quarter 2009

AVIVA INVESTORS

Market Review

With a GDP of -0.7%, the second quarter of 2009 was the fourth consecutive quarter for negative GDP growth – the longest trend since records began in 1947. The unemployment rate continues rising to a multi-year high. We are seeing some signs of stability, as the Index of Leading Economic Indicators has had five positive monthly changes, which could be signaling a bottom to the recession. Housing inventory has stabilized and even begun to fall, and huge government stimulus packages have given some life to consumer spending. We expect growth to turn positive in the fourth quarter and remain so for the rest of the year. We expect a slow and muted recovery in 2010, however, as labor markets remain weak, consumers are further challenged by unemployment, and one-time stimulus effects fade.

While the pace of deterioration in the labor market is beginning to slow, we expect weakness to continue until the middle of 2010. The third quarter saw average monthly job loss at 256,000 – an improvement over the first two quarters of 2009. Unemployment, at 9.8%, should continue rising and is expected to reach 10.2% by 2010. Businesses have reached their limits on cost and inventory reduction, and we may see additional cuts to jobs.

We expect consumers to continue struggling through the first half of 2010, as unemployment continues to rise and one-time stimulus measures end. While trends in consumer spending and confidence have improved, we believe they were driven by temporary stimulus programs. 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 standard 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.

The housing market appears to be setting a bottom, but we don't expect much improvement in the foreseeable future. Home prices have increased; sales have increased; and supply has declined. This could be a true bottom or possibly a seasonal trend, spurred by the $8,000 new-home-buyer credit expiring soon. Inventories are still high, at 8.5 months, but have started to decline from the peaks of 11 months. New housing starts remain at all-time lows, but home prices appear to be stabilizing, as average prices increased in each of the last three months and annual numbers declined at a slower rate.

Lower consumer activity and domestic demand will result in slow and muted manufacturing recovery for 2010. The Institute for Supply Management manufacturing index was up to 52.9 in August and 52.6 in September, indicating that the economy is expanding. Demand for durable goods fell in August by 2.4% after increasing 4.8% in July. New orders for durable goods fell 19.1% year over year, but the pace of yearly declines is slowing. After hitting a low in June, we've seen three monthly inventory increases, which should prove positive for manufacturing growth. Export volumes have been increasing, driven largely by automobiles.

Capital Markets Review

Equity markets have continued to rise. The Standard & Poor's 500 Index was up 17% in the third quarter and is up 52% from its low in March 2009. Bond markets traded in a fairly tight range during the third quarter, although yields continued to move lower, with 10-year U.S. bond yields declining by 23 basis points (bps) to 3.30% and the two-year Treasury note decreasing by 16 basis points to end the quarter at 0.95%.

The yield curve stayed relatively constant, flattening slightly by 7 bps during the quarter, as the spread between two-year Treasuries and 10-year Treasures ended the quarter at a positive 235 bps. The Barclays Aggregate Bond Index was up 6.23% for the quarter, while the more credit-sensitive Barclays High Yield Bond Index was up 14.22%.

Credit Market Review

The Barclays U.S. Credit Index tightened 86 bps, providing excess return of 498 bps for the quarter. According to Barclays, this was the second best quarterly performance ever. The best- performing industries were led by financials, with life insurance, textiles, building materials, paper, REITs and health insurance claiming the top six spots. The worst were the lower-beta, higher-quality sectors, including supranationals, foreign agencies, refinancing, pharmaceuticals and aerospace/defense. Overall, lower-quality, higher-beta sectors outperformed their higher-quality counterparts.

The capital markets opened up to lower quality, riskier companies, led by investors' increasing appetite for investment grade credit products. We saw significant inflows to investment grade mutual funds, increased insurance premiums, allocation shifts into investment grade corporates from other asset classes, and inflows from foreign investors.

In July, the Barclays U.S. Credit Index tightened 51 bps, resulting in 334 bps of excess return. This was the third best month on record for the index, behind April and May 2009. The best sectors were entertainment, driven by Viacom and Time Warner; pipelines, led by Teppco Partners and Plains All American; media non-cable, with News Corp; and the smaller sectors of packaging (Bemis

Co.), building materials, paper and metals and mining. The worst sectors were non-captive consumer finance, supranationals, foreign agencies and airlines. Overall, cyclical issues broadly outperformed non-cyclical and defensive issues, and higher-beta, lower-quality assets outperformed lower-beta, higher-quality assets. In the first half of the month, defensive sectors outperformed. As positive earnings were released, however, the rally in credit spreads was led by down-in-quality and down-in-capital structure trades and supported by strength in the equity market.

The index tightened another 14 bps in August, with 72 bps of excess return. Prices were higher, and spreads were tighter, but the pace of gains was moderate compared to earlier months. We saw a noticeable difference in spread tightening between financials and industrials. Financials returned 161 bps, whereas industrials returned 22 bps. The difference between the two has now fallen below 150 basis points, after coming close to 400 in March. The best sectors this month were life insurance, REITs, building materials and home builders. The worst were independent energy, media cable, oil field services and wirelines. The technical bid remained strong in August, supported by mutual fund and insurance company flows and asset allocation from equities.

In the last month of the quarter, the Barclays U.S. Credit Index tightened by 12 bps and outperformed by 78 bps, leading to the second-best third-quarter performance ever, with 498 bps of excess return. The best-performing industries in September were airlines, life insurance, non-captive consumer and paper. The worst were media cable, pharma, food and beverage, wireless, and wirelines. Again, lower-quality issues outperformed their higher-quality counterparts, with crossovers performing best.

Outlook and Strategy

Fundamentals: Cost cutting continues to drive balance sheet improvements, with credit metrics likely looking better quarter over quarter, but investors are still watching for some sign of top-line revenue growth. We continue to focus on the consumer, and the level of spending throughout the holiday season will be at the forefront. Because consumer activity remains constrained by unemployment and increased savings, we expect the pace of recovery to be slow and drawn out.

Technicals: A strong bid this quarter was driven by cash flows into investment grade credit from mutual funds, insurance premiums and allocations from other asset classes. Shifts from equity funds and money market funds continue to be sources of cash for investment grade credit managers. Dealers were able to increase their positions to investment grade credit product in the third quarter and may have become heavy in inventory in the short term, while remaining relatively light versus historical measures. New-issue concessions during the third quarter were substantially trimmed, as demand overshadowed supply. We don’t believe this trend will continue, however, and would expect to see a bigger concession for new issues going into the end of the year. Strong performance year to date will likely keep investors closer to home, avoiding any unnecessary risk going into yearend.

Valuations: As we come off a record-setting quarter, we still expect spreads to move marginally tighter into the yearend. Current spread levels still look attractive on a historical basis. All-in yields are significantly lower than they were at the end of the second quarter, however, due to spread compression and the Treasury rally. This may keep some of the yield buyers at bay as they wait for higher rates. Given this, we expect a tightening spread bias, but would expect to see more of a range in spread movement both wider and tighter as investors position their portfolios going into yearend.

Looking forward, we expect investment grade credit to outperform Treasuries but remain somewhat muted. We expect demand for investment grade credit to dampen from the third quarter but remain strong overall. The secondary supply will be a little higher than it was in the third quarter, and we would expect to see some concession brought back to the new-issue market. We expect consumer-oriented sectors, defensive low-beta sectors and higher-quality sectors to underperform in the fourth quarter, with outperformance coming from the financial sector and higher-spread sectors. We don’t expect as much performance differentiation between sectors as we witnessed in the prior two quarters, however.