

# 2010 Economic & Market Outlook

## Sustained economic recovery offers opportunities for risk-based assets

January 2010

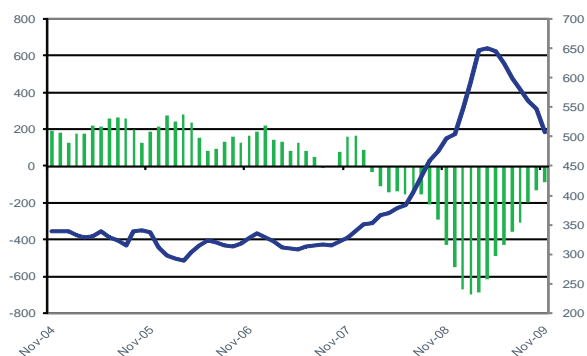


### Economic Outlook

The global economy was paralyzed in late 2008 and early 2009 until government support, central bank stimulus and capital-raising efforts stabilized the financial sector. Led by China, India and other emerging markets, signs of a broad global recovery continue to strengthen. Unprecedented global monetary and fiscal stimulus actions have helped pull the North American economy out of the deep recession and have systematically stabilized the financial markets.

Labor market conditions remain weak, but leading employment indicators are showing signs of improvement, and we expect modest job growth to emerge in the coming months. Despite a three-decade-high U.S. unemployment rate of more than 10%, initial jobless claims have declined to a one-year low, and temporary employment and average hours worked have increased. These are strong indications that the worst of the employment downturn is likely behind us. Structural changes in the labor market, such as permanent layoffs and weaker expected economic growth, drive our expectations for another slow employment recovery, however.

#### Employment Data



*NFP = Non-Farm Payroll, 3-mth Average  
Jobless Claims = 4wk Moving Average  
(As of 11/30/09, Source: Bloomberg)*

The U.S. housing market has likely bottomed. Home prices have stabilized, and housing sales activity has increased because of low mortgage rates and the housing-tax-credit program. The housing market will continue to suffer from excess supply and record mortgage delinquencies, but the worst of the crisis is behind us.

Consumption has stabilized from the depths of the financial crisis, but consumers continue to face headwinds as a result of high

unemployment, tighter lending conditions, high debt levels and reduced wealth effects. Government stimulus programs such as “Cash for Clunkers” have helped to temporarily boost consumption and improve consumer confidence, but we expect consumers to remain cautious, and the trends of increased saving and more moderate consumption will continue for the foreseeable future.

Inflation is expected to remain well under control, because excess capacity, including slack in the labor markets and low industrial capacity utilization levels, continue to prevent upward pressure on core inflation. The key risks to higher inflation include a substantial further weakening of the USD and a sustained V-shaped economic recovery.

The growing budget deficit and large trade deficit combined with the low level of U.S. government bond yields and the flight to quality reversal led to weakness for the U.S. Dollar in 2009 versus all major currencies. Over the near term we expect the USD to stabilize as the economy recovers, Fed tightening is anticipated, and interest rates increase. Longer term, the USD will face pressure from the large fiscal deficit and record government bond issuance. Resource currencies such as the Canadian Dollar have been particularly strong; a further move higher in 2010 will depend on the direction of prices in the commodity complex.

Monetary stimulus, including record low central bank rates, quantitative easing and liquidity-based programs aimed at stabilizing the financial system, has been unprecedented. While the Fed will need to increase its attention on intermediate-term inflationary pressures as the economic recovery matures, we expect it to favor supporting improving labor markets and growth over inflation in the near term. We expect the Fed and U.S. Treasury to cease quantitative easing and begin removing excess liquidity in the first half of 2010, but they will not commence tightening monetary policy until late 2010. The Bank of Canada (BoC) is likely to initiate monetary policy tightening ahead of the Fed, because its economic fundamentals are more positive.

Overall, we expect a sustained but moderate and uneven economic recovery in North America. In the first half of 2010, during the early stages of global economic recovery, the U.S. should benefit heavily from fiscal stimulus and inventory rebuilding. The recovery during the first half of 2010 could look and feel V-shaped, but we do not believe it is sustainable. In the second half of 2010 and into 2011, we expect the U.S. economy to experience slower growth, as the significant impact from fiscal stimulus begins to fade, small businesses and households suffer from lack of credit availability, and extraordinary monetary stimulus begins to unwind. The Canadian economic

recovery is likely to be stronger than the U.S. recovery, because healthier housing and labor markets and strong resource prices support stronger economic growth.

## Market Outlook

The capital markets have improved substantially from the depths of the worst credit crisis in 50 years, as the recovery in risk appetite leads to a strong reversal of the severe flight-to-quality conditions experienced in late 2008 and early 2009. U.S. Treasury yields have increased, and credit spreads have tightened as investors have embraced risk. The early phase of the cyclical recovery, which includes signs of economic growth, stimulative policies and increased risk appetite, is an ideal environment for the performance of risk-based assets. We expect this environment to continue contributing to positive excess returns for investment grade, high yield and other non-government, fixed income securities. Increasing supply, economic recovery and the lack of Fed purchases will pressure Treasury yields higher.

The systemic stability provided by global government and central bank actions has helped the transition from extreme illiquidity to more fluid capital markets. The reversal of investors' risk aversion during the credit crisis drove heavy outflows from money markets into investment grade and high yield fixed income investments. Issuance of investment grade and high yield bonds has exceeded previous annual records, while the heavy supply has been met with even stronger demand from institutional and retail investors, resulting in strong positive returns and substantially tighter credit spreads.

Corporate fundamentals have improved as a result of the economic recovery, cost-cutting efforts and improved access to capital. Companies' renewed access to the capital markets allowed them to retire debt and issue equity capital to reduce leverage and repair balance sheets. Significant cost-cutting efforts have positioned corporate earnings to benefit from top-line revenue growth.

from tighter spreads in credit and securitized markets, but we expect returns to increasingly be driven by security selection and industry allocation as opposed to broad systemic market movements.

The yield curve is likely to flatten, and rates are likely to increase as the markets anticipate monetary policy tightening in late 2010. Heavy Treasury issuance without the Fed buying will force yields higher. While we expect long-term rates to rise, we expect them to be constrained by the slow economic recovery, moderate inflation expectations and demand from long-duration investors.

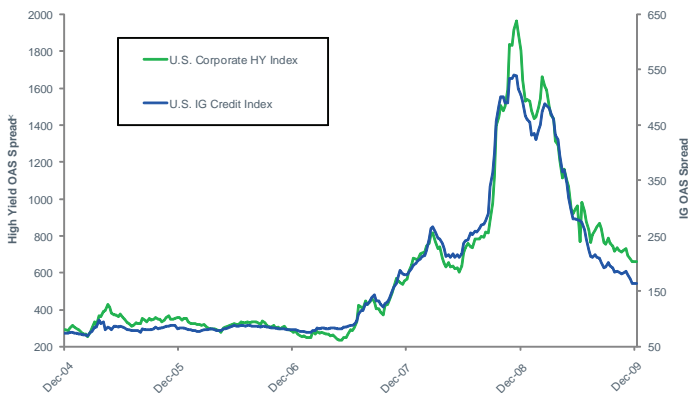
## Strategy Outlook

### Investment Grade Credit

For 2010, we recommend a moderate overweight to investment grade corporate bonds, and we expect spread tightening to continue due to improved fundamental conditions, supportive technical factors and attractive valuations. Since the peak of the credit cycle, average corporate balance sheet leverage has declined from three times to two times and is expected to continue declining as corporate profits and cash flows improve in 2010. New issue supply is expected to decline by 20% due to already-liquid corporate balance sheets and limited refinancing needs. The reduced new issue calendar and limited opportunities in other spread asset classes will create favorable supply/demand conditions that will support credit spread tightening. The investment grade credit market has retraced approximately 65% of the recent cycle's spread widening. Given where we are in the current credit cycle, we anticipate another 10% retracement in 2010, which further supports current market valuations as being attractive.

Unlike 2009, when spread tightening and credit performance were broad based, we expect 2010 spread tightening to be more security specific. Financials, lower-rated issuers in improving sectors and taxable municipal Build America Bonds should see better performance during 2010 than high quality industrial names.

### Credit Spreads



Source: Barclay's Capital

Market valuations of risky assets have increased substantially and are acutely consistent with the position in the cycle. While fixed income credit spreads have tightened from record wide levels, they still remain wide relative to long-term averages. We see opportunities to profit

### High Yield

Going into 2010, we continue to recommend a moderate overweight to high yield bonds within balanced portfolios, given our positive outlook on fundamental credit trends and historically attractive valuations. While 2009 has produced significant gains from what we feel were oversold conditions in the fourth quarter of 2008, we believe that 2010 will see a continuation of the credit rally, although by a much smaller degree. Companies have gained access to the capital markets in 2009, providing them the opportunity to extend their debt payments and reduce the likelihood of default. The Moody's trailing 12-month global speculative default rate is currently 12%, but it is expected to drop to 4% in 12 months, with recent monthly tallies coming in well below 4%. The combination of strengthening balance sheets and increasing operating leverage via cost cutting is putting companies in a good position to service debt when top-line growth returns.

Current valuations of around 700 basis points over Treasuries and a yield-to-worst of 9.5% are still compelling, especially with the backdrop of 4% forecasted default rates. The long-term average spread over Treasuries in high yield bonds is roughly 500 basis points, potentially providing further price appreciation. We also expect the hunt for yield outside of Treasuries to accelerate, as meager Treasury yields and further supply remind investors about interest rate risk. Lastly, while retail investors poured money into high yield bond funds in 2009, leaving many institutional investors in the dust, we expect that institutional investors who have been circling the wagons will pull the trigger on an allocation to high yield, continuing to keep demand high for the asset class.

## Securitized

Heading into 2010 we recommend an underweight to MBS, overweight to CMBS, and moderate overweight to ABS. The securitized market received large amounts of government support in 2009, including \$1.25 trillion of agency mortgage-backed securities (MBS) purchases, Term Asset Loan Facility programs for both asset-backed securities (ABS) and commercial asset-backed securities (CMBS), and the Public Private Investment Program for non-agency residential mortgage-backed securities and CMBS. This was the source of very strong technical demand in the market, which drove spreads tighter, even as fundamentals continued to deteriorate. Spreads on agency MBS reached all-time tights in 2009, and spreads on ABS and CMBS tightened by more than 500 basis points.

The positive technical conditions for securitized will become more balanced early in the first quarter of 2010, as quantitative easing and government programs expire. CMBS and ABS markets have proven their ability to operate without the help of these government programs but levels of securitization activity will continue to be limited. The agency MBS market has relied more heavily on government support as spreads have reached all-time tights and will likely experience some spread widening as the Fed ends its \$1.25 trillion in purchases. Improvements in the economic environment and U.S. consumer activity will help improve the fundamentals of the ABS market and should allow it to continue performing well in 2010. CMBS fundamentals should continue to deteriorate in 2010, with the commercial real estate market beginning to bottom late in the year. However, CMBS valuations remain very attractive relative to other asset classes and we believe investors are being compensated for the underlying risks.

## Private Fixed Income

We anticipate a continued transition by investors and issuers in the current credit cycle. In the first half of 2009, many private debt investors decreased investment activity due to internal constraints and capital preservation needs. Also in 2009, the private fixed income market lagged the public market in pricing and new issuance.

Demand increased significantly for private fixed income during the fourth quarter, and it is expected to remain strong in 2010, as most traditional investors have returned to the market. In addition, the recent strong pickup in volume and pricing performance trends is expected to continue in 2010. Issuers – both domestic and foreign – have expressed renewed interest in the asset class because of narrowing spreads and access to capital.

## U.S. Core Aggregate

After an extreme widening of fixed income spreads late in 2008 led many core fixed income managers to underperform their benchmarks, most have benefited from a sharp rebound in fixed income spreads throughout 2009. All spread asset classes outperformed Treasuries, and overweight allocations to asset classes such as investment grade and high yield credit, ABS and CMBS all outperformed similar duration Treasuries by more than 18%.

While fixed income credit spreads have tightened from record wide levels, they remain wide relative to long-term averages. We continue to see opportunities to profit from tighter spreads in credit and securitized markets, but we expect returns to increasingly be driven by security selection and industry allocation as opposed to broad systematic market movements.

## Canadian Core / Core +

Spread product is expected to outperform government bonds in 2010, but the pace of spread tightening is not likely to repeat the dramatic tightening that took place in 2009. Even though spreads are still trading wide relative to historical averages, credit valuation is fairly reflecting the current economic environment. Because macro economic growth is likely to be moderate in 2010, and Canadian corporate supply will increase over 2009 levels, it follows that the easy money has been made in credit. In this environment, we continue to see relative value opportunities within Canadian credit. BBB corporates look attractive versus A rated corporates due to a lag in performance of lower-rated investment grade corporate bonds and investor demand for additional yield.

Outside the credit market, the Canadian bond market has the potential to see higher yields and a flatter curve in 2010. The Bank of Canada (BoC) is priced in to begin raising rates in the third quarter of the year. Canada has suffered a far less severe recession than the U.S., however, and with Canadian financials enjoying ample liquidity and employment showing signs of strength, there's a substantial risk that the market will start pricing the BoC to move sooner.

In our Canadian Core Plus portfolios, we will maintain a higher weight in the non-core sectors such as securitization and high yield. These products will offer extra carry and a technical advantage, as investors search riskier assets for higher returns.

## U.S. Convertibles

Convertible credit spreads and underlying equity valuations have normalized following the credit crunch of late 2008 and early 2009. Issuance thus far has remained subdued, but we expect a pickup in the next 12 months. With convertible valuations at their present levels, we believe that security selection will be the driving force behind performance. Identifying convertibles with undervalued credit and/or underlying equities will be the key to outperforming the broader convertible marketplace. We expect volatility to rise from the current levels, as uncertainty about the breadth and depth of the recovery enters the marketplace when the unprecedented government support for the financial markets is withdrawn.

## Commercial Mortgage Loans

Because commercial real estate lags the general economy, we anticipate further deterioration in many sectors of the commercial real estate market across the United States. Most of the decline in property values has likely occurred, but rents and occupancies will continue to weaken further. With a relatively jobless economic recovery and cautious consumer spending, real estate fundamentals will face significant challenges for the next several years. These weak fundamentals will continue to stress owners and their lenders throughout 2010 and beyond. Despite this cautious outlook, the current lending environment allows much more conservative underwriting, providing attractive, well-margined lending opportunities for patient investors with available capital.

---

Past performance is not indicative of future results.

Investing in bonds, equities, commodities or other securities is subject to certain risks, including market, interest-rate, issuer, credit, equity, commodity and inflation risk; all or a portion of the investment is at risk and may be lost. Opinions expressed herein were drafted as of the date of this article and are subject to change without notice. This material has been distributed for informational purposes only and should not be considered investment advice or a recommendation or offering of any particular security, strategy or investment product.

Aviva Investors is a globally integrated asset management business with more than \$362 billion (USD as of June 30, 2009) in assets under management; it is comprised of affiliates of Aviva plc, a multinational financial services company headquartered in London. Aviva Investors has more than 450 institutional clients worldwide as of December 31, 2008. Aviva Investors North America, Inc. (AINA) is the U.S. member of the Aviva Investors affiliate group; AINA is an SEC-registered investment advisor. Any statement concerning financial market trends is based on current or past market conditions, which can fluctuate over time. Information contained herein was obtained from sources believed to be reliable, but the accuracy of such information is not guaranteed by the authors or AINA.

No chart, graph, model or other figure or formula, whether provided in this article or elsewhere, should be used to determine which strategies to implement or which securities to buy or sell. Every investor should determine, in consultation with the investor's own advisors, the economic, legal, tax, regulatory and accounting issues and consequences of any investment strategy.

No Aviva Investors entity is soliciting business, holding itself out as being in the business of, or engaging in the business of, providing investment advice or buying or selling securities in any jurisdiction or for any client if such activities are not permitted under applicable law.

This material was produced by AINA and no part of this material may be reproduced in any form, or referred to in any other publication, without advance written permission from AINA.