

2010 Global High Yield Bond and Bank Loan Outlook: The Flight to Credit Risk Maintain Moderate Overweight January 29, 2010



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The year of the great market rebound was characterized by oversold market conditions at the beginning of the year, a rescued banking system, near-record levels of cash earning marginal rates and the belief that the Great Recession would not evolve into another Great Depression. While the nominations are plenty, the Comeback Kid Award goes to Ford Motor Company, whose bonds rallied 282% for the year, while its common equity skyrocketed nearly 337%. The market rebound was led by the corporate credit markets, with risk in the driver's seat: The higher the credit risk, the higher the return. The high yield bond and bank loan markets dominated the year, as forced selling in the fourth quarter of 2008 presented investors with valuations implying a record default rate scenario. Somewhat paradoxically, the smart money was in the retail market, as investors pumped \$32.7 billion into high yield bond funds for the year, or 37.3% of beginning-year assets, according to AMG Data Services.

The global high yield bond and U.S. bank loan markets posted record-high 62.3% and 53.8% returns respectively for the year, surpassing the Standard & Poor's 500, Russell 2000, and MSCI EAFE indices, which returned 26.5%, 27.2% and 32.4% respectively (Exhibit A). Within high yield bonds, the CCC and CC rating categories rallied 99.5% and 155.9% respectively, leading to outsized returns based on lower default rate expectations in 2010. (Spreads typically lead default rates by six to nine months¹.) However, the CCC and below rally has caused the lowest quality tier's valuations to appear unattractive relative to BB and Bs². The flight to credit risk has been swift and aggressive.

Exhibit A: Index Comparison

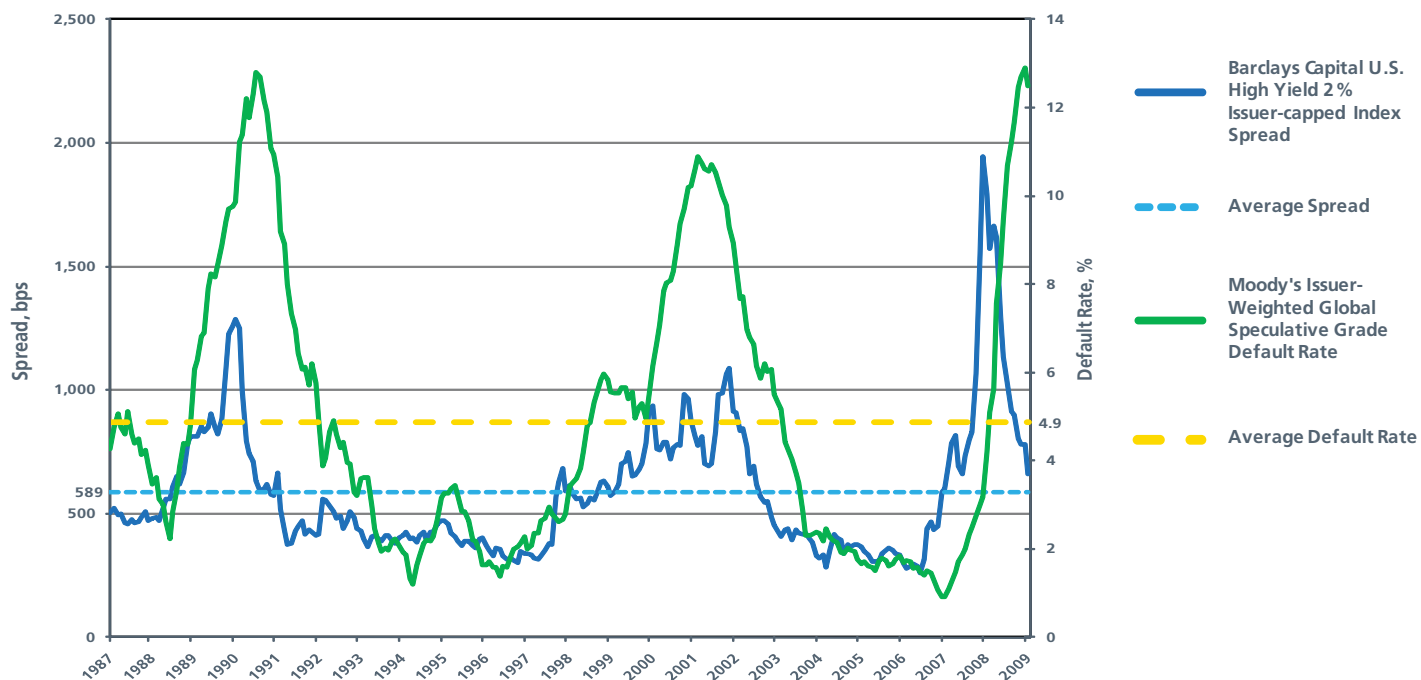
INDEX	2008	2009
Global High Yield	-26.5%	62.3%
U.S. High Yield	-25.9%	58.7%
Euro High Yield	-32.6%	73.5%
Global High Yield - BB	-17.7%	50.2%
Global High Yield - B	-27.8%	50.1%
Global High Yield - CCC	-44.6%	99.5%
Global High Yield - CC	-47.7%	155.9%
Global Investment Grade Corp.	-5.1%	16.6%
Bank Loans	-29.5%	53.8%
U.S. Treasury Bonds	13.7%	-3.6%
S&P 500	-37.0%	26.5%
Russell 2000	-33.8%	27.2%
EAFE	-43.1%	32.4%

*Multi-currency and Euro indices are 100% hedged to USD.
Source: Barclays Capital, Bloomberg*

While another 62.3% year in 2010 is not in the cards mathematically, we believe attractive returns can be realized with the improving fundamental backdrop of declining default rates and spreads that are wider than the historical average (Exhibit B). We continue to recommend a moderate overweight to the global high yield bond and bank loan asset classes, because we expect the year's returns to be slightly higher than their long-term averages. We are forecasting a 10% return in the global high yield bond market and a 7% to 8% return in the bank loan market in 2010. With the global high yield bond market providing a spread of 641 basis points (bps) over Treasuries and a yield of 9.3%, we anticipate a year of coupon-clip plus marginal price appreciation, net any defaults.

Exhibit B:

High Yield Spreads Wider Than Long-Term Average



Source: Bloomberg; Barclays Capital; 12/31/1987 - 12/31/2009

What Default Risk?

As Exhibit B illustrates, the Moody's global high yield bond trailing 12-month default rate ended the year at 12.5%, but it is significantly front-end loaded; the most recent months have recorded minimal defaults. Moody's is forecasting the default rate to materially decline to 3.3%, below the long-term average of around 5.0%, over the next 12 months. With expectations of lower-than-average default rates and current, higher-than-average spreads, we continue to favor the valuation proposition for high yield bonds.

Curiously, many of the defaults of 2009 had a different look about them; a large number of defaults have been in the form of bond exchanges rather than bankruptcy filings. Research by Fitch found that the average company that defaulted and emerged from bankruptcy from 2000 through 2006 came out with about one-third the debt it had pre-bankruptcy. Bond exchanges have only had a marginally positive impact on balance sheets, however, which is why most companies that went through a bond exchange remain rated at CCC or lower. The theme of 2009's deferral of maturities through the combination of refinancings and debt exchanges will be a risk to monitor. The 2010 and 2011 maturities are relatively few and far between, however, making default risk expectations via refinancings relatively low in the near future.

How About U.S. Treasury Risk?

Going into 2010 presents investors with a new set of risks. While default risk has largely been reduced with the significant number of refinancings and maturity extensions, earnings risk will be closely monitored because the operating leverage created by cost reductions is expected to provide more cash flow to the bottom line as revenue growth kicks in. With a 10% U.S. unemployment rate and a consumer who has rediscovered the meaning of frugality, we expect consumer spending patterns to stay restrained for some time. A sustainable improvement in profitability will depend whether we see job creation at the end of the inventory cycle. Incidentally, U.S. consumer credit is contracting at a rate implying a level of fiscal responsibility, while the consumer savings rate of around 4% has been on the rise. This lends itself to a recovery that is more gradual and guarded rather than V-shaped.

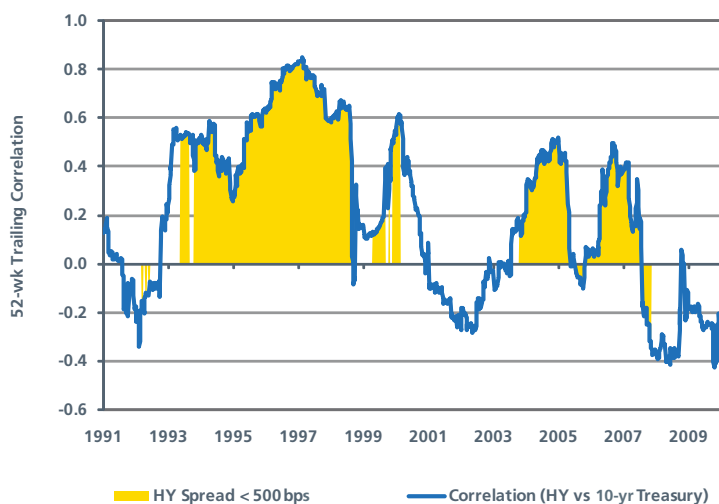
Also, interest rate risk is back in vogue. The U.S. government sold a record \$2.1 trillion of Treasury securities in 2009 and is expected to sell an equivalent amount in 2010. The difference, however, is that the government's quantitative easing program purchased \$1.7 trillion of treasuries in 2009, helping to keep rates relatively low. With the quantitative easing program expected to end in March, the market will need to absorb this new supply by other means. The net new supply is expected to increase the size of U.S. Treasury indices, which will have implications for the Barclays Capital Aggregate Index by increasing the Treasury component from 27% to about 35% in 2010. A combination of heightened inflation concerns from a rebound in growth with a large net supply of U.S. Treasuries is expected to present a challenge for investors who are long the "risk free" universe of Treasuries.

The Benefits of Not Behaving Like Bonds

High yield bonds historically have had a low sensitivity to interest rate fluctuations. This low correlation to interest rates has provided a strong diversification benefit in a rising rate environment (Exhibit C). Bank loans have provided even more diversification from interest rates because of their floating rate coupon, and they have a -0.3 correlation with government bonds over the long term. By contrast, U.S. credit, or investment grade corporate bonds, have a 0.8 correlation to government bonds³. Given that the total rate of return behavior of high yield bonds is highly idiosyncratic, the high yield bond asset class has been categorized by many investors not as fixed income but more as an equity surrogate or even an alternative asset class.

Exhibit D:

Treasury Correlation's Inverse Relationship to Spreads



Source: B of A Merrill Lynch Global Research

Exhibit E:

Relatively Stable Correlation Between Bank Loans & Treasuries



Source: B of A Merrill Lynch Global Research

Exhibit C:

Monthly Return Correlations (since 1984)

	High Yield
Credit	0.5
S&P 500	0.6
EM *	0.6
Govt	0.1
Agg	0.3

*EM since 1994

Source: Barclays Capital; 1984 to 12/31/2009

When digging a bit deeper into the historical sensitivity of high yield bonds to interest rates, one discovers that the correlation has not been constant. As spreads over Treasuries narrowed, the correlation of high yield bonds to Treasuries has increased. Exhibit D portrays this inverse relationship between spreads and the correlation to Treasuries. The blue line indicates the trailing 12-month correlation between high yield bonds and 10-year Treasury notes. The yellow shaded area represents periods in which the high yield bond spread is less than the long-term average of 500 bps, accentuating the higher correlation to Treasuries at tighter spreads. At year-end, however, the spread on the global and U.S. high yield markets was 641 and 618 bps respectively, according to Barclays, providing plenty of room before interest rate sensitivity has typically come into play.

Based on the same analysis for bank loans and Treasuries (Exhibit E), the correlation range is much tighter than the high yield bond/Treasury relationship. This is because of the floating rate coupon that keeps interest rate duration low, even as the discount margin and spread compresses. Because of the long-term negative correlation to rates, bank loans have been a good diversifier⁴.

Institutional Demand Expected to Have a Bid

While high yield bond mutual fund inflows of \$32.7 billion in 2009 broke the previous record of \$27.2 billion in 2003, we believe that the institutional demand for high yield will pick up steam in 2010, continuing to provide a strong bid to the market. A recent study by Bank of America Merrill Lynch surveyed 111 large, institutional investors to understand their outlook on asset allocation trends in 2010⁵. The survey results revealed that more U.S. institutional investors are expecting to increase rather than decrease their allocations to both high yield and investment grade corporate bonds. From our travels throughout North America, Europe and Asia over the past 12 months,

talking with clients and prospects, we would concur that institutional investors are taking a serious look at increasing their high yield bond allocation as a way to capture significant yields in a declining default rate environment and diversify away from interest rate risk in their portfolios.

Issuance in 2009 Dominated by Refinancing

In 2009, we saw \$185 billion of global high yield bond new issuance, which broke the record of \$172 billion set in 2006, and came in significantly higher than the \$55 billion that priced in 2008. The major theme in 2009 was the refinancing wave, primarily from bank loans refinancing into the high yield bond market. More than \$131 billion or 71% of new issuance was categorized as refinancing. This had a large impact on the quality of issuance, because more than 37% of total new issuance was secured, and only 9.5% was CCC rated and below. It may be intuitive to think that the amount and quality of issuance had a material impact on the makeup of the market, but the distribution across the quality tiers has remained relatively constant, with BBs steady, comprising 41%, and Bs giving up about 3% to the CCC and below category, for 33% and 26% weightings respectively.

Bank Loans Are Back From The Dead

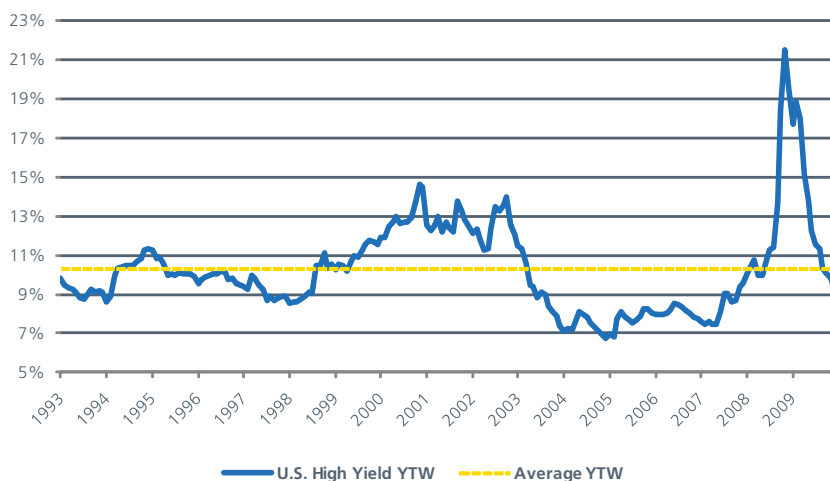
For 2010, we anticipate the bank loan market will continue to exhibit signs of strength in terms of new issuance and returns. Many new issues have contained LIBOR floors, Original Issue Discounts (OIDs), and maintenance covenants providing investors with added protection. In contrast to the high yield bond market, the primary loan market did not meaningfully open up until the fourth quarter of 2009. Investor demand has been strong (AMG inflows of \$3.4 billion for the year vs. an outflow of \$4.6 billion in 2008), with new deals being greatly oversubscribed. The calendar remains robust, and we expect supply to grow materially over 2009 levels (\$38 billion). While returns modestly trailed those of U.S. high yield corporate bonds (53.8% vs. 58.7%), we anticipate that the same technical and fundamental drivers

will continue in 2010. Prepayments of loans at par via bond issuance and loan amendment fees also have been additive to returns. While new issuance deals have frequently been instituting LIBOR floors (usually starting at 2%) to compensate investors for the current meager LIBOR rate of 25 bps, the secondary market also is positioned to provide strong returns. As rates eventually begin to rise, loans rates are expected to reset at higher levels. Additionally, with an average loan price of about \$90, capital appreciation also should be a contributor. We are forecasting bank loan returns of around 7% to 8%, ahead of their long-term average of approximately 5%.

Looking Ahead

We are advising investors not to get caught up with the recent past, but instead to focus on today's valuations and the risk/return landscape going forward. There is one valuation metric that is not pointing toward a cheap valuation: Yield. While the yield of 9.3% on the global high yield bond market and 9.0% on the U.S. high yield bond market are below the historical average (Exhibit F), the current risk premium, or spread, in excess of 600 bps is more than 100 bps wide of the long-term average. Combine this valuation with a forecasted default rate of 3.3% in 12 months, an improving earnings outlook, short-term bond yields near zero, and a continued bid for yield by institutional investors, and we believe the high yield bond and bank loan asset classes continue to offer compelling value. We reiterate our moderate overweight.

Exhibit F:
Yield to Worst (YTW)



Source: Barclays Capital U.S. High Yield 2% Issuer Cap Index; 1/29/1993 - 12/31/2009



Todd J. Youngberg, CFA
Senior Vice President, Head of High Yield

Todd Youngberg joined Aviva Investors North America, Inc. in 2008. He is responsible for overseeing all high yield strategies and managing the high yield business.

He has more than 19 years of investment management industry experience. Prior to joining the firm, Todd was senior managing director and global head of high yield for ABN AMRO Asset Management, Inc.

Todd earned his bachelor’s degree in business management from Central College and his master of business administration degree from Drake University. He holds the chartered financial analyst designation and is a member of the CFA Institute and the CFA Society of Chicago.

Key to Index Names:

- Barclays Capital Global High Yield xCMBS xEMG 2% Cap Index
- Barclays Capital U.S. High Yield 2% Issuer Cap Index
- Barclays Capital Euro High Yield 2% Issuer Cap Index
- Barclays Capital Global High Yield 2% Issuer Cap Ba Component Index
- Barclays Capital Global High Yield 2% Issuer Cap B Component Index
- Barclays Capital Global High Yield 2% Issuer Cap Caa Component Index
- Barclays Capital Global High Yield 2% Issuer Cap Ca Component Index
- Global Aggregate - Corporates
- Barclays Capital U.S. High Yield Loans Index
- Barclays Capital U.S. Treasury Index
- S&P 500 Index
- EAFE Index

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Important information:

Past performance is not indicative of future results.

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Aviva Investors North America, Inc., 699 Walnut Street, Suite 1700, Des Moines, Iowa 50309-3945, 800-281-4607, www.avivainvestors.com

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