

April 2010

ING INVESTMENT MANAGEMENT

HouseView



Global Overview

Over the month of April, the global economy was impacted by the opposing forces of favourable economic data and sovereign credit concerns.

Business confidence in the world's leading nations has improved to the extent that it is now consistent with above-average economic growth. Furthermore, the broadening of the recovery via stabilisation in the labour markets and renewed investment spending continues unabated. This represents a powerful dynamic that engenders confidence that the global economy has finally achieved a measure of self-sustaining forward momentum. Moreover, there is the supportive impact of stimulatory monetary policy, which normally tends to bolster overall financial conditions by facilitating the expansion of supply and demand for credit.

However, the issue of sovereign credit risk, specifically in Europe, has led to a sharp deterioration in risk appetite and investor confidence. The significant amount of stimulus provided governments in the face of private sector de-leveraging has, in a sense, merely shifted the problem rather than solving it. Now that many private sector risks have ended up on the public sector balance sheet, attention has now become focussed on sovereign debt markets.

It is important to emphasise that most countries do not face a debt challenge as great as that in Greece. Their debt dynamics are not necessarily unsustainable, though it must be said that in view of their unfunded pension and healthcare liabilities many of them do face the need for substantial fiscal tightening at some point this decade. In this respect, it is important to understand the exact function of fiscal deficits in a crisis like that being experienced in Europe. It amounts to spreading the digestion of over-indebtedness over time by buying the private sector valuable time to sort out its own balance sheet problems through an increase in public sector leverage. As we have seen and still see in many countries, notably the US and Germany, this can be financed because of a large amount of private sector savings as well as very low official interest rates. Once, the private sector returns to a firmer footing, the public sector is expected to embark on a deleveraging process of its own.

However, it is likely that this will result in low growth for many years to come.

In China, recent economic data has confirmed that the economy is slowing only moderately. Retail sales growth slowed from an annualised rate of 22% to 19% in March, while the similar measures of industrial production and fixed-asset investment remained at 18% and 26% respectively. Elsewhere, the annual rate of import growth eased from 66% to 50%. Although consumption and investment growth appear to be easing, the pace of the slowdown is perhaps slower than the Chinese authorities would have hoped for. Nevertheless, it appears unlikely that recent policy tightening measures will be more intensively applied over the next few months. Further hikes in reserve requirement ratios are nevertheless likely, along with the prospect of renewed currency appreciation. However, major steps such as the recent tightening of criteria with regard to real estate financing are unlikely to be repeated, simply because the authorities will be inclined to give the earlier measures more time to take effect.

In Australia, housing lending is showing signs of easing as a result of the expiry of the First Home Owners' Grant. Moreover, rising interest rates and accelerating growth in house prices have negatively impacted home affordability. Any further slowdown in housing credit may help to contain the rate of credit growth across the broader economy. With regard to housing starts, the recent easing in new lending suggests we are close to the peak in residential building approvals. This has clear implications for domestic monetary policy.

The tone of its latest policy statement suggested that the Reserve Bank of Australia (RBA) has a positive view with regard to the current state of the economy. Accordingly, interest rates are likely to continue moving upwards. The statement also noted that Australia's terms of trade are rising "by more than expected" and should surpass their 2008 peak at some point this year. Of particular importance for financial market participants was the RBA's expectation that inflation is likely to be in the upper half of the target band over the coming year. This warrants an upward bias in interest rate expectations.

Asset Sector Overview

Australian Cash

Australian cash returned 0.35% in April, lifting its twelve-month return to 3.63%. The RBA lifted the official cash rate to 4.25% on 6 April, and subsequently increased it by a further 0.25% to 4.50% on 4 May.

Bank bill yields maintained their upward trend over the month, pricing in expectations of further rate hikes. The 30-day bank bill yield rose by a further 0.19% to 4.45%, while 90-day and 180-day bank bills rose by 0.16% and 0.14% respectively. Given the RBA's near-term expectation with regard to inflation, we believe that further increases in the official cash rate remain in play. Accordingly, we retain an overweight position in cash within our diversified funds.

Australian Fixed Interest

The Australian fixed interest sector gained ground in March, with the benchmark index rising by 0.55%. This brought the sector's twelve-month return to 3.29%. In contrast to shorter dated yields, longer dated maturities finished the month slightly lower, with the yield on the Commonwealth 10-year bond falling from 5.77% to 5.71%. Meanwhile, within the corporate bond sector, there was a spike in credit spread volatility, amid concerns over the potential impact of proposed US regulatory reforms on US securities listed in Australia. We presently hold an underweight exposure to Australian fixed interest within our diversified funds.

International Fixed Interest

The international fixed interest sector, as measured by the JP Morgan World Government Bond Index (ex Australia), rose by 1.06% in Australian dollar terms in April, bringing its twelve-month return to 7.03%.

Sovereign credit fears in Europe, and a growing fear that debt difficulties in the region's most heavily indebted countries could lead to a broader contagion effect, prompted a widespread move by investors to the perceived safety of German and US bonds. In the US, the yield on the 5-year US Treasury bond declined from 2.56% to 2.42%, while the 10-year maturity fell from 3.83% to 3.66%. In the UK, the 10-year bond yield declined from 3.94% to 3.85%, while the corresponding maturity in Japan fell from 1.39% to 1.28%. Bonds in the corporate market performed well over the month. Investment grade US corporate bonds were a notable area of strength, benefiting from better than expected corporate earnings results. We retain a positive outlook for investment grade corporate bonds and continue to expect robust returns from this sector relative to government bonds. We presently hold an underweight exposure to international fixed interest within our diversified funds.

Australian Shares

The Australian sharemarket, as measured by the S&P/ASX 200 Accumulation Index, declined by 1.4% in April, following strong gains in the previous two months. Risk aversion dominated sentiment over the month, amid overseas concerns that centred on economic growth prospects in China, and disruptions to air traffic and debt concerns in Europe. Investors were further unnerved by local events and issues, most notably the proposed additional tax on mining companies and the rejection by the competition regulator of National Australia Bank's takeover bid for AXA Asia Pacific Holdings.

In the wake of a positive US quarterly earnings reporting season, where more than three-quarters of companies exceeded their guidance estimates, local analysts have moved to fine tune their earnings forecasts for domestic companies. The latest estimates show earnings growth forecasts for the 2010 and 2011 financial years of 9.9% and 24.8% respectively, up from the previous estimates of 9.3% and 23.1% made only a month ago. Moreover, against the backdrop of improving earnings prospects, the recent sell-off in the market has significantly improved valuations. As at the end of April, market prices reflected a price-to-earnings ratio of 15.5 times 2010 financial year earnings and 12.4 times next year's earnings. We presently hold an overweight exposure to Australian shares within our growth-oriented diversified funds, and a benchmark exposure within our more defensive funds.

International Shares

Following two months of strong gains, the upward momentum in the global sharemarkets eased in April, with the MSCI World (ex Australia) Index rising by 0.4% in local currency terms. However, this translated to a fall of 1.3% in Australian dollar terms, reflecting the impact of another monthly rise in the value of the Australian dollar. The dollar gained ground against all of the major currencies, rising by 3.2% against the Euro, by 2.3% against the Japanese Yen, and by 1.4% and 0.5% against the US Dollar and Sterling respectively.

The recent strength in the sharemarkets has been significantly underpinned by renewed earnings optimism. US companies in particular are benefitting from improving economic conditions and an increased willingness on the part of consumers to spend after a period of increased savings in 2008-09. Companies globally also continue to reap the benefits of cost containment measures implemented over the past two years. These have boosted profit margins, which were a key feature of the recent profit results. Another positive for US companies with global business revenues has been the weaker US dollar and its consequent impact on export competitiveness. We presently hold an overweight exposure to international shares within our diversified funds.

Australian Property Securities

The Australian property securities sector, as measured by the S&P/ASX 200 A-REIT Accumulation Index, rose by 3.7% over the month of April, outperforming the broader domestic sharemarket.

At the sectoral level, the industrial (+6.7%) sector posted a particularly strong gain, with strength similarly evident in the retail (+6.3%), commercial (+4.2%) and leaders (+3.8%) sectors. This left the diversified (-0.3%) sector as the sole area of weakness for the month.

At the individual stock level, there was a further narrowing in the spread of returns. Having been as wide as 22.1% as recently as February, the spread for the overall sector narrowed to 13.9% in April. We presently hold an underweight position in the A-REIT sector.

Global Property Securities Trusts

The global property securities markets outperformed the broader global sharemarkets in April, with the UBS Global Investors Index rising by 3.9% in local currency terms. At the regional level, performance was somewhat mixed. North America (+6.8%) was the best performer, followed by Singapore (+5.6%) and Japan (+3.9%). Conversely, Continental Europe (-4.0%) and the UK (-1.6%) ended the month in negative territory.

At the overall level, capital market conditions appear more conducive to corporate activity, evidenced by a rebound in the rate of company formation. In this regard, activity in the area of initial public offerings (IPOs) has increased to a significant extent, indicating that public real estate companies are moving rapidly to take advantage of market opportunities. In particular, there has been an increase in acquisitions, as companies utilise the flexibility created by their strengthened balance sheet positions. We presently hold an overweight exposure to global property securities within our growth-oriented diversified funds, and a benchmark exposure within our more defensive funds.

For more information please contact:

Emmanuel Calligeris

Chief Investment Officer

Multi Strategies Group

emmanuel.calligeris@ingim.com.au

ING Investment Management Limited

ABN 23 003 731 959

Level 21, 83 Clarence Street

Sydney NSW 2000 Australia

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