



Global Overview

The history of financial crises suggests the presence of certain recurring patterns of events that are relevant in assessing prospective global economic growth trends. A key point is that the recovery phase tends to be more muted than is the case following milder downturns. This is because both credit demand and supply typically remain depressed for some time as excess leverage is removed from the system. Such a process need not weigh unduly on growth, provided consumption does not exceed income and interest rates remain below the pace of increase in income growth. Importantly, the situation where an ever-increasing level of debt is required to attain the same rate of growth becomes unsustainable.

Another reason to expect more subdued growth is that financial crises tend to leave a permanent mark on the level of potential output and sometimes also on the growth rate. This is because part of the investment in physical capital becomes obsolete once the bubble bursts and particular sectors shrink relative to others in the economy. Also, the average cost of capital tends to be higher after a crisis. When combined with a heightened degree of uncertainty, this may lead to lower rates of investment and innovation.

A second common feature of the recovery phase is a sharp rise in the ratio of sovereign debt to gross domestic product (GDP). This occurs as governments allocate funds towards fiscal stimulus measures and the recapitalisation of banks, resulting in an expansion in budget deficits due to the permanent loss of revenue from previously bloated sectors of the economy. Of course, this is exactly what has occurred in this particular instance. Essentially, it implies that growth over the past year or so was very much dependent upon further debt accumulation, as the increase in public sector debt outweighed the decrease in private sector debt in many economies. In the midst of a downturn, this is a desirable situation as it allows private sector deleveraging to proceed at a measured pace, thus preventing a depression or deflationary scenario. Nevertheless, it cannot go on forever and at some point the public sector will need to tighten its belt as well.

In the past, doubts over the ability and willingness of governments to rein in their debt often led to sovereign debt crises in which markets essentially forced governments to bring forward the fiscal consolidation phase. This situation currently applies in the peripheral European Union (EU) countries. It should nevertheless be noted that although countries such as the US, the UK and Japan also have high debt ratios, they need not necessarily also fall victim to this kind of market discipline.

In the case of the US, the dollar's status as the world's reserve currency offers a large deal of protection from market disruption, while Japan has the advantage that a lot of its outstanding debt is held domestically. Nevertheless, these countries will need to embark on fiscal tightening at some point. The affect on growth will then depend very much on the particular circumstances prevailing at the time. If fiscal tightening takes place in a situation where private sector demand remains weak, there could well be a more marked downward impact on growth. However, if tightening is implemented against the background of strong demand from either the private or overseas sectors, the impact on growth could well be limited. Also, if tightening is accompanied by structural reform and is implemented by way of spending cuts rather than tax hikes, growth need not suffer significantly as the improvement in longer-term prospects lifts income expectations.

In this respect, it is interesting to note that during a number of previous major recoveries growth became robust even in the face of fiscal policy tightening, although usually after the exchange rate peg had been abandoned and monetary policy had been substantially eased. Of course, these recoveries typically took place against the background of solid global growth, exchange rate depreciation and a declining trend in long-term interest rates that became more pronounced in the country where budget deficits were cut. The backdrop for the developed world is currently not as benign, however the difference should not be overestimated. Global growth is currently forecast by the IMF to slightly exceed 4% in both 2010 and 2011, mainly driven by strength in the emerging economies.

Our base case remains that the recovery in the developed world will continue into next year. However, there are associated downside risks. Wide-spread fiscal tightening in the developed world could yet occur at a point where private sector demand has yet to strengthen sufficiently, which could lead to a slowdown in growth. Furthermore, if the sovereign debt situation in Europe worsens over the next few months, any premature fiscal tightening could weaken bank balance sheets and lead to a broader tightening in financial conditions. Somewhat further out, re-regulation of the financial sector could well have the same affect. In this sense, the decisions of policymakers are presently critical to the outlook for the global economy.

In Australia, the Reserve Bank of Australia (RBA) decided on June 1 to retain the official cash rate steady at 4.50%, following a series of moves that had seen it increase the rate from 3.00% in October last year. The subsequent publication of the minutes from that meeting revealed that the RBA intends to closely examine the Consumer Price Index (CPI) data, scheduled for release in late July, for "information on the extent of inflationary pressures in the economy". This comes against the background of a somewhat less than expected moderation in the rate of inflation to date. In this regard, the RBA noted that "recent data for prices and wages suggested that the disinflationary forces in the economy were not quite as strong as previously expected". However, it went on to caution that "global events could also have implications for the inflation outlook in the medium term." In summary, this tone and commentary from the RBA leads us to the view that domestic monetary policy will remain on hold for the remainder of the year.

Asset Sector Overview

Australian Cash

Australian cash returned 0.38% in May, lifting its twelve-month return to 3.75%. The RBA lifted the official cash rate by 0.25% to 4.50% on 4 May, setting the scene for an upward movement in short-term yields over the month. Yields on 30-day bank bills ended the month at 4.68%, whilst 90-day and 180-day yields rose to 4.89% and 4.88% respectively.

Against the backdrop of the RBA's observation that inflation has not moderated to the extent expected, we retain an overweight position in cash within our diversified funds.

Australian Fixed Interest

The Australian fixed interest sector gained ground in May, with the benchmark index rising by 1.65%. This brought the sector's twelve-month return to 5.75%. The yield on the 3-year Commonwealth Government bond fell from 5.36% to 4.72% over the month, as concerns over the possibility of an economic slowdown in China and sovereign credit concerns in Europe led to an increase in global demand for the bonds of less risky governments. Similarly, the yield on the 10-year maturity ended the month 0.34% lower at 5.37%.

Corporate bonds underperformed relative to government bonds, as increased risk aversion led to a widening in credit spreads. Volatility remains a prominent feature of the current financial environment, and has prompted investors to demand correspondingly greater returns for assuming risk. Looking beyond this current period of uncertainty, the outlook for Australian corporate bonds remains positive, reflecting the underlying strength of the domestic economy. 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 1.54% in Australian dollar terms in May, bringing its twelve-month return to 9.45%. Although the joint European Union (EU) and International Monetary Fund (IMF) rescue package served to partially alleviate short-term fears, investors remained concerned over the longer-term solvency of several European countries. The yield on the US 5-year Treasury bond declined from 2.42% to 2.09%, while the 10-year maturity fell from 3.65% to 3.29% over the month. In the UK, the 10-year government bond yield declined from 3.9% to 3.58%, while the corresponding maturities in Japan and Germany ended the month at 1.27% and 2.66% respectively. Corporate bonds performed strongly despite the increase in aversion to risk, with US investment grade corporate bonds benefiting from better-than-expected corporate earnings. We presently hold an underweight position in international fixed interest within our growth-oriented diversified funds, and a benchmark exposure within our more defensive diversified funds.

Australian Shares

The Australian sharemarket lost ground in May, with the S&P/ASX 200 Accumulation Index declining by 7.5%. This was the market's worst monthly performance since October 2008, when it dropped by 12.6%. Sentiment was undermined by a combination of local and international factors. Locally, the potential impact of the Federal Government's proposed Resource Super Profits Tax (RSPT) on profitability and activity within the mining sector remains the subject of significant comment and speculation.

A breakdown of the overall Index return revealed uniform weakness at the sectoral level, with the heaviest falls recorded by the industrials (-11.3%) and financials ex-REITs (-10.6%) sectors. Somewhat surprisingly, these were followed by the utilities (-7.4%) and telecommunications (-7.2%) sectors, which are normally somewhat immune to heavy selling due to their defensive nature. Consumer discretionary (-6.9%), energy (-6.9%) and materials (-5.9%) stocks also fell sharply, leaving the REITs (-4.1%), health care (-4.1%) and consumer staples (-1.1%) sectors as the only areas that did not post falls of at least 5%.

In terms of the major near-term drivers of the market, we note that there are a number of factors presently at play. The Australian dollar has weakened against the US dollar amid a renewed aversion to risk on the part of global investors. This nevertheless represents a source of potential upside for domestic companies having US dollar earnings exposure, and indeed represents the key theme of our present portfolio strategy. We presently hold an overweight exposure to Australian shares within our diversified funds.

International Shares

The global sharemarkets were heavily sold off in May, with the MSCI World (ex Australia) Index falling by 7.5% in local currency terms. However, this translated to a rise of 0.8% in Australian dollar terms, reflecting the impact of a sharp drop in the value of the Australian dollar. The dollar lost ground against all of the major currencies, falling by 11.2% against the Japanese Yen, 9.9% against the US Dollar, and by 5.1% and 2.4% against Sterling and the Euro respectively.

Investors have become increasingly wary regarding the sustainability of earnings growth in 2011, given the stiff headwinds of weak economic growth in Europe and Japan, high global unemployment, and government moves to reduce their deficits post a period of strong stimulus injection in 2008-09. At a sectoral level, companies that have sustainable earnings and are less sensitive to the impact of changing economic fortunes outperformed in May, as investors sought safety in their stock selection. As a result, stocks within the consumer staples, telecommunications and healthcare industries typically fared better than energy, materials and financial stocks. We presently hold an overweight position in international shares within our defensive diversified funds, and a benchmark exposure within our more growth-oriented diversified funds.

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Australian Property Securities

The Australian property securities sector, as measured by the S&P/ASX 200 A-REIT Accumulation Index, declined by 4.1% over the month of May, outperforming the broader domestic sharemarket.

At the sectoral level, the industrial (-11.8%) sector fell sharply, having strongly outperformed over the previous two months. Weakness, albeit to a lesser extent, was also evident in each of the commercial (-5.9%), diversified (-5.7%), leaders (-3.5%) and retail (-1.3%) sectors.

At the individual stock level, there was a renewed widening in the spread of returns. Having narrowed to 13.9% in April, the spread for the overall sector widened to 22.7% in May. We presently hold an underweight position in the A-REIT sector within our diversified funds.

Global Property Securities Trusts

The global property securities markets outperformed the broader global sharemarkets in May, although the UBS Global Investors Index declined by 5.7% in local currency terms. At the regional level, performance was uniformly weak, with all of the major markets ending the month in negative territory. Japan (-8.2%) was the worst performer, followed by Continental Europe (-7.1%), the UK (-6.5%), Singapore (-6.2%), and North America (-5.2%).

The sharp sell-off in the markets in May has improved valuations to the extent that we currently estimate that global property companies are trading at an average 7% discount to NAV. Although we suspect that yield compression may have further to run, we anticipate that the pace of price returns may moderate from last year. In essence, a positive outlook for property companies remains warranted, predicated on a continuing improvement in economic conditions. We presently hold an overweight exposure to global property securities within our growth-oriented diversified funds, and a benchmark exposure within our more defensive diversified funds.