

June 2010

ING INVESTMENT MANAGEMENT

HouseView



Global Overview

Barely two months ago, the US economy appeared to be growing at an above-average pace. This was despite the fact that a significant portion of the growth was attributable to fiscal stimulus measures and firms rebuilding their inventories. Moreover, there were indications that private sector demand was poised to assume a leading role in driving further growth, a necessary outcome given the finite nature of the stimulus provided by inventory rebuilding and government spending.

More recently, the tone of US economic data has become less positive. This was explicitly acknowledged in the statement by the Federal Open Market Committee (FOMC), in which it sounded a cautious note with regard to the outlook for growth. The FOMC identified a number of particular areas of concern, specifically housing, retail sales and a number of labour market indicators. It also recognised the impact of financial market conditions, particularly the stronger US dollar, lower share prices and wider credit spreads.

Furthermore, the FOMC also adopted a somewhat more cautious view of the outlook for inflation. Importantly, it reiterated its view that its present monetary policy stance would remain in place for an "extended period". In fact, given the significant degree of surplus capacity presently evident in the US economy, coupled with the easing in the contribution from the inventory rebuilding phase, it is plausible that the contribution made by fiscal policy to overall growth will steadily diminish over the coming months and into 2011. Accordingly, it appears unlikely that US official interest rates will be increased before at least June next year.

At present, our base case scenario for 2011 is that there will be some slowdown in growth momentum, as the negative effect from the diminishing fiscal stimulus will not be completely counterbalanced by the contribution from the private sector. Nevertheless, for now, we do not foresee a return to weakness to the extent that the economy falls into a double-dip recession.

In Europe, the economic recovery continues to face substantial headwinds, resulting in underlying inflation remaining largely subdued. Accordingly, the European Central Bank (ECB) is unlikely to start tightening monetary policy until at least the end of 2011. Recent regional economic data show that retail sales remain weak, as high unemployment is outweighing the positive impact on household spending of modest inflation and record-low interest rates.

The European labour market remains weak, with the unemployment rate presently in the region of 10%. This will consequently restrain household confidence and spending levels, while sovereign risk issues may further weigh on sentiment. Fiscal tightening, which has already begun in a number of European countries, is another factor that has the potential to restrain spending. The reluctance of consumers to spend has been further illustrated by a fall in demand for consumer credit, which has also led to a fall in the broad measure of regional money supply.

In China, the scheduled reduction in new loans provided by the banking system continues. A total of CNY603 billion in loans was granted in June, compared with CNY774 billion in April, showing that the Chinese authorities' program of quantitative tightening is being implemented according to plan. The year-on-year rate of credit growth has fallen to 18%, which is broadly in line with its ten-year average. As recently as five years ago, the pace of credit growth stood at 34% per annum.

A move that was started in April to tighten conditions in the real estate market is also starting to yield results. Property prices dropped by 0.1% in June, however the year-on-year rate of increase remains approximately 11%. It is clearly too early to definitively state that the tightening measures are taking effect. Nevertheless, prices appear to have stopped rising and transaction volumes have fallen. Rental rates, particularly in the larger cities, have been rising steadily since the tightening started.

This reflects a decreased interest in buying and an increased interest in renting houses. As a consequence, the authorities are likely to increase their efforts to provide public housing. In accordance with several announcements over recent months, the government is likely to take a more active role in building affordable houses for the rental market. In the event of a sharper-than-expected slowdown in the private real estate market, the public sector is likely to step up its efforts in the housing construction sector.

In other economic developments in China, recent trade data broadly matched expectations. Data for June showed that exports rose by 4% over the month, lifting the year-on-year rate of growth to 44%. We anticipate that export growth will moderate over the coming months, as global trade growth slows from its recent peak. As external demand for Chinese goods slows, the country's authorities are likely to respond by increasing policy stimulus measures with a view to lifting the contribution of the domestic sector to overall economic growth.

In Australia, recent economic data has revealed that retail spending has maintained a modest pace of growth, as consumer confidence has fallen back to around its long-run average level. In addition, residential building approvals have fallen sharply, while business surveys point to a weakening in growth momentum. On the positive side, the sharp increase in the terms of trade has seen the trade balance move into a significant surplus. Furthermore, the labour market remains buoyant with continued strong growth in full-time employment driving the unemployment rate down to 5.1% in June.

Asset Sector Overview

Australian Cash

Australian cash returned 0.40% in June, lifting its twelve-month return to 3.89%. The Reserve Bank of Australia (RBA) left the cash rate unchanged at 4.50% following its June meeting, with the accompanying statement providing a balanced assessment of the local economy. With the RBA describing the current cash setting rate as "appropriate for the near term", investors have shifted their attention to consumer price inflation data, due for release in late July. Moreover, there will be a particular focus on the composition of the overall result. Higher taxation and utility charges will be of less concern than any evidence of rising wage pressures. We retain an overweight position in cash within our diversified funds.

Australian Fixed Interest

The Australian fixed interest market returned 1.37% in June, lifting its twelve-month return to 7.86%. The yield on the Commonwealth 3-year bond declined from 4.72% to 4.34% over the month, as investors contemplated the possibility of a near-term cut in the official cash rate.

Furthermore, concerns related to the state of the European sovereign debt market persisted, ensuring that demand for domestic bonds remained strong.

Corporate bonds performed broadly in line with their government counterparts, although there was some weakness in issues with lower credit ratings. Overall, the outlook for corporate bonds remains favourable, leading us to a positive view of the sector's prospects. By comparison, government bonds have remained within a trading range since late 2009 and this looks set to continue amid the contrasting influences of relatively robust domestic economic data and uncertainty overseas. We retain 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 1.50% in Australian dollar terms in June, bringing its twelve-month return to 9.97%. The US 10-year Treasury bond was one of the strongest performers over the month, posting a fall in yield from 3.29% to 2.93%, while the 10-year maturity fell from 3.65% to 3.29%. In the UK, the 10-year government bond yield declined from 3.58% to 3.35%, while the corresponding maturities in Japan and Germany ended the month at 1.29% and 2.57% respectively. The strength in the developed bond markets has been driven by investor concerns of a double-dip recession associated with the removal of government spending from economies that are reliant on that spending to grow. We presently hold an underweight position in international fixed interest within our growth-oriented diversified funds, and an overweight position within our more defensive diversified funds.

Australian Shares

The Australian sharemarket lost ground for a third consecutive month in June, with the S&P/ASX 200 Accumulation Index declining by 2.6%. The market nevertheless remains 13.1% above its level of a year ago.

As is customary within an uncertain environment, stocks with earnings streams that are not unduly influenced by economic developments tended to perform well. Telstra (+10.5%) was a case in point, as investors responded favourably to the company's signing of a non-binding financial heads of agreement with NBN Co to participate in the rollout of the proposed national broadband network. Telstra's gain underpinned the strong performance of the telecommunications (+9.5%) sector, with each of the utilities (+2.0%), consumer staples (+0.7%) and health care (+0.5%) sectors also ending the month in positive territory. Conversely, the industrials (-7.3%) sector was heavily sold off, with each of the financials ex REITs (-5.4%), consumer discretionary (-5.3%), energy (-2.6%), materials (-1.1%) and REITs (-0.8%) sectors also losing ground.

Consensus expectations currently price the market at 11 times 2011 forecast earnings. This represents an almost 30% discount to historical trading averages. Investors will undoubtedly re-assess earnings assumptions during the forthcoming August reporting season and the risk is clearly for some downward revisions to forecast earnings. However with such a large discount implied in prices, valuation support is likely to emerge and the market should begin to focus on an underlying earnings recovery, rather than the immediate direction of earnings adjustments. We presently hold an overweight exposure to Australian shares within our diversified funds.

International Shares

The global sharemarkets were heavily sold off for a second consecutive month in June, with the MSCI World (ex Australia) Index falling by 4.2% in local currency terms. This translated to a fall of 4.1% in Australian dollar terms, reflecting the impact of the mixed performance of the Australian dollar. The dollar lost ground against the Japanese Yen (-2.9%) and Sterling (-2.2%), however it rallied against the Euro (+0.9%) and the US Dollar (+0.7%).

At present, the markets remain finely balanced between fears of a potential economic slowdown and a generally reasonable level of stock valuations. Investors are presently scrutinising corporate earnings reports, the tone of which will most likely determine the near-term direction of the markets. At present, we note that market sentiment appears somewhat cautious towards shares, although we believe that this caution may to a certain extent be overdone. We presently hold an overweight position in international shares within our growth- and defensively-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 0.8% over the month, outperforming the broader domestic sharemarket.

At the sectoral level, the industrial (+2.8%) sector staged a partial recovery, having been sold off heavily in the previous month. The commercial (+2.0%) and diversified (+1.2%) sectors also gained ground, in contrast with falls in the retail (-3.3%) and leaders (-1.2%) sectors.

At the individual stock level, there was a significant narrowing in the spread of returns. Having widened to 22.7% in May, the spread for the overall sector narrowed to 12.7% in June. 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 June, although the UBS Global Investors Index declined by 3.0% in local currency terms. However, performance at the regional level was somewhat mixed. North America (-4.9%) and the UK (-4.7%) posted substantial falls, followed by Japan (-3.7%). In contrast, Continental Europe (+1.4%) and Singapore (+2.2%) ended the month in positive territory.

A number of factors suggest to us that, from a bottom-up perspective, property fundamentals are improving. At the overall global level, we note that occupancy rates currently exceed 90%. Meanwhile, market rents have evidently reached a bottom, with some areas even showing signs of improvement. Furthermore property companies' balance sheets have returned to more healthy levels, with the average loan-to-value percentage having fallen to 40%, down from approximately 55% at the nadir of the global financial crisis. Moreover, improved capital strength has encouraged a renewal of confidence, evidenced by an increased number of property transactions being completed. 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.