

Overview

- Greece and Portugal had their respective sovereign credit ratings downgraded which only served to heighten concerns regarding the stability of sovereign debt amongst the P.I.I.G.S economies, and in particular the ability of Greece to repay its debts.
- While Europe grappled with financing the Greek bailout, the US showed promising economic signals pointing to a steady recovery. In fact US bonds have been seen as a safe haven for investors during the Greek sovereign crisis.
- In Australia, continued tightening of monetary policy sees our official cash rate now at 4.50% and there are prospects for further tightening which could see it at 5% by year end. Not surprisingly the short end of the yield curve has risen while longer dated bond yields have fallen.

April 2010

FOR PROFESSIONAL INVESTORS ONLY

ING INVESTMENT MANAGEMENT

Fixed Income Update



MARKET REVIEW

Bond Market Performance as at 30 April 2010

| Market | 1 Month Return | 3 Month Return | 12 Month Return |
|-----------------------|----------------|----------------|-----------------|
| Cash | 0.4% | 1.0% | 3.6% |
| Aust Fixed Income | 0.6% | 0.5% | 3.3% |
| Australian Credit | 0.6% | 0.9% | 5.5% |
| Global Sovereign Debt | 0.7% | 1.9% | 6.8% |
| Global Fixed Income | 0.9% | 2.2% | 10.5% |

The returns are based on the following indices in order of appearance: UBS Bank Bill Index, UBS Composite Bond Index 0+Yrs, UBS Non Govt (Core Credit) index, Barclays Capital Global Treasury Hedged (\$A), Barclays Capital Global Aggregate Hedged (\$A).

Australian Economy

The Reserve Bank of Australia (RBA) announced a further 0.25% increase on 6 April followed by another 0.25% rate increase on 4 May, bringing the official cash rate to its current level of 4.50%.

The RBA's latest decision was significantly influenced by signs that domestic inflation is unlikely to fall by as much as was earlier forecast. In this regard, the Consumer Price Index (CPI) rose by 0.9% over the March quarter, slightly ahead of expectations for a rise of 0.8%.

The CPI result revealed that growth was driven primarily by sharp gains in education (+5.6%) and health (+4.7%) expenses. These outweighed falls in the prices of clothing and footwear (-4.3%) and household contents and services (-1.3%). In annual terms, the rate of inflation lifted from 2.1% in the previous quarter to 2.9%, placing it near the top of the RBA's target band of 2% - 3%. In addition, the underlying rate of inflation, known to be a point of focus for the RBA, has similarly moved towards the 3% level.

Global Economy

Major news impacting global bond markets was the respective actions of ratings agencies Moody's and Standard & Poor's (S&P) in downgrading the sovereign credit ratings of Greece and Portugal. The move by Moody's followed the announcement by Eurostat, the statistical office of the European Union, of an upward revision to its earlier estimate of Greece's 2009 fiscal deficit. Less than a week later, S&P cut its rating of Greece by three notches to BB+, effectively removing the country from the universe of investment-grade sovereign issuers.

In addition, S&P downgraded its sovereign rating of Portugal by two notches to A-. Although at this stage Portugal's debt retains investment-grade status, the willingness of S&P to downgrade its rating by a full two notches signifies the extent of the debt problem facing a number of highly indebted European countries, whose ranks presently include Portugal, Ireland, Greece and Spain.

Meanwhile, in the US, economic data continues to improve. The latest data shows that the US economy expanded at an annual rate of 3.2% in the first quarter of 2010. Consumer spending was a main driver of growth as it increased 3.6%. Even so, the US Federal Reserve kept the benchmark interest rate on hold. The "extended period" phraseology was left intact.

US consumer confidence has also bounced back to pre-crisis levels, at 57.9 in April from 52.3. Both components, present situation and consumer expectations, were up on the month.

The initial phase of US economic recovery, supported by fiscal policy and rebound in inventories, appears to be coming to an end. In future, growth should be supported by business investment, recovery in housing and modest growth in consumption.

Australian Cash and Bonds

Short-term yields in the domestic money market remain within an upward trend. Having risen by 36 basis points (bp) the previous month, the yield on domestic 90-day bank bills rose by a further 14bp in April to reach 4.63%. The rise in yields took place against the backdrop of the RBA continuing its move to lessen the degree of monetary stimulus within the Australian economy.

In contrast to the rise in shorter dated yields, longer dated maturities finished the month slightly lower. The yield on the Commonwealth 10-year bond declined from 5.78% to 5.71%.

Australian Credit Market

Within the domestic credit market, lower rated credits outperformed their higher rated counterparts over the month, evidenced by the respective 18bp and 10bp tightening in 5-year BBB+ and AA+ spreads, as measured by CBA Spectrum relative to swap.

Activity within the primary sector of the asset backed securities (ABS) and residential mortgage backed securities (RMBS) markets was quiet in April, following a major issuance program in March. The major transaction for the month was a \$350 million issue, originated by CNH Capital. The deal, CNH Capital Australia Receivables Trust Series 2010-1, is backed by a pool of agricultural and construction equipment, and comprises three tranches.

The two AAA rated tranches were priced at 85bp and 180bp respectively over the 3-month bank bill swap rate (BBSW), while the AA rated tranche was priced at 220bp over BBSW.

Unsecured issuance for the month totalled \$8.6 billion, comprising \$6.8 billion in fixed rate securities and \$1.8 billion in floating rate securities. Slightly more than two-thirds of the total issuance was AAA rated, with the major ex-financial sector participants being Dexus Property Group, AMP Capital Shopping Centre Fund and Adelaide Airport. Within the loan market, Origin Energy completed the syndication of three facilities, with multi-tranche (\$2.3 billion), bi-lateral (\$200 million), and guarantee (\$100 million) components.

Global Bond Markets

Despite assurances that a rescue loan will prevent a default on its obligations maturing May 19, investors have remained sceptical about the long term solvency of Greece. Germany's reluctance to bail out Greece without some more tough measures for many years has not helped either.

Towards the end of the month fixed income markets came under pressure again as the sovereign credit ratings downgrades were announced. This triggered a massive sell-off of bonds issued by countries with a weak balance sheet.

The 5-year bond yield for Greece reached 12% and the CDS passed the 800-level. Meanwhile, safe haven US treasuries and German bunds were highly demanded, pushing yields down. US Treasuries were yielding 3.66% while the Bund yield dropped to 2.97%. Short term rates in the US and in Europe were little changed or a bit higher at the margin.

In the credit space the story was more or less the same as investors favoured the higher quality papers. In this context, the US investment grade spread narrowed while High Yield and EMD spreads slightly widened.



OUTLOOK

Rising US interest rates are inevitable

The US economy should continue to expand at a moderate pace. Inventory swings, gradual recovery in consumer spending, business fixed investment and fiscal stimulus will enable the economy to gain traction, aided by improving financial conditions and a recovery in households' net worth. Risks to the US economy are broadly balanced. House prices could slide as tax incentives end.

Against a backdrop of increasingly positive US economic data, investors appear to be positioning themselves for the inevitability that the US and other central banks will move towards a less stimulatory monetary policy stance. In such an environment, yield curves tend to flatten as short dated yields rise faster than their long dated counterparts. Having experienced this in the Australian context last year, we envisage similar moves in the US, Canada and New Zealand over the coming months. Moreover, as speculation mounts as to when central banks will move away from accommodative monetary policies, further increases in yields and yield volatility are likely to follow.

Credit investment still attractive in certain sectors

Notwithstanding concerns over the outlook for Greece's debt position and, perhaps more importantly, the likelihood of the Greek government successfully implementing a range of proposed austerity measures, we anticipate continued investor interest in credit investments.

In the specific context of RMBS, we note that arrears on residential mortgages underlying prime RMBS remain well below their long-run average. Given that the unemployment rate remains at 5.3%, the domestic labour market clearly remains healthy, which is conducive to householders being able to meet their mortgage commitments. Moreover, given that many of the RMBS currently on issue have been in existence for two years or more, the likelihood of their experiencing an untoward spike in defaults is comparatively small. This reflects the observed tendency for mortgage holders to default within the first two years of a mortgage. Thereafter, they are generally quite likely to meet their commitments to maturity.

Domestic cash rate at 5% by year end?

With regard to domestic monetary policy, the RBA indicated on 6 April that its monetary adjustment was part of a "process" of moving interest rates "closer to average". Following its latest move the RBA updated this comment, stating that "rates for most borrowers will be around average levels," perhaps indicating that it is nearing its goal. It would nevertheless be somewhat premature to suggest that we have reached the end of the tightening cycle, as the commodity boom appears set to greatly increase national income at a time when capacity constraints are not far from re-emerging.

Accordingly, it remains plausible that the official cash rate will move closer to 5%, and perhaps beyond, later this year and into 2011.

For more information please contact:

ING Investment Management Limited
ABN 23 003 731 959
Level 21, 83 Clarence Street
Sydney NSW 2000 Australia

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