

## Overview

- Domestic bond yields retraced in December as investors faced another interest rate rise by the Reserve Bank of Australia. This resulted in both short and long term bond yields rising.
- In global bond markets the major international news was the downgrade of Greece's sovereign credit rating by ratings agencies. This was due to major concerns about the country's large budget deficit. Other fiscally weak economies such as Ireland, Spain and Italy also came under pressure as a result of the action taken on Greece.
- Credit markets were somewhat flat in December, with much of the strong rally in 2009 having waned. However, the outlook for default risk in high yield credits continues to improve and this augurs well for the coming year.

December 2009

FOR PROFESSIONAL INVESTORS ONLY

ING INVESTMENT MANAGEMENT

# Fixed Income Update



## MARKET REVIEW

### Bond Market Performance as at 31 December 2009

Market	1 Month Return %	3 Month Return %	12 Month Return %
Cash	0.32	0.88	3.47
Aust Fixed Income	-0.38	1.04	1.73
Australian Credit	0.01	1.43	4.11
Global Sovereign Debt	-0.72	0.60	3.96
Global Fixed Income	-0.62	1.11	8.03

*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).*

Economic news flow over the month was highlighted by growth data for the September quarter. Australia's Gross Domestic Product (GDP) posted a rise of 0.2%, which was somewhat lower than market expectations of 0.4%. The data revealed that the impact of the measures taken to boost consumer spending and business capital expenditure is now fading, ahead of the growth baton being taken up by public capital spending aimed at schools and public housing.

In this regard, dwelling commencements rose by 9.4% over the quarter, driven by a 44% jump in public housing. This suggests that the Federal Government's policy of boosting the level of affordable housing is taking effect.

A further interesting aspect of the result was the continued relative shortfall in housing supply. Commonwealth Research suggests that, based on a population growth rate of just over 2 per cent per annum, Australia needs to build 443,000 new houses each year. Given that the latest annual rate of production is less than one-third of that, it appears as though continued upward pressure on rents is in play.

Meanwhile, job creation significantly exceeded expectations in November, adding weight to the view that a recovery in the domestic economy is underway. Compared to market expectations for a gain of 5,000, a total of 30,800 full-time jobs were added over the month. The result produced a slight decline in the unemployment rate, which fell from 5.8% to 5.7%. Importantly, the strengthening job market is taking place against a backdrop of moderation in the pace of wage increases. This bodes well for corporate sector profit growth as 2010 unfolds.

As a result of improving economic conditions, the Reserve Bank of Australia (RBA) continued to move monetary policy away from what was an extremely stimulatory setting. Having increased the official cash rate in 0.25% increments on October 6 and November 3, the RBA announced a further 0.25% increase on December 1, bringing the rate to its current level of 3.75%.

### Greece's sovereign debt problems create uncertainty in bond markets

At the end of November, markets were startled by the news that Dubai World was to defer payment on some of its debts. Nevertheless, investors realised that the "Dubai crisis" was a stand-alone event and that the risk of contagion to other regions was limited. Confidence was restored further once it was known that fellow Emirate, Abu Dhabi, was to provide financial assistance.

The storm had barely subsided in Dubai when credit rating agencies started to share their concerns about Greece, which faces a sizeable budget deficit. Greece's sovereign credit rating was downgraded by Standard & Poor's, Moody's and Fitch. Nervous investors began to look at other fiscally weak euro zone countries such as Ireland, Italy and Spain for similar action by ratings agencies.

However these economies presented more convincing plans to cut their budget deficits. We expect that eventually Greece will present a convincing recovery plan too. Furthermore, it has the full support of the European Central Banks and the European Union and possibly the IMF.

As a result of Greece's sovereign debt woes, the euro weakened quite a bit against the US dollar. Due to the stronger dollar, the prices of oil and gold also came under downward pressure.



Apart from the Greek crisis, investor sentiment kept up well due to economic data pointing to a persistent recovery. The US reported some encouraging data during the month with the index of leading indicators rising for an eighth consecutive month in November - a sign economic growth will extend into the first half of 2010.

An important figure was US non-farm payrolls which showed only 11,000 job losses in November. The unemployment rate declined from 10.2% to 10%. However, we think it is too early to count on a sustained recovery of the US labour market. We believe recent improvements are the result of a correction to an overshoot in job shedding during the height of the financial crisis.

### Australian Cash and Bonds

After rising modestly in the previous month, yields on domestic 90-day bank bills accelerated higher in December. From an opening level of 4.03%, yields rose by 25 basis points (bp) to end the month at 4.28%.

We also saw a narrowing across the yield curve of between 5 and 15 basis points in the spread of semi-government over government bonds. The yield on the Commonwealth 10-year bond rose from 5.24% to 5.64%, mirroring the performance of its US counterpart, which rose from 3.20% to 3.79%.

### Australian Credit Market

Within the domestic credit market, lower rated credits outperformed their higher rated counterparts over the month, evidenced by the respective 10bp and 3bp tightening in 5-year BBB+ and AA+ spreads, as measured by CBA Spectrum relative to swap. There was nevertheless a lessening in the extent to which credit spreads contracted relative to previous months.

From an issuance perspective, news flow over the month was highlighted by Westpac Banking Corporation launching its first residential mortgage backed securities (RMBS) deal since May 2007. The initial amount of the issue was \$1 billion. However, this was subsequently doubled in response to strong investor demand. The issue was made in three separate tranches. The major portion was priced at approximately 130bp over the Bank Bill Swap Rate (BBSW) and has a weighted average life of approximately 2.6 years.

The remaining two tranches were issued with weighted average lives of approximately 7.6 years, but pricing details were not disclosed.

### Global Bond and Credit Markets

The yield on German 10-year government bonds has spent almost the entire year fluctuating between 3% and 3.5%. Normally, yields rise following better than expected macroeconomic figures, but the persistently high demand for government bonds is keeping yields low.

We have been most positive about European AAA asset backed securities (ABS) and EMD listed in local currencies. The European Triple A ABS market is one of the few markets in which a substantial liquidity premium is still being paid. At the same time, the underlying fundamentals are also improving. The robust liquidity conditions are also a boost to this category, as they are for almost all asset classes with a higher yield than cash.



\* Data till 4th of December

## OUTLOOK

### RBA monetary policy now in normal range

The present focus of debate among investors is whether the RBA, having raised rates at each of its last three meetings, will implement further significant increases over the course of 2010.

The Deputy Governor of the RBA, Ric Battellino, recently said that, on the basis of historical comparison, it could be argued that monetary policy "is now back in the normal range". This comment would appear to suggest that a pause in monetary tightening may be in play. However, given that the present interest rate setting is "in the expansionary segment of that range", and that the RBA anticipates a close-to-trend rate of economic growth in the coming year, it appears likely that there will be further increases in the cash rate in 2010.

The next question is "Will interest rates increase significantly?"

It should be remembered that there remains a significant difference between the official cash rate and the financing costs of both consumers and businesses. In particular, the action by one of the commercial banks to pass on almost double the amount of the December rate rise to its mortgage holders represents a further 'de facto' tightening of monetary policy. Similarly, the business sector is experiencing financing challenges, with anecdotal evidence suggesting that many face difficulties in securing credit even at significant premiums to the prevailing cash rate.

We suspect that, despite the "material" adjustments made to date, the RBA does not have a pre-determined pace or target of policy adjustment in mind, but rather intends to continue assessing the situation as it develops. In this regard, retail sales over the Christmas period and the December-quarter inflation result are likely to represent key points of near-term focus for the RBA in its thinking on monetary policy.

Our near-term interest rate outlook is predicated on our expectation that the RBA will be inclined to increase the official cash rate towards 4.25%, commencing in the first quarter of 2010. The December quarter Consumer Price Index (CPI), scheduled for release in late January, will be critical in determining whether the RBA tightens policy at its first 2010 meeting on 2 February. The market is currently pricing in a cash rate of 5.0% by December 2010, a scenario we regard as plausible.

### Short term yields will come under pressure

The prospect of further monetary tightening in Australia is likely to ensure that short-term domestic yields remain under pressure, and this could lead to a renewal of flattening pressure on the domestic yield curve. We nevertheless caution that this rather benign domestic economic and interest rate outlook is not without risk.

Specific factors that could present a near-term challenge to higher yields include: a further strengthening in the Australian dollar; the fading impact of the fiscal stimulus measures; increased regulatory costs; and persistently tight lending standards.

On the other hand, we remain mindful of the persistently high inflation rate; surprisingly tight employment conditions; high levels of migration; an ongoing structural surge in commodity demand from China; and signs of economic recovery in the US. These factors could lead to even higher interest rates in the months ahead.

### Credit markets unlikely to experience rallies seen in 2009

In our opinion, the recent rally in credit spreads is being driven by three principal forces:

- the sharp fall in government bond yields;
- a strong demand for yield enhancing fixed income investments from both private and institutional investors. This has been evidenced by the favourable market response encountered by primary issuers; and
- the continuous improvement in default risk perceptions which are being reflected in the global decline in high-yield default rates since March 2009. Moreover, ratings agency Moody's anticipates that defaults will peak at 12.5%, ahead of a decline to approximately 4.2% later this year.

The sharp and sustained contraction in credit spreads since the first quarter of 2009 leads us to expect that further such exceptional gains are unlikely. Instead, we anticipate that medium-term tightening will more likely be gradual in nature.

We believe that stock selection and relative value will assume particular importance, as credit investment has returned to being more of a yield enhancement mechanism, as opposed to a capital appreciation tool.

## How long can the US maintain an accommodative monetary policy?

In the context of US bonds, debate remains focused on how long an accommodative monetary policy stance will be maintained. Although it is widely acknowledged that the Federal Reserve (Fed) is wary of the potential medium-term consequences of "persistently raising the monetary base", it remains of the opinion that overall economic activity in the US is "likely to remain weak" for some time yet.

In this regard, we note that the re-capitalisation process within the corporate sector is far from over, and that job shedding continues. Accordingly, it appears likely that the present US monetary policy setting will remain in place for some time.

Notwithstanding this, bond investors are unlikely to wait for the Fed to actually adjust interest rates before repositioning themselves. For example, bond yields began rising in March 2009, six months before the RBA first adjusted monetary policy. We envisage a similar scenario playing out in the US.

## Global bond markets will respond to a low interest rate scenario

Fuelled by liquidities, low interest rates, fiscal stimulus and restocking, the global economy is climbing out of a severe recession. Despite huge uncertainties, prospects for a sustained recovery are favourable. These uncertainties, which mainly relate to the debt-laden US consumer facing increasing unemployment and limited wage growth, could weigh on consumption in the US as well as in other major economies.

The run-down in fiscal and monetary stimulus could also feed this uncertainty. As a result, there is a risk of disappointing economic data, particularly in the second half of 2010. We expect monetary policy to remain accommodative. We also anticipate low inflation and ongoing low interest rates, taking into account the major overcapacity in the manufacturing industry.

The downward pressure on inflation, high levels of liquidity and extremely low yields on the money markets mean that investors are searching for bonds with long maturities. We anticipate that this situation will continue in 2010.

We expect the yield differential between long term and short term bond yields to gradually narrow in both the euro zone and the US. We forecast that 10-year bond yields will continue to hover within a 3 to 3.5% bandwidth in the US as well as in the euro zone (Germany).

Despite the strong rally in the more risky fixed income segments such as (high-yield) corporate credits and emerging markets debt, these sectors still have upward potential in the longer term.

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