

Overview

- Sovereign debt issues continued to be a concern for investors in June resulting in a widening in credit spreads.
- The G20 Summit during the month showed a concerted effort by economic leaders to reduce government deficits within their respective economies as a necessary step to promote economic recovery and reduce the risk of spiralling interest rates. A proposal to introduce higher levels of capital and liquidity for banks was put forward in order to create a more resilient financial system in the face of future financial shocks.

June 2010

FOR PROFESSIONAL INVESTORS ONLY

ING INVESTMENT MANAGEMENT

Fixed Income Update



MARKET REVIEW

Bond Market Performance as at 30 June 2010

Market	1 Month Return	3 Month Return	12 Month Return
Cash	0.4%	1.1%	3.9%
Aust Fixed Income	1.4%	3.6%	7.9%
Australian Credit	1.1%	2.9%	8.2%
Global Sovereign Debt	1.1%	3.5%	9.3%
Global Fixed Income	1.3%	3.4%	11.5%

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).

Global financial markets closed out a dismal quarter in June, as disappointing economic data in the US, signs of a slowdown in China and continued worries about the serviceability of European sovereign debt sent already-skittish investors to the sidelines. After a downgrade warning from Moody's, Spain proved there was still a market for its debt. It sold €3.5 billion of five-year bonds at an average yield only slightly higher than its early May auction of similar paper.

The other major event during June was the G-20 summit in Toronto which resulted in an agreement among the participants to slash government deficits in half by 2013 and stabilise debt loads by 2016. The agreement indicated how important debt reduction is to future economic sustainability and growth. The G-20 is concerned that high debt levels could lead to high interest rates.

Another important decision at the G-20 meeting was an agreement that co-ordinated regulation of the financial system was required to create a much stronger financial framework in order to avoid or minimise global disasters like the global financial crisis. The aim is to introduce higher levels of capital and liquidity for banks by the end of 2012. By raising capital levels banks should be able to absorb market shocks much better and avoid relying on taxpayer support.

The 2012 timeline should give banks sufficient time to adopt the tighter banking rules. However, the G20 was also open to phase-in arrangements whereby some banks would adopt the new rules at a later date depending on the health of their local economy.

Australian Cash and Bonds

A widening in credit spreads ensured that bank bill yields continued on an upward path in June, reaching their highest level since November 2008. Having risen by 24 basis points (bp) the previous month, the yield on domestic 90-day bank bills rose by a further 5bp in June to reach 4.92%. In contrast to the rise in bank bill yields, longer dated maturities generally moved lower over the month. The yield on the Commonwealth 10-year bond fell from 5.37% to 5.09%.

Australian Credit Market

The financial year-end period is generally characterised by relative tightness in market liquidity, and this was one of the factors that contributed to the widening in spreads. The market was further impacted by deteriorating sentiment with regard to the issue of European sovereign credit. Amid ongoing concerns over the longer-term outlook for the region's financially weaker countries, spreads in the inter-bank market widened in anticipation of potential re-financing difficulties associated with the rolling over of European Union liquidity support measures.

In terms of specific performance, higher rated credits marginally outperformed their lower rated counterparts over the month, evidenced by the respective 1bp and 20bp widening in 5-year AA+ and BBB+ spreads, as measured by CBA Spectrum relative to swap.

More broadly, the widening in credit spreads was evident in the Australian iTraxx Index, which rose from 125 to 135 in June. The iTraxx Index comprises 25 investment grade Australian banks and corporate issuers.

Following a period of inactivity in May, issuers returned to the market in June, raising \$2.2 billion in fixed rate securities and \$1.4 billion in floating rate securities. AAA-rated supranational and agency issuers accounted for the majority of supply, while the major banks also featured prominently.

National Australia Bank issued a \$1 billion 3-year note priced at 85bp over the benchmark, while Westpac Bank issued an \$800 million 5-year note at 135bp over the benchmark. Other major issuers included Telstra (HK\$330 million and \$150 million) and Sydney Airport, which issued a \$175 million 5-year note while redeeming \$120 million of existing securities. In the loan market, the major issuers included Dulux Group (\$400 million), Computershare (US\$600 million), and Vodafone Hutchison Australia, which completed a \$3 billion issue that was increased from \$2 billion initially.

Within the asset backed securities (ABS) and residential mortgage backed securities (RMBS) markets, Liberty Financial completed a \$90 million ABS transaction backed by a pool of motor vehicle loans.

Global Bond Markets

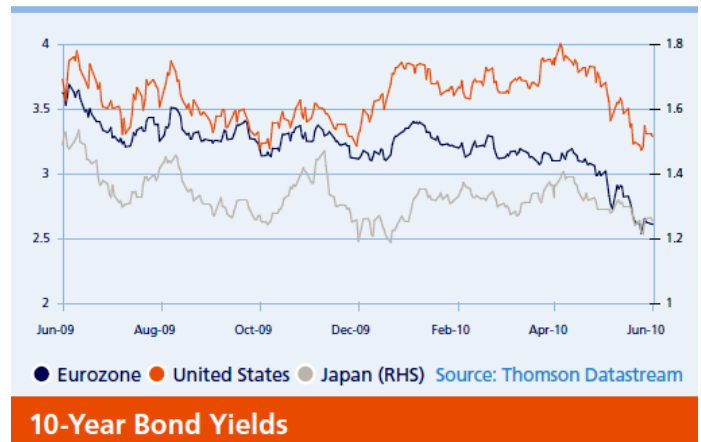
Since the beginning of May, a remarkable divergence between market pricing and underlying macro and earnings fundamentals has emerged. With markets focussing on sovereign solvency issues in Europe and global growth risks on the back of policy tightening, most risky assets sold off significantly. At the same time, economic data has remained resilient, even if it did not surprise to the upside to the same extent as earlier in the year. Interestingly enough the latter holds mainly for the US, while Asia (inflation numbers) and Europe (activity outside of Greece) have continued to send supportive signals of further cyclical upside.

Especially important has been the more unified policy 'voice' and increased transparency in Europe. A combined press conference by Merkel (Germany) and Sarkozy (France) that focussed on European policy coordination and additional structural reform initiatives in France and Spain signalled stronger willingness to move forward in a more cooperative fashion.

Moreover, more operational and rating details about the European Financial Support Facility (EFSF), the rejection of the German Constitutional Court of a claim against the legal status of the EFSF and the announcement that stress-tests on the 25 largest European banks will be made public should help to reduce uncertainty surrounding sovereign and financial sector worries.

The announcement of the Chinese government to allow more "flexibility" in its exchange rate regime was an important policy step towards a more balanced global economy and to some extent also a vote of confidence on the strength of the global recovery.

On top of all this, growth supportive comments of Fed Chairman Bernanke to the Congress and the instalment of more aggressive credit easing by the Bank of Japan suggested that monetary policy settings remain supportive in most parts of the world.



OUTLOOK

Investors remain concerned about European sovereign debt problems

Notwithstanding the announcement of the joint EU and IMF financial support package, the longer term debt-servicing abilities of Greece and the other heavily indebted European nations remain in question. Accordingly, investors remain mindful of the possibility that any failure on the part of a European government or bank could lead to a renewed freeze in the credit markets.

These concerns have been reflected in a widening in the London Inter-Bank Offered Rate (Libor). This is the rate at which banks lend to each other in the overnight market, and is a good indicator of prevailing sentiment within the credit markets.

However, of key importance is the fact that the widening in spreads over recent weeks has not reached levels anywhere near those that prevailed at the height of the global financial crisis when Lehman Brothers collapsed. The reasons for the comparatively contained nature of this latest spread widening are, firstly, the clear willingness of governments to ensure that failures are avoided, and secondly, the prompt moves by leading central bankers to provide financing facilities in the markets to ensure that sufficient liquidity remains readily available.

Accordingly, although a period of heightened spread volatility is in play, it appears likely that spreads will remain within their recent trading range.

Moreover, any episodes of undue weakness are likely to be limited by the generally positive tone of economic data releases, and investors seeking to capture attractively valued opportunities.

Yield curve flattening expected to continue

While bond yields have declined in line with deteriorating economic sentiment, we do not anticipate that this will persist for too much longer. In line with official cash rates, short dated yields in most major countries, with the notable exception of Australia, are at or near historically low levels. Accordingly, downward pressure on yields is manifesting itself particularly amongst long dated maturities. This is causing yield curves in countries such as the US and Germany to flatten. We anticipate the trend toward curve flattening will continue.

With specific regard to the credit sector, we note that the banks' funding costs in the international wholesale markets have increased lately, which has caused credit spreads on bank securities to widen. However, we contend that this is solely a liquidity issue, and does not represent an adverse reflection of the banks' underlying creditworthiness. Moreover, we expect that regulation aimed at restricting the investment activities of the US banks will serve to lower their risk profile and hence their funding costs in the medium term. A flow on effect would most likely also lead to a lowering of funding costs for the domestic banks, which would further underpin their attractiveness to holders of their debt.

RBA watchful of local inflation pressures

In a statement released on 1 June, the RBA suggested that current interest rate settings are "appropriate for the near term". When it updated this comment on 6 July, it chose to leave out the phrase "for the near term", perhaps implying that it harbours concerns over the outlook for inflation and regards the necessity for a near term rate adjustment as a distinct possibility.

Despite the current "caution" in the financial markets, "driven principally by concerns about European sovereigns and banks", the RBA evidently remains concerned over the potential inflationary implications of the ongoing strength in demand for our resources. It notes that commodity prices that are "most important for Australia remain at very high levels", reflecting the underlying momentum in economic growth, particularly in Asia, where it remains "very strong".

The inflationary implications of this assessment become even more apparent when considered against the backdrop of a move towards the re-emergence of capacity constraints in the domestic economy. Progressive gains in the area of job creation over recent months have prompted the RBA to note that the labour market "has continued to firm", and that growth in wages "has picked up".

Accordingly, we believe that further increases in the official cash rate remain a distinct possibility over the coming months. In this regard, the release of the Consumer Price Index (CPI) for the June quarter, scheduled for 28 July, is likely to be a key point of focus for investors.

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