

Overview

- Despite the announcement of a €50 billion financial rescue package for Greece and other troubled Euro Zone economies, investors continued to doubt whether these measures would succeed and accordingly financial markets were particularly volatile during the month. The US, Germany and Netherlands stood out as safe haven markets for global bonds investors, leading to falls across the yield curve in these markets.
- Investor demand for bonds in lower risk economies was a positive for Australia with Commonwealth Government bond yields falling. As a result, corporate bonds underperformed relative to government bonds, which led to a widening in credit spreads.

May 2010

FOR PROFESSIONAL INVESTORS ONLY

ING INVESTMENT MANAGEMENT

Fixed Income Update



MARKET REVIEW

Bond Market Performance as at 31 May 2010

Market	1 Month Return	3 Month Return	12 Month Return
Cash	0.4%	1.0%	3.8%
Aust Fixed Income	1.7%	1.6%	5.8%
Australian Credit	1.2%	1.6%	6.5%
Global Sovereign Debt	1.7%	2.8%	9.2%
Global Fixed Income	1.2%	2.6%	11.4%

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

As is customary in May, the highlight of domestic economic and financial news flow was the Federal Treasurer's Budget delivery speech. This year's budget was largely concerned with returning to a surplus position over the medium-term, however its detail was largely overshadowed by ongoing media and financial market commentary related to the earlier announcement of a proposed resource super profits tax (RSPT).

In terms of economic data, the addition in April of 33,700 jobs suggests that the domestic labour market continues to strengthen. In contrast, the housing finance sector continues to weaken, with both the number and value of loans to owner-occupiers falling by 3.4% in March. Retail sales figures for the month were similarly disappointing, revealing a rise of barely 0.3%, following a fall of 1.2% in the previous month.

There were no changes to the cash rate during the month. Having last increased the official cash rate on 4 May to 4.5% the Reserve Bank of Australia (RBA) stated that current interest rate settings are "appropriate for the near term".

However, it would 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.

Global Economy

In spite of an enormous €750 billion financial rescue package announced by the European Union (EU) and the International Monetary Fund (IMF) in May for Greece and other troubled Euro Zone economies, investors continued to doubt whether these measures would succeed. In addition, German regulatory authorities unexpectedly banned speculative transactions in (derivatives on) European government bonds and in the equities of 10 large German financial institutions. The measures led to speculation that German regulatory authorities were better informed than the market about the real economic conditions and increased the unease in already jittery financial markets.

To add to these concerns, the new Hungarian government made statements which implied that it would be difficult for Hungary to avoid a 'Greek scenario'. There was talk that the country could potentially go bankrupt. Hungary was one of the countries which got into difficulties at the start of the credit crisis in 2008. At that time the IMF, the EU and the World Bank came to the country's rescue with a €20 billion bail-out package. The new Hungarian government now wants to renegotiate the terms of the loan. Hungary has since hastily tried to reassure markets by announcing measures to reduce its budget deficit. Nevertheless, the market reaction was typical of investors' fragile confidence.

In the US, the passage through the US Senate of a bill designed to restrict the activities of US banks and the announcement of a criminal probe into the activities of investment bank Goldman Sachs soured investment sentiment.

However, on the economic front there continues to be numerous signs of improvement as a cyclical transition to sustainable, demand-driven economic expansion takes hold. For example, manufacturing activity remains robust, consumer confidence is making a comeback, and housing data showed evidence of stabilisation.

Stubborn unemployment levels continue to be a very large thorn in the side of recovery. While 431,000 jobs were added in May, only 41,000 were generated by the private sector. Continued employment growth is critical in order for the US economy to successfully transition to a sustainable expansion.

China's determination to engineer a slowdown of its economy was also a source of consternation during the month. Data regarding retail sales, bank lending and home prices have all been trending up in the country, and inflationary pressure has been increasing. May consumer prices were up 3.1% from a year earlier, the fastest rate of increase in 19 months. Two recent surveys of Chinese purchasing managers indicate that Beijing's efforts to curtail growth appear to be working; while still indicative of an expanding economy. There are concerns that the government's ongoing efforts to curb the economy will hurt corporate profits.

Australian Cash and Bonds

Short-term yields in the domestic money market extended their upward trend in May. Having risen by 14 basis points (bp) the previous month, the yield on domestic 90-day bank bills rose by a further 24bp in May to reach 4.87%. The impetus for the latest rise in bank bill yields was not entirely due to market expectations of higher cash rates. Rather, the growing concerns about European sovereign debt and the flow-on effect to banks that have exposure in this area appears to have caused a general increase in the yields at which banks are prepared to lend to each other.

In contrast to the rise in shorter dated yields, longer dated maturities finished the month significantly lower. The Commonwealth Government 3-year bond yield fell from 5.36% to 4.72% and the 10-year bond yield fell from 5.71% to 5.37%.

Australian Credit Market

Within the domestic credit market, there was a general trend towards spread widening over the course of the month. In terms of specific performance, higher rated credits marginally outperformed their lower rated counterparts over the month, evidenced by the respective 13bp and 14bp widening in 5-year AA+ and BBB+ spreads, as measured by CBA Spectrum relative to swap.

More broadly, the widening in credit spreads caused by the shift towards the relative safety of government bonds was illustrated by the Australian iTraxx Index, which rose from 85 to 125 in May. The iTraxx Index comprises 25 investment grade Australian banks and corporate issuers.

Within the asset backed securities (ABS) and residential mortgage backed securities (RMBS) markets, four new securitisation transactions, with a total issuance volume of \$1.83 billion, were priced during the month.

There was also significant activity in the loan markets. Qantas completed a 4-year syndication facility (\$430 million) to 27 banks, Sonic Healthcare arranged a multi-currency multi-tranche revolving facility (\$1.3 billion), and Goodman Australia Industrial Fund finalised a 5-year bilateral facility (\$250 million). In addition Macmahon Holdings completed the syndication of a 3-year multi-tranche facility (\$240 million).

Global Bond Markets

Ahead of the announcement of the joint EU and IMF financial support package, investors were particularly concerned over the debt-servicing challenges facing Greece and the other heavily indebted European nations. These concerns were 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.

In Europe the Bund, the German 10-year government bond, reinforced its reputation as a safe haven. Many investors exchanged their government bonds issued by euro countries with weak budgets for stable German government bonds. The Bund yield fell to just above 2.5% at the end of May, an all-time low. The Dutch 10-year yield also dropped to just over 2.8% at the end of May. Alongside Germany, the Netherlands are considered as one of the most creditworthy countries within the euro zone and can therefore borrow relatively cheaply from capital markets.

US Treasury yields were also considered a safe haven for bond investors and were the best performing asset class in US markets for the month. During the month US yields fell across the yield curve with both the 10-year and 30-year reaching year-to-date lows. The US 10 year bond yield declined from 3.72% to 3.29% over the month. US Corporate bonds also performed well during the month, benefiting from better than expected corporate earnings.

OUTLOOK

Europe faces long term funding issues

After the announcement of the massive liquidity support package for troubled Euro economies in early May most investors expected sovereign risk worries to move to the background. With funding needs over the next 2-3 years basically taken out of the equation and the degree to which treasury yields in peripheral European markets can rise (to a large extent capped by ECB intervention), it seemed likely that market turmoil would cool at least temporarily.

Clearly, this assumption was proven to be too optimistic as yield spreads (compared to Germany) and CDS levels of the 'weaker' European countries are at, or even some cases above, their early May highs. Risky assets have continued to sell off globally as equities and commodities have fallen further and credit spreads moved to their highest level since the beginning of the year.

So why is there persistent risk aversion among investors?

A debate has emerged as to the meaning of a "risk free" asset - an expression that often refers to the 'safe' cornerstone of a diversified portfolio and one which traditionally includes government bonds. The experience of the last couple of months has made a lot of risk-averse type investors think twice about the concept of "risk free" assets. Many of them have actually started to reconsider the strategic composition of the defensive part of their investment portfolios.

In the segmented fixed income world it will not be easy to find a new home for peripheral European treasury bonds as many other fixed income investors will either feel they lack the skill (corporate credit, ABS, MBS) to assess sovereign solvency risks or lack the willingness and/or funding (Multi Asset, EMD) to pick up all the issuance that still needs to be done by the troubled European countries over the next couple of years.

Therefore, it is difficult to see where the willing buyers of 'nearly orphaned' European treasury paper will come from or if there will be enough of them. Meanwhile, lingering doubt on the practical and political feasibility of the European support mechanism, rising illiquidity in interbank repo and funding markets and fear over the negative impact on growth from fiscal tightening going forward also play a role in the increase in risk aversion.

We anticipate that the significant yield differences between core and peripheral European countries will persist for government bonds issued in euros. This will only change once concerns about potential non-compliance with yield and/or redemption obligations by the peripheral countries have diminished. Spreads could widen gradually, but will not increase sharply.

We continue to have a negative view about credits most exposed to the risks arising from the sovereign debt crisis: the financial sector, the peripheral euro countries and investment grade credits. We are more positive on non-financial corporate credit and emerging markets debt.

US economic recovery – slow but steady

The minutes from the latest meeting of the Federal Open Market Committee (FOMC) of the US Federal Reserve indicate an upward revision to the 2010 growth outlook for the US economy and a lowering of unemployment expectations. This serves to heighten the sense of inevitability that, as has already occurred in Australia, the US will begin to raise interest rates. We note that this process has already started in Canada, with the Bank of Canada recently raising its key lending rate by 0.25%. However, in the short term we believe the US will continue to keep interest rates low due to the uncertainty around the world.

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