

# Fixed Income Perspectives



From left to right: Matt Toms, Head of U.S. Public Fixed Income; Christine Hurtsellers, CIO Fixed Income; Mike Mata, Head of Multi-Sector Fixed Income

**ING Investment Management's fixed income strategies** cover a broad range of maturities, sectors and instruments, giving investors wide latitude to create a new portfolio structure or complement an existing one. We offer investment strategies across the yield curve and credit spectrum, as well as in specialized disciplines that focus on individual market sectors. We build portfolios one bond at a time, with a critical review of each security by experienced fixed income managers.

As of March 31, 2010, ING Investment Management managed over \$355 billion in fixed income strategies globally.

## Bond Market Outlook

**Treasuries & Agencies:** Short-term rates are likely to stay very low, as the Fed remains dovish given the lack of near-term inflation pressures.

**Mortgages:** Positive technicals continue to dominate non-agency and commercial mortgages, but record-high agency prices could make sector vulnerable.

**Corporates:** Despite recent tightening, valuations are still fair to modestly cheap amid good fundamentals.

**High Yield:** Good fundamentals and attractive valuations drive our positive long-term outlook.

**Emerging Markets:** Despite near-term global macro concerns, our long-term outlook is positive.

## Macro Overview

- Given the recent softening of U.S. economic data, our baseline view is that the U.S. economy will expand at a more restrained pace during the second half of 2010, with GDP growth of less than 3%. Persistent weakness in the labor and housing markets, increased global uncertainty and a smaller contribution from fiscal spending and inventory building culminate in more significant headwinds for the U.S. economy.
- The U.S. is most likely to experience disinflation, but it will likely avoid deflation with appropriate proactive policy measures. Policy considerations — such as large-scale public works program and a reduction of or “holiday” from payroll taxes — and efficient spending on public infrastructure could overcome disinflation/deflation by creating jobs, increasing real average hourly earnings and real disposable income, and sustaining a healthy pace of personal consumer spending on goods and services.
- On the global front, the euro zone economy is performing better than expected, in part due to asset purchases by the European Central Bank and the willingness of European authorities to save the financial/banking system. Nevertheless, the euro zone faces significant medium-term problems, particularly around austerity measures (such as tax increases and spending cuts) in the currency bloc's peripheral countries that will curtail their growth.
- Some central banks that raised rates earlier this year — such as those in Australia, New Zealand and Norway — are likely close to done for 2010; while these banks may still tighten policy rates, it's likely to be only by a moderate amount. Meanwhile, the major central banks — that is, those of the U.S., U.K., Europe and Japan — will remain on hold.
- July featured meaningful rallies across spread assets, as earnings season provided fundamental strength. We retain a generally positive view on fixed income spread assets but expect security selection to be of increasing importance in generating excess returns given current valuations.

## Bond Spreads and Returns

Index	Percentage of Index	Spread (bps)	Returns	
			July 2010 (%)	YTD (%)
<b>U.S. Investment Grade</b>				
Barclays Aggregate	100.0	57	1.1	6.5
Treasury	32.5	0	0.7	6.6
Gov't Related	12.1	54	1.1	5.2
Corporate	18.3	175	2.0	7.9
Fixed-Rate MBS	32.6	-7	0.9	5.5
ABS	0.3	72	1.2	6.1
CMBS	3.0	346	2.1	14.5
Hybrid ARM	1.2	54	0.5	1.9
<b>Other</b>				
High Yield		642	3.6	8.2
Global Aggregate		54	3.4	3.1
Emerging Markets		337	4.4	9.7

Note: All spreads are to Treasuries and option adjusted except for Emerging Markets, which is nominal. All returns are total returns including dividends expressed as percentages.

Source: Barclays Capital, JPMorgan, Standard & Poor's.

## Sector Overviews

### Treasury & Agency Debt

- Short-term U.S. treasury rates continue to move to remarkably low levels and are likely to stay in this range for some time to come. The Fed's decision to reinvest its maturing mortgage investments into two- to ten-year Treasuries underscores the central bank's desire to keep rates highly accommodative for the economy. As a result, we maintain some expectation for further U.S. yield curve flattening. We maintain our negative view on agency debt, driven by valuations and given the current relative attractiveness of other spread assets.

### Mortgages

- Fundamentally, agency mortgages have benefited from limited supply in July; however, if low supply numbers are due to direct purchases by banks, this benefit could prove temporary. There appears to be limited upside from current record-high dollar prices in agency mortgage-backed securities. The vulnerability of current prices was demonstrated by a sharp market reaction to rumors of a national refinancing program. While such a program is unlikely to prove feasible, the rumor had a meaningful impact on higher-coupon mortgage securities.
- In the non-agency mortgage sector, positive technicals — including the participation of Public-Private Investment Program (PPIP) buyers and negative net issuance in the sector — continue to dominate the market. Given the end-April expiration of the homebuyers tax credit, we expect to see some weakness in housing prices over the rest of 2010 but not enough to force residential mortgage prices meaningfully lower.
- Commercial mortgage-backed security fundamentals have become increasingly transparent, with moderating delinquency growth, greater stability in commercial real estate prices and more liquidation data that is helping to better define loss severity expectations. The sector rallied in July on fundamentals, increased market risk appetite and the positive technicals associated with a somewhat revitalized new-issue market.

### Investment Grade Corporate

- Credit markets have cleared several potential hurdles in the last month, including the European bank stress tests, U.S. financial regulatory reform, the BP oil spill and earnings season. Although the market tightened sharply in July, slightly front-running positive fundamental news, the clearing of these hurdles still leaves the short-term outlook more positive.
- The majority of earnings reports have beaten expectations in the last several quarters, which is notable even though earnings data is backward-looking and many leading indicators show signs of slowing. Management teams remain friendly to debt holders, with a decline in share buybacks during the second quarter. This fundamental backdrop suggests that valuations are still modestly cheap with GDP growth running at or above 2%.

### High Yield

- High yield has continued to exhibit fundamental strength after a strong earnings season that featured positive outlooks for future quarters. Although the sharp spread tightening in July tempers our short-term view, we maintain a positive long-term outlook for the sector predicated on sustained, positive GDP growth.

### Emerging Markets

- Emerging market spreads tightened about 50 basis points in July, as the sector hovers near all-time-low yields, spurring a high level of new issuance. This new supply however, has been absorbed extremely well, and the cash buildup resulting from inflows to the sector provides a very positive technical backdrop.
- Fundamentals remain very strong in the sovereign space, but U.S. economic concerns do weaken the global macro environment, which impacts fundamentals and sentiment for emerging markets. Concerns of sovereign defaults in Europe and the management of China's growth slowdown have been somewhat alleviated by recent data, and our long-term outlook remains positive.

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