

# Fixed Income Perspectives

ING PERSPECTIVES

MARKET SERIES



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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 June 30, 2012, ING Investment Management managed \$126 billion in fixed income strategies in the United States.

## Bond Market Outlook

**Global Interest Rates:** Central bank support should continue to anchor the front end and belly of the curve in a weak economy.

**Global Currencies:** We remain bearish on the dollar and euro, opting for better-yielding EM currencies that will benefit from lower volatility.

**Corporates:** While current-quarter earnings estimates are weaker, we expect spreads to remain tight.

**High Yield:** A more-neutral tactical posture is warranted given tighter spreads and high dollar prices, though macro-driven upside potential exists.

**Mortgages:** Government intervention will keep mortgages well-supported as investors search for high-quality yield.

**Emerging Markets:** While downside risk for global growth is concerning, demand for the higher yields EM offers should remain robust.

## Macro Overview

- It's hard for any baseball fan to curb his or her enthusiasm this time of year, as today's sultans of swat look to punch their tickets to the World Series. While an entire era of America's favorite pastime may have been tainted by the choices of its juiced-up heroes, a walk-off homer washed down the nostalgic gullet with a \$15 beer gives us hope that there still might be some real magic left in October.
- Financial market fanfare post-QE3 is no different. Markets the world over have been knocking it out of the park, with the S&P 500 and fixed income asset classes like high yield and emerging market debt delivering double-digit year-to-date returns. We wonder if these prolific stats should carry an asterisk, however.
- At summer's end, Ben "The Babe" Bernanke and other central bank all-stars spent a couple of days in Jackson Hole batting around ways to help the global economy bust out of its cold streak via monetary policy. The tape-measure blasts that followed from European, U.S. and Japanese bankers brought back memories of a more innocent time when we actually rooted for the likes of Sammy Sosa and Mark McGwire.
- If we learned anything from baseball's Steroid Era, it's that while PEDs may temporarily turn slap hitters into sluggers and sluggers into legends, fundamentals — like U.S. fiscal and regulatory mechanics, Europe's weak peripheral roster and shaky emerging market production — ultimately determine performance. As the effects of monetary juicing start to wane, investors are likely to head for the exits if these macro issues go unaddressed and impede authentic global economic recovery.
- In our view, Europe's issues are not career-ending. Moreover, stability overseas coupled with a cleaner fiscal and regulatory framework in the U.S. should inspire the corporate-spending boo-birds to join ebullient consumers already cheering the fundamental improvements in the U.S. housing market. Of course, the outcome of November's elections — and the policy that results — will help determine whether the market for risk assets is the real Hammerin' Hank or just another juiced-up mirage.

### Spreads, Returns and Yields

Index	Percentage of Index	Spread (bps)	Returns (%)	
			September 2012	YTD 2012
Barclays U.S. Aggregate	100.0	48	0.4	4.0
Treasury	36.1	0	0.0	2.1
Investment Grade Corporates	21.1	156	1.1	8.7
Fixed-Rate MBS	29.2	24	0.4	2.8
Other				
High Yield		551	1.5	12.1
Global Aggregate		67	1.6	4.8
Emerging Markets		291	1.7	14.2

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%)	
			September 2012	YTD 2012
U.S.	1.6	EUR/USD 1.29	2.2	-0.8
Europe	1.4	USD/JPY 77.96	0.6	-1.4
Japan	0.8	USD/BRL 2.03	0.2	-7.9
Brazil	9.8			

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. All returns in U.S. dollars.

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

## Sector Overviews

### Global Interest Rates

- Much of the recent QE trade has started to fade. Though yields remain lower than inflation expectations would suggest, central banks will keep interest rates and volatility low by continuing — and, if necessary, expanding — their easing programs. Given this and the weak economy, the bid for duration should continue to outweigh inflation fears in the near term, at least in the front end and belly of the curve.
- Uncertainty about Spain will drive risk sentiment, which may lead to a flight-to-quality bias and strengthening of U.S. Treasuries. However, the ECB's incorporation of ESFS conditionality within its bond-buying program has created a framework to contain tail risks associated with troubled sovereign credits. Given the global liquidity glut, higher-beta European peripherals are attractive at current levels and likely to benefit from ESFS/ECB purchases and renewed interest from international investors.

### Global Currencies

- We remain bearish on the U.S. dollar and tactically overweight select emerging market currencies — like the Malaysian ringgit — that offer a substantial yield advantage and stand to benefit from the reduced volatility expected in coming months.
- We are underweight the euro but maintain select exposures to Eastern European currencies that are benefitting from the improvements in the euro zone, like Polish zloty and Hungarian forint. We are overweight the Russian ruble and Indian rupiah given the strong rally in commodity prices but may look to trim these exposures as valuations become stretched.

### High Yield Corporates

- The high yield market continues to grind tighter with the QE3-prompted rally in spread assets. While earnings momentum is waning, corporate balance sheets and credit quality remain intact. The possibility of a U.S. recession is the biggest threat, though GDP growth remains modestly positive. Monetary and fiscal policy both are expected to remain supportive of credit creation, furthered by strong consumption.
- Given tighter spreads, low all-in yields and high dollar prices, we recommend a more-neutral tactical position to high yield. However, upside potential remains should macro uncertainty abate and fundamentals improve. At a spread of nearly 600 bps to Treasuries, high yield offers more-than-adequate compensation for likely credit losses, even if defaults were to increase from the current low level.

### Investment Grade Corporates

- Corporate leverage is still low, and liquidity is strong. Though spreads are likely trading at fair value (+150 bps), they are at their tightest levels of the year and are approaching what has been a three-year resistance point (+140 bps). Current-quarter earnings estimates are coming in weaker — down about 2%. While there's always the possibility of upside surprises, it's hard to get excited about earnings growth at the moment.
- Financials tends to dominate the asset class, however. Given the risk rally and strong market performance for financial equities, coupled with strong new-issuance volume, we expect corporate spreads to remain well-supported.

### Mortgages

- Agency MBS rallied sharply, outperforming Treasuries in anticipation and on the announcement of QE3. The supply/demand dynamic remains compelling; given the Fed's promise to ramp up its buying on top of existing reinvestments, total repurchases represent 70–80% of monthly supply. Prepayments continue to rise as mortgage rates hit new lows and HARP 2.0 effects increase. While prepayments remain the primary risk, government intervention will keep the asset class well-supported.
- Having successfully cleared the September/October new-issue supply hurdle, the CMBS market is better positioned from a technical standpoint. With limited alternatives for quality spread product, CMBS is likely to remain well-bid. While we are concerned that supply could begin to outpace demand, crossover buyers should help sustain near-term valuations.
- Fundamental tailwinds for the housing market and the search for yield are benefitting non-agency mortgages. While the recovery will be a multiyear process, near-term technicals are robust. Uncertainty regarding regulation is the largest obstacle.

### Emerging Markets

- Emerging markets have benefitted from central bank action. While global growth remains a concern, liquidity conditions and low global rates should support demand for the higher yields offered in the emerging markets. Hard-currency sovereigns should continue to outperform local-currency assets, as investors remain cautious about the risk rally.
- Strong EM corporate performance is likely to continue, as commodity-based credits — which account for about 30% of the market — will likely be the largest beneficiaries of the QE rally. Despite record new issuance in September, technicals remain strong due to higher-than-usual inflows. As earnings season approaches, we expect strong performance from exporters, as weaker currencies are translating into profitability.

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