Fixed Income Perspectives

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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 September 30, 2010, ING Investment Management managed $360.5 billion in fixed income strategies globally.

Bond Market Outlook

Treasuries & Agencies: Additional fiscal stimulus pushed rates higher in December, though we still expect Treasuries to be range bound for the majority of 2011.

Mortgages: We remain bullish on CMBS and RMBS, while agency mortgage valuations appear moderately attractive.

Corporates: Finished the year strong supported by good fundamentals; we expect more of the same in 2011.

High Yield: Sustained economic recovery and low default rates are supportive.

Emerging Markets: Strong fundamentals and relatively attractive valuations outweigh inflation concerns. We remain overweight.

Macro Overview

- Euro zone issues continued to make headlines in December, as Ireland sought a bailout from the European Union and International Monetary Fund. All eyes are now on Portugal, as investors worry about its delicate growth prospects, dependency on external funding and prominent fiscal deficits. While the country claims it will be able to resolve its financing problems, Portugal's troubles are another sign of the continued sovereign debt issues and potential for contagion in the euro zone.
- Inflation in emerging economies is an area of concern in 2011. Prices of commodities and food have skyrocketed over the past year, increasing the likelihood that certain countries will have to hike interest rates to help stem inflationary pressures. Investors likely will be more cautious in emerging markets in 2011.
- The "currency wars"were a highlight of 2010 and continue to be a topic of discussion. As the Fed continues to pump money into the U.S. economy, many of these dollars are flooding into emerging nations and threatening to push local currencies to overvalued levels, hurting exports. In response, Taiwan and Thailand recently imposed capital controls on foreign investments in their bond markets, and Brazil tripled its tax on international financial capital.
- The U.S. economy continues to inspire optimism for 2011. Improvement in manufacturing numbers, retail sales and stock prices are all positive indicators. Job creation in December was up from the prior month, though the 103,000 new jobs lagged the consensus expectation and is well below the level needed to bring sustained recovery into the labor markets. Though the positive economic indicators are hopeful, we remain cautious of a slow recovery given the persistently high unemployment rate.
- A two-year extension of the tax cuts originally put in place by George W. Bush was yet another effort by the federal government to bolster the subdued economic recovery. The total package of $858 billion also includes 99 weeks of continued jobless benefits and a two-point reduction in Social Security payroll tax. This new federal support, coupled with better than expected economic data, fueled the December sell-off in interest rates, with the yield on ten-year Treasuries backing up from 2.8% to 3.3% over the month.

Bond Spreads and Returns

Index	Percentage of Index	Spread (bps)	Returns (%)	
			December 2010	YTD
U.S. Investment Grade				
Barclays Aggregate	100.0	56	(1.1)	6.5
Treasury	33.1	0	(1.8)	5.9
Gov't Related	12.1	54	(1.0)	5.0
Corporate	19.0	156	(0.9)	9.0
Fixed-Rate MBS	31.8	41	(0.6)	5.5
ABS	0.3	82	(1.0)	5.9
CMBS	2.5	234	0	18.5
Hybrid ARM	1.1	55	(0.1)	2.5
Other				
High Yield		526	1.8	15.1
Global Aggregate		66	1.3	5.5
Emerging Markets		291	(0.5)	12.8

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.

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

Sector Overviews

Treasury and Agency Debt

- The Fed has made it evident that the quantitative easing program will continue for the next several months. In agencies, the long end of the curve remains illiquid and rarely traded, while spreads in the short end are not appealing relative to other asset classes. We continue to have an unenthusiastic view for the asset class; however, callables look relatively attractive as an alternative to Treasuries given the volatility in the interest rate environment.

Mortgages

- Agency mortgages soundly outperformed Treasuries in December despite an increase in implied and realized interest rate volatility. Valuations still appear cheap, especially at lower coupons, and very low net supply is expected in 2011.
- Tactically, the sharp and sustained rally late in 2010 leaves us wary of a potential pullback, making our short-term outlook more neutral. Unlike past years, there are no early signs of a positive January effect, and it is unclear where the sector will find a strong natural buyer in 2011. The government is a net seller, foreign buyers appear to have stepped away, and it is unclear if bank demand can sustain a rally in agency mortgages.
- Non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) are both poised to benefit from extremely positive seasonals early in 2011. In the first quarter, $4–6 billion of CMBS new issuance is expected, a healthy signal. Within RMBS, new issuance is a near-term driver of investment returns, but the Dodd/Frank rulemaking efforts should make the ability of banks to hold downgraded RMBS less punitive from a capital standpoint.
- While CMBS fundamentals are improving, the residential market has seen four straight months of price declines, and the end of the various foreclosure moratoria suggest that distressed sales could make up a growing share of this market. Legal uncertainty stemming from foreclosure issues is still on the table as well. In this environment, we expect high-quality borrowers and structures to stand out against weaker bonds.

Investment Grade Corporates

- Fundamentals continue to be sound, even with a heightened level of shareholder-friendly activity (now near the long-term average). Balance sheet deterioration has not been an issue due to strong earnings. Cash on balance sheets is at record levels, and the improvement of the political environment bodes well for the sector.
- Technicals have weakened, with the trend of positive net inflows having reversed after the sharp interest rate sell-off late in 2010, but we expect inflows to return after interest rate volatility moderates. Deleveraging in the bank sector and the end of the Build America Bond program auger for low supply on the long end of the curve, providing a technical boost for existing long bonds. January and February are typically strong months for corporate credit, and we expect strong technicals to provide a tailwind this year as well.

High Yield

- We remain constructive on high yield, as strong fundamentals remain in place. High yield bonds posted strong performance in December despite the backup in U.S. Treasury rates; however, the rally has brought spreads much tighter and made valuations less attractive. While this makes us somewhat more cautious, a sustained economic recovery, strong credit fundamentals and a lack of catalysts for defaults in 2011 and 2012 support the sector.
- From a technical standpoint, the shutdown in the new-issue market near the end of the year created a lack of supply, increasing demand for securities in the secondary market and bolstering the rally. As new issuance returns, the bid for riskier credit assets such as over-leveraged LBOs could fade; as such, we are positioning portfolios in more st able high-quality credits.

Emerging Markets

- Strong fundamentals are still the story in emerging markets. Double-dip recession risks in the U.S. and Europe seemingly have diminished, commodity prices are supportive, and GDP/inflation projections for emerging market economies are promising. Technically, record inflows in 2010 will likely slow this year but remain positive. Financing needs are very modest, particularly in the sovereign space.
- Central banks are fighting currency appreciation; they should be able to slow, but not reverse, this trend. Considering 5-6% currency returns with local rate expectations, double-digit returns from local currency bonds are not completely unrealistic in 2011.