ING Global Perspectives July 2011

Market Update • August 5, 2011

Debt Fracas Obscures Earnings Fireworks and Fire-Sale Prices

Douglas Coté, CFA
Chief Market Strategist

Traditionally, fireworks are lit on the Fourth of July to commemorate America's hard-fought independence. This July, however, political pyrotechnics dominated the landscape as America struggled to stave off a looming default that would put its financial independence in jeopardy. Meanwhile, the private economy generated some fireworks of its own; with one-third of the S&P 500 having reported second quarter results, U.S. corporate profits have blasted off to their best start in four years.

Like the first half of 2011, July was far from a smooth ride. A rally in the first half of the month was followed by the markets' worst week since the depths of the credit crisis, as debt emergencies in both Europe and the U.S. commanded the world's attention. Despite the apparent resolution of these issues, equity markets continued to suffer through the first days of August, as nervous investors sought refuge in the safety of Treasuries, gold and currencies like the Swiss franc and Japanese yen.

Unlike the issues plaguing the euro zone periphery, the U.S. debt crisis was not the result of an inability to pay but rather a lack of leadership and decision-making from our politicians. It took not one, but two stern warnings from Standard & Poor's to awaken politicians to the fact that the AAA/A-1+ rating on U.S. debt was on negative credit watch and was likely to be downgraded should the gridlock persist. Moreover, it became clear that the debt crisis — and the future of our credit rating — was no longer just about raising the debt ceiling, it was about having a credible, sustainable plan that would put the U.S. on a path suitable for the home of the world's foremost reserve currency. At the eleventh hour, the politicians finally got the joke: Greek-like profligacy would incur Greek-like debt downgrades.

At the eleventh hour, the politicians finally got the joke: Greek-like profligacy would incur Greek-like debt downgrades.

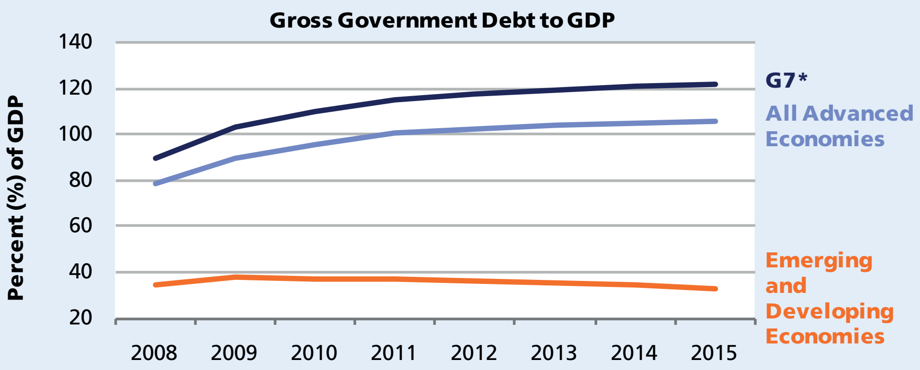
Indecision and delay by the government — and the warnings that came out of the rating agencies as a result — have had unintended consequences on the private economy, adding another major uncertainty to an already tenuous economic environment. Corporations are prudent and

Diversifying With Bonds and REITs Mitigates Risk from Equities

Index	Wgt	Jul-11	YTD	2010	2009	2008	2007	2006	1 year	3 years	5 years	10 years
Equity												
S&P 500	10%	(2.0)	3.9	15.1	26.5	(37.0)	5.5	15.8	19.7	2.9	2.4	2.6
S&P 400 Midcap	10%	(3.6)	4.0	24.9	35.0	(37.3)	6.7	9.0	24.1	5.5	4.9	6.3
S&P 600 Smallcap	10%	(3.3)	3.5	25.0	23.8	(32.0)	(1.2)	14.1	23.4	4.9	3.5	6.5
U.S. REITs	10%	1.4	9.9	23.5	21.0	(41.5)	(20.2)	30.2	19.7	(0.3)	(2.7)	7.8
EAFE	10%	(1.6)	3.7	8.2	32.5	(43.1)	11.6	26.9	17.7	(0.7)	1.4	6.1
Emerging Markets	10%	(1.8)	(1.9)	9.8	93.5	(59.3)	59.1	56.6	9.1	1.2	11.4	19.5
Average		(1.8)	3.8	17.7	38.7	(41.7)	10.2	25.4	18.9	2.3	3.5	8.2
Fixed Income												
Corporate	10%	2.5	5.8	9.0	18.7	(4.9)	4.6	4.3	6.9	9.7	7.3	6.3
U.S. Treasury 20+	10%	4.6	6.4	9.4	(21.4)	33.7	10.2	0.9	1.9	6.8	7.3	6.8
Global Aggregate	10%	2.1	6.5	5.5	6.9	4.8	9.5	6.6	9.1	6.7	7.3	7.4
High Yield	10%	1.2	6.2	15.1	58.2	(26.2)	1.9	11.8	13.0	13.6	9.3	9.0
Average		2.6	6.2	9.8	15.6	1.9	6.5	5.9	7.7	9.2	7.8	7.4
60/40 Portfolio		**(0.1)**	**4.8**	**14.5**	**29.5**	**(24.3)**	**8.8**	**17.6**	**14.5**	**5.0**	**5.3**	**7.8**

Source: FactSet

Emerging Market Debt Lower than that of Developed Markets



* G7 = France, Italy, Germany, Japan, U.K., U.S. and Canada

Source: IMF, CIA World Factbook

hedge for a range of outcomes, but a potential financial Armageddon had not been among them until the final week of the debate. The 2008 credit crisis was too fresh in mind for anyone to forget that a credit rating downgrade (or worse, default) could cause the banking system to freeze up. The consequences of system-wide cash hoarding and hedging — which have displaced long-term, job-creating investment and robust consumer spending — suddenly became abundantly clear.

The final trading day of July was truly dismal; as the debt crisis continued unresolved, the market was walloped by the latest gross domestic product (GDP) or real economic growth statistics. Not only was second quarter growth — at 1.3% — far below expectations, first quarter results were revised down to a disheartening 0.4% from a previously reported 1.9%. This brought the politicians to their knees and paved the way for a debt agreement that, after all the turmoil, looks as good as gold. Let's be clear: If the broader economy — and, with it, job growth — fails, Washington might get its best cleansing since the War of 1812, and even the politicians know it!

Fear sure sells, doesn't it? But we don't forecast fear, we forecast markets, and markets are driven by fundamentals. The most important fundamental driver happens to be impervious to politics: the bottom line is the bottom line. At the beginning of the year, we projected S&P 500 earnings to reach an all-time record level of $96.50 per share; two quarters later, this ebullient forecast looks far too low, even though we were among the most optimistic strategists at the time. We underestimated first quarter profits by a not insignificant 30%. Second quarter earnings growth, so far, has fully doubled our expectations! In conjunction with the recent decline in market levels, there is a veritable fire sale on shares of the most ambitious and globally oriented companies the world has ever seen. At today's rates, the forward price-to-earnings ratio on the S&P 500 is around 12, or an earnings yield of over 8%. Compare that to a 3% yield on ten-year U.S. Treasuries.

One reason U.S. corporations appear highly resistant to U.S. economic reports is that half their revenue comes from overseas — from developed, emerging and frontier markets alike. In terms of the latter group, the real and potential contributions to global economic growth and corporate profits of markets like Vietnam, Turkey and even the African continent are wholly misunderstood.

Corporate Earnings Strength Support Continued Strong Fundamentals

Sector	Reported			Earnings Growth			Earnings Surprise		
	Actual	/	Total	Percent	Positive	Negative	Percent	Positive	Negative
Energy	28	/	41	43.0%	25	2	1.3%	19	9
Materials	25	/	30	43.8%	21	4	1.5%	16	9
Industrials	48	/	60	17.3%	42	4	4.4%	39	9
Consumer Discretionary	34	/	79	3.2%	26	8	8.0%	29	5
Consumer Staples	19	/	41	9.1%	16	3	2.6%	16	2
Health Care	39	/	52	7.2%	35	4	4.9%	32	7
Financials	64	/	82	4.9%	45	16	8.7%	50	14
Information Technology	46	/	75	32.6%	32	12	13.5%	39	6
Telecommunication	3	/	8	(3.6%)	0	3	(8.5%)	2	1
Utilities	10	/	33	6.4%	7	2	6.5%	7	3
S&P 500	316	/	500	18.6%	249	58	5.8%	249	65

Note: Earnings Growth is the percentage change in the cumulative share weighted EPS Earnings from that of a year ago. Surprise Percent is the share weighted average of the ratio of actual company earnings vs. the consensus estimate.

Source: Bloomberg, Standard and Poor's, FactSet

Consider Africa:

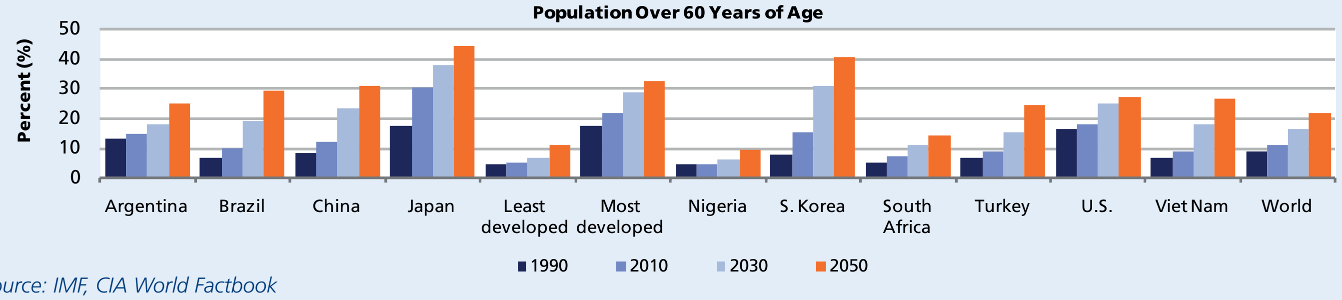
- A vast and diverse continent with 54 countries and 24 distinct capital markets, Africa's wealth of natural resources includes oil reserves, gold reserves and other strategic metals.
- In addition to resources, Africa's demographics are highly favorable to rapid growth, with an average age of 21 (compared to 45 for developed economies) and expected population growth that dwarfs that of developed economies.

We expect Africa to be underestimated. But it's sad that July's political histrionics have obscured America's continued dominant position in the world economy:

- The U.S. economy is larger than that of the entire 17-nation euro zone.
- The U.S. economy is larger than that of the next three largest economies in the world — China, Japan and Germany — combined.
- The U.S. military is the beneficiary of an advantageous geographical position, with access to both Atlantic and Pacific trade routes.
- U.S free trade, capitalism, rule of law and entrepreneurial capacity are the envy of the world.
- The U.S is a $15 trillion economy; even a slight increase in the trajectory of its growth would fuel explosive global expansion.
- The depth and breadth of U.S. natural resources are without peer.

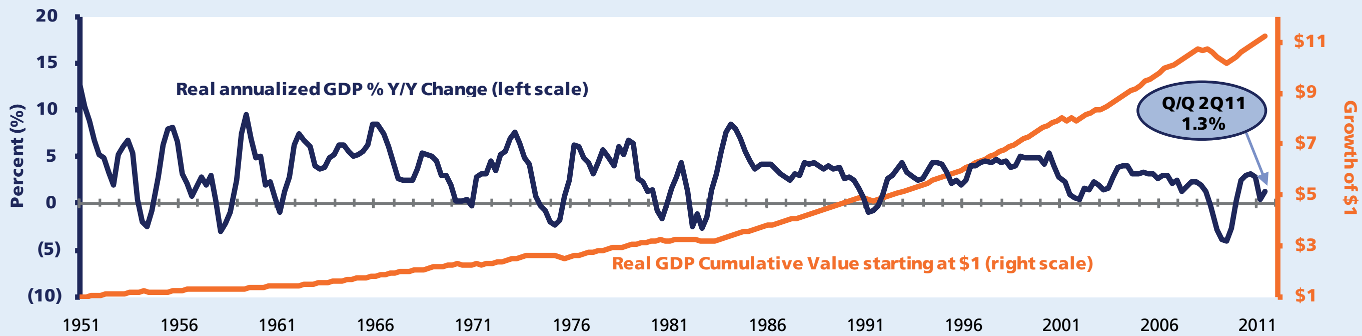
The United States of America is the most powerful nation on earth. Fireworks — especially during July — should be about celebrating our continued independence, the entrepreneurial capacity of our citizens and the increasingly global perspective of our businesses. ■

Frontier Markets — and African Countries in Particular — Hold Promise Due to Young Workforce



Source: IMF, CIA World Factbook

Despite Sluggish Growth of Late, the U.S. Remains the World's Dominant Economy



Source: Bloomberg

ING INVESTMENT MANAGEMENT