

Market Update • August 3, 2012

Market Continues to Climb the Wall of Worry with Fireworks in July



Douglas Coté, CFA
Chief Market Strategist

There has been plenty to worry about, and investors have voted with their feet, continuing to exit the market en masse to avoid the Armageddon scenarios bandied about by the media. There is only one problem: The equity market is having its best year since 2003 and its second best since 1998. Even more astounding is that fixed income is also having one of its best years ever. It has been almost impossible to avoid making money in 2012, but have investors noticed?

In an unscientific sampling we asked advisors, media mavens and institutional investors how many of ten broadly globally diversified asset classes in equity and fixed income were negative through June 2012. The answers ranged from three to seven,

and why not, since it feels like another horrific year for investing. But they would be wrong indeed, since all ten asset classes were positive through June — and July as well — a certifiable bull market.

Investors are right — it does “feel” bad — but feelings are not facts, and the facts have been telling a very different story. One reason, paraphrasing Mark Twain, is that there are lies, damned lies and government statistics. Growth in gross domestic product (GDP), the official government statistic on U.S. economic activity, for example, was just plain wrong in the fourth quarter of 2011. The U.S. Bureau of Economic Analysis this month published an enormous positive revision for the fourth quarter from 3% to 4.1%, a mere \$165 billion in missed economic activity. Businesses and consumers have been delivering the goods — certainly assisted by very accommodative Federal Reserve policy — apparently well in excess of the levels recognized by the government bean counters.

Executive Summary

- Risky assets are having their Olympic moment, winning ten out of ten thus far in 2012.
- Fact versus fiction: It “feels” worse than it is, as markets climb the wall of worry.
- Fundamentals have been mixed of late, but U.S. corporations have continued their remarkable run and global risks have mostly eased.

Returns for a globally diversified strategy over the last 10 years refute the notion of a “lost decade”

Index	Wgt	Jul-12	YTD	2011	2010	2009	2008	2007	1 Year	3 Years	5 Years	10 Years
Equity												
S&P 500	10%	1.4	11.0	2.1	15.1	26.5	(37.0)	5.5	9.1	14.1	1.1	6.3
S&P MidCap 400	10%	(0.0)	7.9	(1.7)	26.6	37.4	(36.2)	8.0	1.2	16.1	3.4	9.3
S&P SmallCap 600	10%	(0.8)	7.1	1.0	26.3	25.6	(31.1)	(0.3)	4.0	15.6	2.7	9.5
Global REITs	10%	6.6	25.6	(5.1)	28.4	36.9	(46.2)	(14.0)	21.2	21.3	0.8	8.0
EAFE	10%	1.1	4.6	(11.7)	8.2	32.5	(43.1)	11.6	(11.0)	3.8	(5.1)	6.8
Emerging Markets	10%	1.4	2.0	(22.7)	9.8	93.5	(59.3)	59.1	(19.6)	1.1	(2.7)	19.5
Average		1.6	9.7	(6.3)	19.1	42.0	(42.2)	11.6	0.8	12.0	0.0	9.9
Fixed Income												
Corporate	10%	2.9	7.7	8.1	9.0	18.7	(4.9)	4.6	10.1	10.1	8.2	6.9
U.S. Treasury 20+	10%	3.8	8.2	33.8	9.4	(21.4)	33.7	10.2	36.2	15.4	12.6	9.3
Global Aggregate	10%	1.2	2.7	5.6	5.5	6.9	4.8	9.5	1.8	5.7	6.5	6.5
High Yield	10%	1.9	9.3	5.0	15.1	58.2	(26.2)	1.9	8.1	14.7	9.6	10.9
Average		2.4	7.0	13.2	9.8	15.6	1.9	6.5	14.0	11.5	9.2	8.4
60/40 Portfolio		1.9	8.6	1.5	15.3	31.5	(24.6)	9.6	6.1	11.8	3.7	9.3

Source: FactSet and FTSE NAREIT Index

No “Lost Decade”

Fundamentals and Global Risks

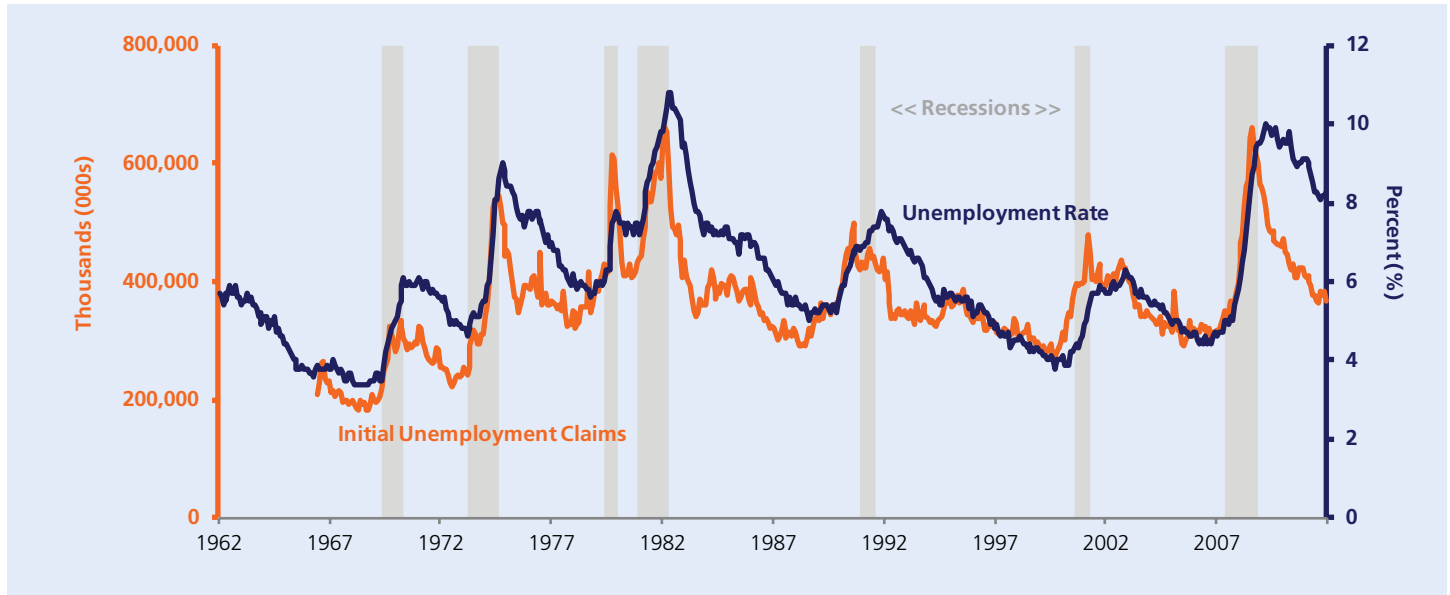
But recent data have been cause for concern with a marked slowdown evident. Let's analyze it. There are two drivers of market prices. The primary driver is the fundamentals, also known as the private economy and the essence of our capitalist system, while global risks are a big bucket but clearly secondary. In the short term, though, global risks can disrupt normal pricing, creating

extraordinary volatility. Granted, over the past couple months we have seen a marked slowdown in two of our fundamental drivers: manufacturing and unemployment.

We've witnessed two consecutive negative months in manufacturing activity, indicating contraction not seen since January 2009. Manufacturing is our second most important pillar of fundamentals. Nonfarm payrolls also saw a marked deceleration, from 225,000 per

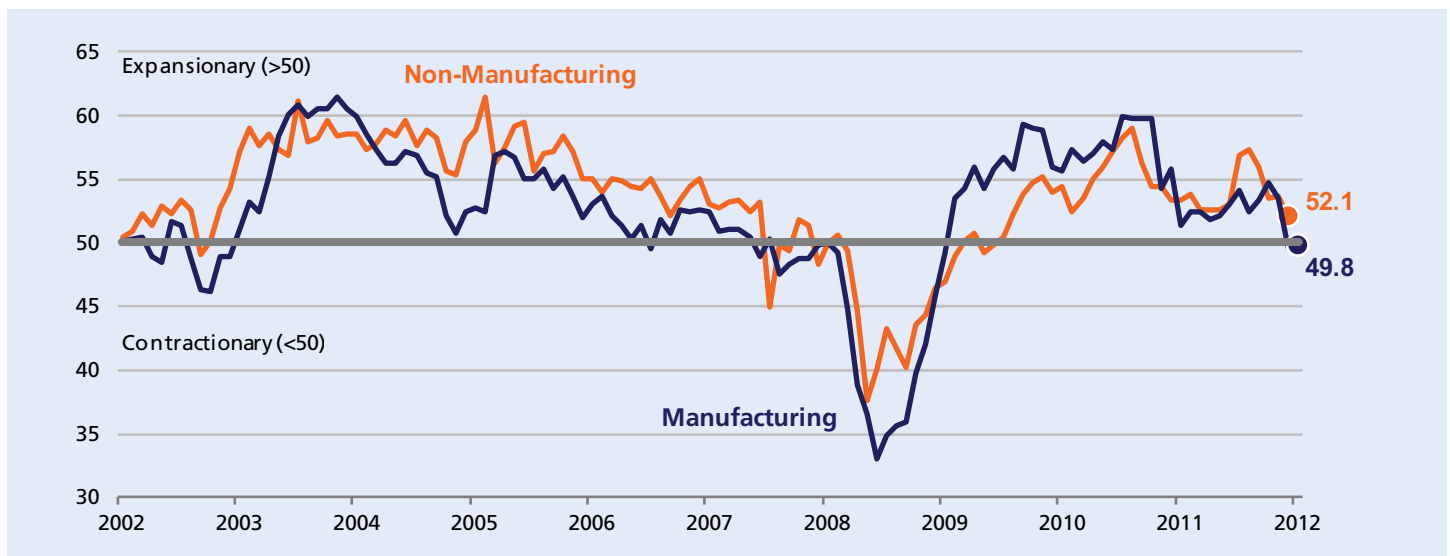
month for the three months ended in March down to 73,000 for the three months ended in June; payrolls did surprise on the upside in July, however, with 163,000 jobs added. The consumer is 70% of the economy, and, to support growth in consumer spending, it is essential for the unemployment rate to continue its downward trend. Nevertheless, the all-powerful U.S. corporate earnings have continued their remarkable run, so we are still constructive on the markets.

High unemployment may reluctantly recover as growth resumes; recent reports and news of job growth and payrolls have been a mixed disappointment



Source: Bureau of Labor Statistics, FactSet

U.S. factory activity slipped into contraction territory due to economic uncertainties in the euro zone and China



Source: Institute of Supply Management, Federal Reserve, FactSet

We think uncertainty about global risks and government policy is at the root of the slowdown. Here are some areas we are watching closely and are most concerned about.

- The U.S. fiscal cliff, a capitulation by Congress to allow automatic spending cuts and draconian tax increases, will hurt the private economy and severely damage the after-tax return to investors for dividends and capital gains alike.
- Interest rates on Italian and Spanish debt have reached levels that are unsustainable — above 7% on ten-year issues. It is confounding that a peripheral country like Italy is the fourth-largest debtor nation in the world. Policies intended to spark economic growth and debt reduction will fail in the absence of serious structural reform in labor markets and sharply reduced taxes and spending. The ESM/EFSF bailout funds will be woefully inadequate if both countries continue to drift toward the abyss.
- China seems to be heading for a hard landing as its most important export markets, the U.S. and Europe, either slow or head into recession.

Global Risks: Europe Is Bad but not Beyond Repair

While Europe is making progress with a Chinese water torture approach, we think even more bold and aggressive action needs to be taken. Europe is not beyond repair. Here are our observations:

- The euro currency and euro zone will survive because the world needs it.
 - The euro zone crisis had its roots in the euro launch in January 1999 and not the 2008 credit crisis.
 - A viable solution requires the monetary union to be bolstered by a fiscal union, a banking union and political integration.
 - These discrepancies are being addressed by the troika (European Commission, European Central Bank and International Monetary Fund) along with the full support of the U.S. Federal Reserve.
- Though more needs to be done, impressive actions already have been taken. For example:
- U.S. Federal Reserve floods major central banks with dollars in September and again in November 2011.
 - The euro zone bolstered its EFSF and ESM bailout funds in 2011.
 - Initiation of two robust lending facilities surprised the markets: LTRO I in late December 2011 and LTRO II in early 2012.
 - The euro zone summit in June made enormous progress toward a fiscal and banking union — the genesis of a solution to the current dilemma.

Notwithstanding low interest rates, year-to-date 2012 bond flows have been very strong, while net outflows from domestic equity funds show that investors remain spooked by market volatility

<i>millions USD</i>	2012	2011	2010	2009	2008	2007
Asset Class Flows						
Total Equity	(51,879)	(164,174)	(28,765)	(9,056)	(234,387)	90,816
Domestic	(81,920)	(168,746)	(87,739)	(39,666)	(151,749)	(47,791)
Foreign	30,040	4,572	58,975	30,613	(82,635)	138,609
Hybrid	34,349	44,969	23,522	22,764	(18,414)	24,162
Total Bond	198,095	174,747	246,000	376,137	27,593	108,768
Taxable	163,322	177,903	234,817	307,052	19,773	97,895
Municipal	34,773	(3,159)	11,183	69,086	7,820	10,874
Total	180,566	55,541	240,756	389,847	(225,209)	223,749
AUM						
Money Market	2,554,967	2,694,825	2,814,001	3,302,793	3,840,054	3,122,000
Change YTD	(139,858)	(119,176)	(488,792)	(537,261)	718,054	

Source: Investment Company Institute

The mistake investors have made with regard to Europe is to analyze each decision independently instead of seeing the broader trend and the impact that word and deed were having on resolving the crisis. Investors' mispricing of the euro crisis has led to what we have mentioned before for investors: the "risk gap" — an inordinate fear of any risky asset class, which has left \$7.5 trillion on the sidelines during (arguably) a raging bull market.

Fundamentals Press on Despite Global Risks Advancing

Corporate Profits

Expectations for second quarter profits were ratcheted down significantly, but with more than half the S&P 500 companies reporting, earnings growth has once again confounded Wall Street — for the 12th-consecutive quarter — currently at 6.4% over the second quarter of 2011.

Broadening Manufacturing

The most recent report showed the ISM manufacturing index up slightly, but it was the second-consecutive sub-50 reading after 34 consecutive months of expansion. Indeed, the current 49.8% level of the ISM is historically consistent with U.S. GDP growth of only around 1%.

Consumer as Game Changer

The consumer is gaining strength. Personal income rose this month; even though consumer spending was flat and retail sales retreated slightly, the savings rate rose to 4.4%. Housing, however, has been a bright spot on the economic landscape, with the second-straight month of housing price increases according to the S&P/Case-Shiller Index.

Developing Economies

The developing economies are not immune to the woes of the euro crisis. But consider this — in 2001, less than half of global economic growth was attributable to "developing countries," including BRIC powerhouses like China, but today they account for nearly 80% of global growth.

We're in a Bull Market, but Risks Remain

The private economy around the world has been relentless in its march forward despite the global risks, but risks are like cockroaches, and more seem to appear every day. The markets recently have been doubly bolstered by a marked reduction in these global risks and continued strength in the fundamentals. As 2012 enters the dog days of summer, we know that investors must be vigilant, and policy makers must remember that the private economy's resilience has its limits.

Policy makers in Europe and the U.S. likely will act — whether voluntarily or forced by market events — to restore growth and rein in debt. Meanwhile, investors who have not capitulated are being handsomely rewarded by accepting the interim volatility, which is the price of building wealth. ■

This commentary has been prepared by ING Investment Management for informational purposes. Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults (5) changes in laws and regulations and (6) changes in the policies of governments and/or regulatory authorities.

The opinions, views and information expressed in this commentary regarding holdings are subject to change without notice. The information provided regarding holdings is not a recommendation to buy or sell any security. Fund holdings are fluid and are subject to daily change based on market conditions and other factors.

Past performance is no guarantee of future results.

©2012 ING Investments Distributor, LLC • 230 Park Avenue, New York, NY 10169



INGINVESTMENT.COM