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Perennial May Euro Crisis Hits U.S. and Global Markets

Douglas Coté, CFA
Chief Market Strategist

For the third straight year a euro crisis hit markets in the month of May. This time it started with European elections and a relatively smooth change of leadership in France from Sarkozy to Hollande. But the Greek elections, held on the same day, were anything but smooth and descended toward anarchy, culminating in threats of a Greek exit from the euro or forcible expulsion at the hands of other euro zone members — a veritable Rubik's cube dilemma. Concurrently, Spanish banking woes were compounded by a flurry of weak economic data from the U.S. and abroad. Friday, June 1 witnessed a pummeling of United States markets into a technical correction, and global bourses were hit even harder. As uncertainty and doubt overshadow fundamentals, investors are fearful and look to their advisors for a plan of action and an explanation of the most likely outcome.

An Investment Strategy Plan

Since many investors are intent on selling now, it makes sense to evaluate the merits of a plan that distinguishes a true sell signal from a false one. A true sell protects investors from further losses, while a false sell is a lack of discipline in the face of a temporary market drop, a potentially costly response. We believe a plan should be defensive against bear markets but not overreact to normal volatility. Defense is necessary because investors fear losses twice as much as they appreciate gains — an observation attributed to behavioral theorists Kahneman and Tversky in a paper titled "Prospect Theory: An Analysis of Decision under Risk." If investors are twice as anxious about losses, then it certainly makes sense to be on guard. No matter how fervent the commitment to an objective set of signals, it takes a strong discipline to persevere in times of duress because the temptation to lose heart is

Executive Summary

- **For the third straight year, a Euro-crisis hit markets in May**
- **Investors are fearful and looking for a plan of action**
- **A good plan should defend against bear markets but not overreact to normal volatility**
- **Earnings growth remains positive — the U.S. is slowly but surely moving forward**
- **Ample rewards await those who stay focused on long-term goals**

Fixed income effectively protected a globally diversified portfolio from volatility so far in 2012

Index	Wgt	May-12	YTD	2011	2010	2009	2008	2007	1 Year	3 Years	5 Years	10 Years
Equity												
S&P 500	10%	(6.0)	5.2	2.1	15.1	26.5	(37.0)	5.5	(0.4)	14.9	(0.9)	4.1
S&P MidCap 400	10%	(6.5)	5.9	(1.7)	26.6	37.4	(36.2)	8.0	(6.1)	18.9	1.7	7.2
S&P SmallCap 600	10%	(6.3)	3.6	1.0	26.3	25.6	(31.1)	(0.3)	(4.4)	18.7	0.7	6.9
Global REITs	10%	(3.9)	9.0	7.3	27.6	27.8	(37.8)	(17.8)	3.3	27.6	(1.0)	10.2
EAFE	10%	(11.4)	(3.4)	(11.7)	8.2	32.5	(43.1)	11.6	(20.1)	3.9	(6.9)	4.5
Emerging Markets	10%	(13.1)	(2.8)	(22.7)	9.8	93.5	(59.3)	59.1	(25.6)	1.8	(1.1)	16.0
Average		(7.9)	2.9	(4.3)	18.9	40.5	(40.8)	11.0	(8.9)	14.3	(1.2)	8.2
Fixed Income												
Corporate	10%	0.8	4.3	8.1	9.0	18.7	(4.9)	4.6	8.4	11.4	7.5	6.6
U.S. Treasury 20+	10%	8.5	5.9	33.8	9.4	(21.4)	33.7	10.2	36.1	15.0	12.6	9.6
Global Aggregate	10%	(1.0)	1.0	5.6	5.5	6.9	4.8	9.5	2.3	6.0	6.5	6.8
High Yield	10%	(1.3)	5.0	5.0	15.1	58.2	(26.2)	1.9	4.0	16.6	7.6	9.1
Average		1.7	4.1	13.2	9.8	15.6	1.9	6.5	12.7	12.3	8.5	8.0
60/40 Porfolio		**(4.0)**	**3.4**	**2.7**	**15.3**	**30.6**	**(23.7)**	**9.2**	**(0.2)**	**13.5**	**2.7**	**8.1**

Source: FactSet

compelling. Once implemented, the same signal or set of signals should govern the timing of an exit from the defensive posture.

One effective signal is corporate earnings growth for the S&P 500 (as a proxy for the markets). Corporate earnings are the canary in the coal mine, and since about half the sales of the U.S. market are from overseas, U.S. corporate earnings also serve as a global warning sign. CEOs are paid to grow earnings, and although not all succeed, the market as a whole usually does. If the market can't get it done, then something is seriously wrong, and it is time to take decisive defensive action, recognizing that bad markets, once firmly in place, may ripen into a trend.

Today, corporate earnings growth is clearly and unequivocally positive, despite the ugly markets we find ourselves in. First quarter earnings growth is up six percent (year-over-year), meager certainly, but three times the consensus view of analysts at the beginning of the quarter. In our view, this is not a time to capitulate; rather, it is a time to be disciplined, to be a committed investor, to ride this temporary volatility with an effectively diversified global portfolio.

The accompanying charts show that earnings growth remains very impressive. In fact, the market's earnings level hit an all-time record high in 2011 and is fully on track to surpass it in 2012. Since 1999 the market's price return is negative, but earnings have grown 250% — from $39 to $97 in 2011 — and are on track to reach $105 by the end of 2012. This is compelling fundamental value for the market and an extraordinarily strong platform from which to withstand a temporary market downturn — such as the one we are experiencing today.

The Global Risk Meltdown 2012

The global markets were off to the races through the first quarter, the best since 1998, and then it started to unravel.

- Spain tried to recapitalize its own banks and was summarily rejected by the European Central Bank (ECB). They need help from the European bailout fund, the Europe Stability Mechanism (ESM), but bank recapitalizations are not allowed.
- The result of Greece's election bordered on anarchy. The hard fought agreements to put a firewall around the country's extraordinary debts are now in serious jeopardy, adversely impacting European banks directly, but implications for banks around the world are also perilous.
- The BRIC countries are struggling for growth, and China in particular looks vulnerable to a hard landing.
- The U.S., still the economic bright spot and world leader, hit a series of weaker than expected economic data, notably an anemic non-farm payrolls report.

This was enough for investors without a plan to run for the exits and ask questions later. But for disciplined investors, it bears repeating that history favors patience and fortitude.

Fundamentals Press On Despite Global Risks

- Advancing corporate profits. Profits for Q1 2012 increased 6% over Q1 2011. Top line revenues increased 5.2%.
- Broadening manufacturing. The U.S. ISM manufacturing index expanded for the 35th month, and non U.S. manufacturers agree. Manufacturing is buttressed by higher productivity, cheap natural gas, and reduced political risk and regulatory burdens.
- Consumer strength underestimated. While the rate of consumer spending has abated, consumers still increased their spending in April to a new all time monthly high.
- Developing economies are driving global growth. Not all is doom and gloom. Turkey, Greece's neighbor, has dazzled investors with 9% growth in 2010 and 8.5% in 2011.

The fundamental bottom line: the U.S. is slowly but surely moving forward. Perhaps the pace is not as fast as investors would like, but the U.S. is the best horse in this race.

European Resolution Scenario

A look at recent history suggests the most likely outcome for the present difficulties. The troika (ECB, EC, IMF) and the U.S. Federal Reserve showed determination and resolve by acting in concert to stave off the last crisis, and we doubt this situation will produce a different result. June will be a busy month,

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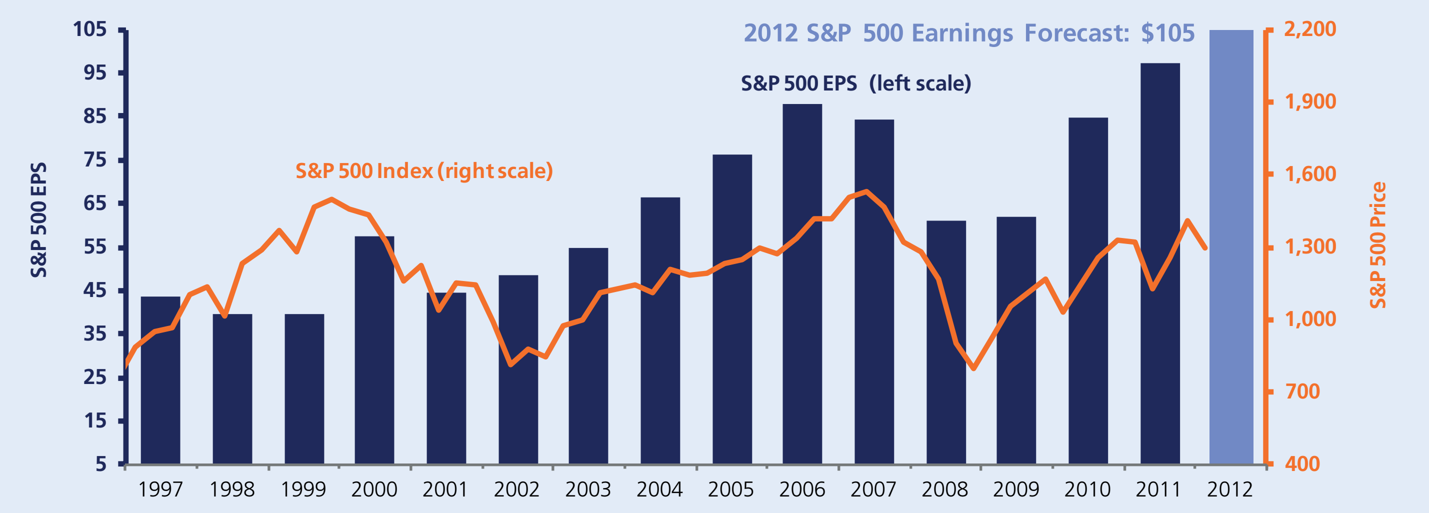
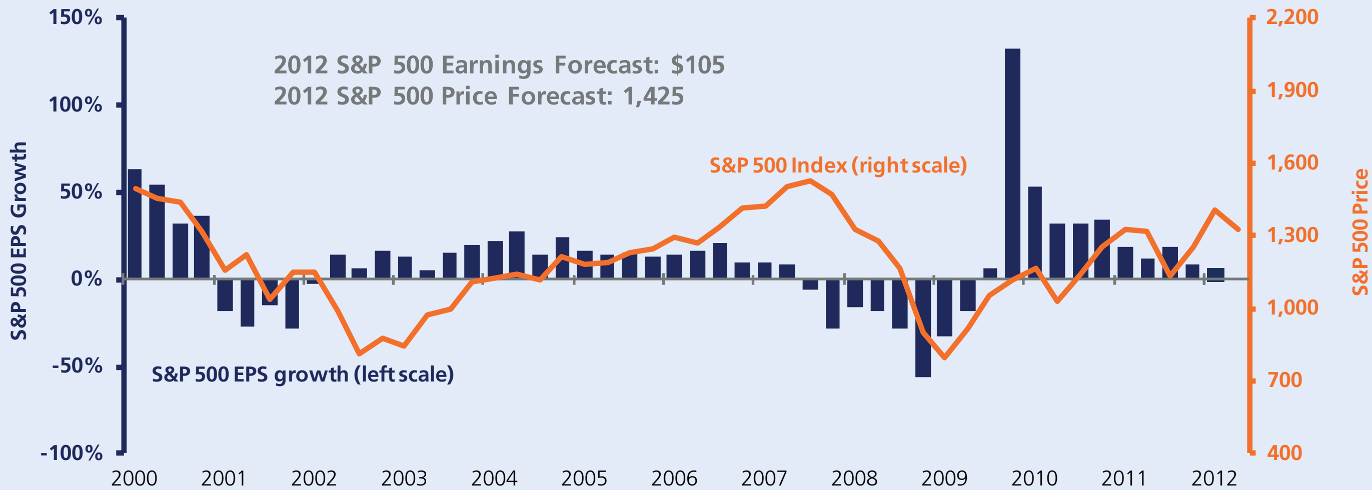


Source: FactSet

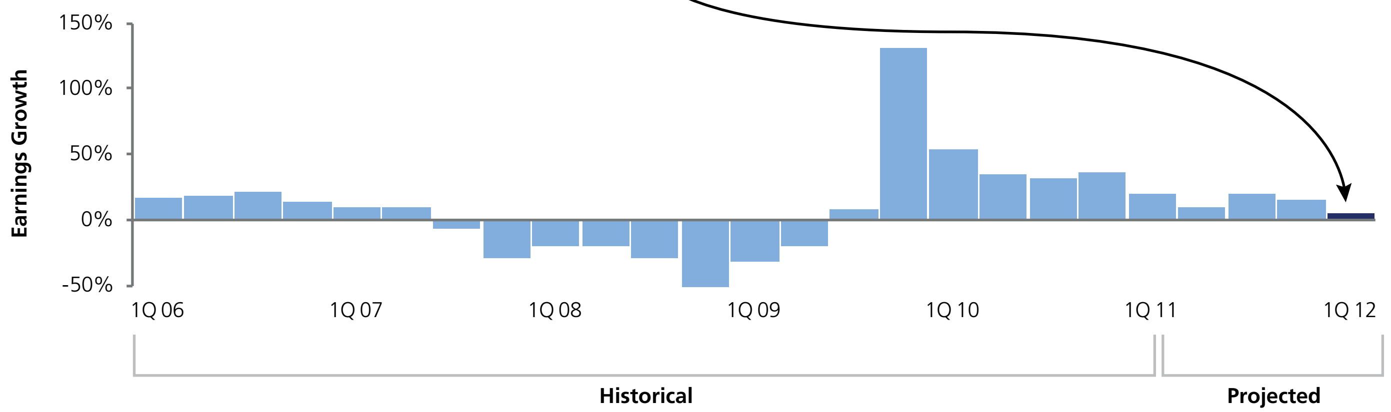
Advancing earnings drive markets up, and negative earnings drive markets down, albeit with a reporting lag.



Source: Standard & Poor's, First Call, FactSet, ING Investment Management

Earnings have advanced for the eleventh consecutive quarter which bodes well for market strength to resume.

Sector	Reported		Earnings Growth			Earnings Surprise		
	Actual	Total	Percent	Positive	Negative	Percent	Positive	Negative
Energy	43	42	-5%	22	19	-2%	24	19
Materials	30	31	-8%	14	14	7%	24	5
Industrials	60	61	14%	43	15	7%	45	14
Consumer Discretionary	79	80	4%	47	27	6%	59	12
Consumer Staples	39	42	3%	20	19	3%	29	5
Health Care	51	52	0%	33	18	3%	35	10
Financials	81	80	19%	54	23	9%	52	22
Information Technology	71	71	12%	35	35	9%	50	11
Telecommunication	8	8	3%	4	2	15%	4	4
Utilities	32	33	-7%	10	21	-1%	15	15
S&P 500	494	500	6%	282	194	5%	337	117



Source: Bloomberg, FactSet, Standard & Poor's offering clarity to the most serious impending risk and a possible positive outcome for Europe, as well as other important background events.

- Irish voters approved the European Union (EU) fiscal compact and euro zone austerity rules as reported on June 1.
- Greece's pro-bailout New Democracy party is ahead in the polls for the June 17 elections. A victory would resolve one of the biggest threats to the European Union.
- A European Union official declared that July 9 is the target date to kick off its permanent euro-area rescue fund, the 500 billion euro ($620 billion) European Stability Mechanism.
- Germany is not only the mainstay behind financial support for the euro — its growth rate, unemployment and business momentum kept Europe out of technical recession.
- The U.S. Federal Reserve flooded the four central banks with U.S. dollars in September and again in November to dramatic effect.

The market has experienced tremendous volatility over the past three years. Nevertheless, corporate earnings growth has been positive, suggesting a steadfast commitment to a globally diversified portfolio of risky assets. During this time investors could have earned double digit returns with less risk. Ample rewards still await disciplined investors who can look across this valley of temporary volatility and stay focused on long-term goals.