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As Europe Backs Away from the Abyss, Fundamentals Remain Firm

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September's headlines were ominous, ranging from near-certain Greek default to rumors of a bank run in Europe to credit downgrades of sovereign banks and major financial institutions on both sides of the pond. Given this backdrop, who could blame investors for capitulating?

And capitulate they did; despite a brief rally near month end, September ended on a weak note to lock in the Dow's worst quarterly return since 2009. While such selloffs can be painful in the short term, capitulation also provides disciplined investors with the opportunity to separate themselves from emotional investors by rebalancing out of high-priced fixed income holdings and into beaten-down equities — a classic buy-low/sell-high strategy that has historically been successful.

The global macro risks that have bedeviled markets for the past several months are inherently policy driven. Yes, debt levels across the developed world are unsustainable. But this has been known for three years; it has been the inability of policy makers to adequately address the debt issues in a timely manner that has been the bigger drag on market sentiment. Europeans are in a particular pickle when it comes to politics in that each decision made by the euro zone leadership must be vetted and approved by the governments of 17 independent countries. In the U.S. we have but one federal government to establish policy, and that has presented its own set of challenges.

> **Successful investing demands a choice between prudent risk control and outright risk avoidance.**

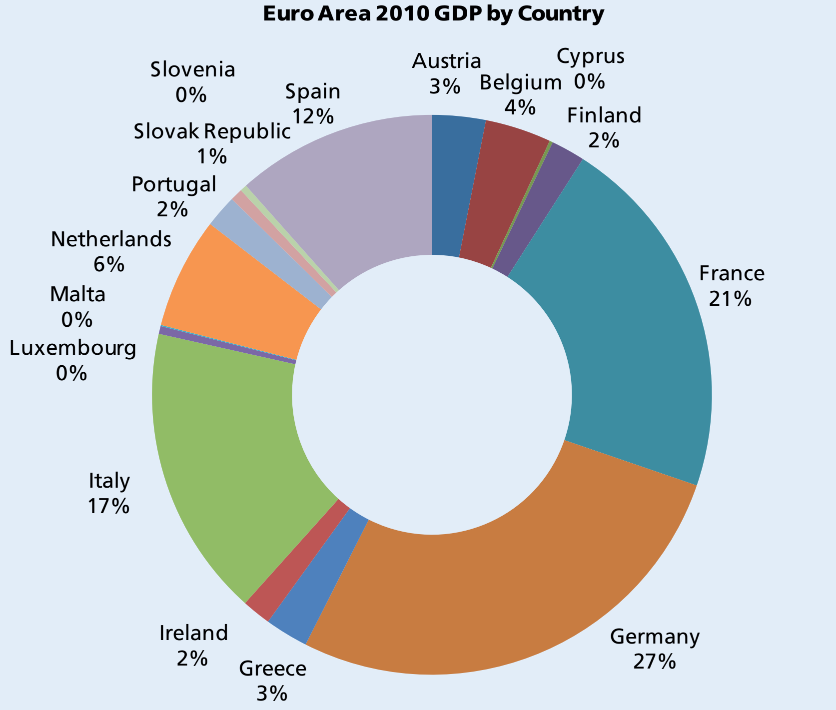
However, global risks are only one of the drivers of markets. The primary driver is bottom-up fundamentals — corporate profits, in particular. Earnings have been signaling smooth sailing as far as the eye can see, and top-line revenues are exhibiting massive strength as they benefit from demand around the world. Earnings are critical to the market landscape because they pick up early the signals of directional change in the markets, which tend to persist once they take hold. When fundamentals are trending positive, it is wise to ride out the volatility presented by global risks. And the best way to do that is through a broadly diversified

Strong U.S. Treasury Performance Has Partially Offset Challenging Equity Markets

Index	Wgt	Sep-11	YTD	2010	2009	2008	2007	2006	1 year	3 years	5 years	10 years
Equity												
S&P 500	10%	(7.0)	(8.7)	15.1	26.5	(37.0)	5.5	15.8	1.1	1.2	(1.2)	2.8
S&P MidCap 400	10%	(10.7)	(13.9)	24.9	35.0	(37.3)	6.7	9.0	(2.6)	2.4	0.7	6.1
S&P SmallCap 600	10%	(10.4)	(14.5)	25.0	23.8	(32.0)	(1.2)	14.1	(0.9)	(0.5)	(0.9)	6.3
U.S. REITs	10%	(11.3)	(8.2)	23.5	21.0	(41.5)	(20.2)	30.2	(2.4)	(6.5)	(7.1)	5.9
EAFE	10%	(9.5)	(14.6)	8.2	32.5	(43.1)	11.6	26.9	(8.9)	(0.7)	(3.0)	5.5
Emerging Markets	10%	(16.5)	(25.9)	9.8	93.5	(59.3)	59.1	56.6	(23.1)	3.2	4.8	18.9
Average		(10.9)	(14.3)	17.7	38.7	(41.7)	10.2	25.4	(6.1)	(0.1)	(1.1)	7.6
Fixed Income												
Corporate	10%	0.3	6.1	9.0	18.7	(4.9)	4.6	4.3	4.4	12.6	6.7	6.2
U.S. Treasury 20+	10%	12.4	31.4	9.4	(21.4)	33.7	10.2	0.9	19.2	12.9	10.8	8.8
Global Aggregate	10%	(2.3)	5.4	5.5	6.9	4.8	9.5	6.6	4.0	7.8	6.8	6.9
High Yield	10%	(3.3)	(1.4)	15.1	58.2	(26.2)	1.9	11.8	1.8	13.8	7.1	8.8
Average		1.8	10.4	9.8	15.6	1.9	6.5	5.9	7.3	11.8	7.9	7.7
60/40 Portfolio		**(5.8)**	**(4.4)**	**14.5**	**29.5**	**(24.3)**	**8.8**	**17.6**	**(0.7)**	**4.6**	**2.5**	**7.6**

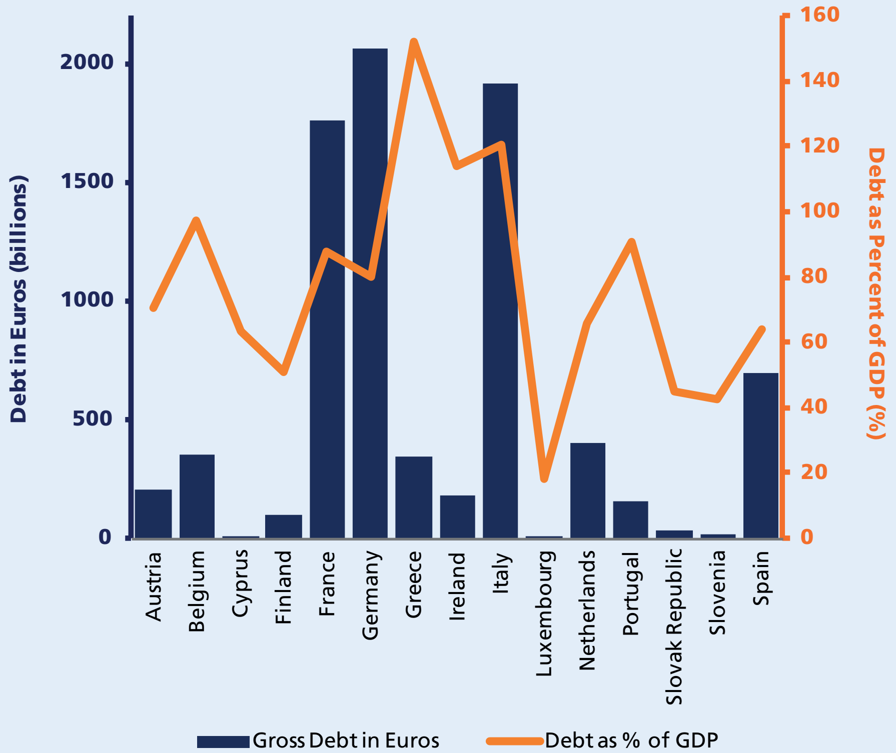
Source: MSCI, Standard & Poor's, FactSet

The Euro Zone's Economic Growth Is Tied Largely to the Success of Germany



Source: International Monetary Fund

Italy's High Debt Has Markets Worried



Source: International Monetary Fund

global portfolio composed of both equity and fixed income assets. Fixed income returns have been extraordinary in both August and September, smoothing out the equity market volatility for those appropriately positioned. Diversified portfolios, equipped to weather the storm, bring confidence to investors and tend to forestall capitulation at inopportune times.

And inopportune times were plentiful in September. For much of the month, Greece was scrambling to enact deeper fiscal spending cuts in an effort to obtain the next tranche of its financial aid. And there is still persistent, widespread fear that a Greek default would inspire contagion not only to other peripheral European nations but to banks across the continent.

Meanwhile, macroeconomic data released of late have been mostly weak, heightening concerns that we were on the precipice of a new global recession. A manufacturing index in Europe indicated a contraction in activity for the first time since July 2009, while several Italian lenders had their long-term ratings cut by Standard & Poor's. Even China has become a question mark, as its manufacturing index deteriorated to a two-month low.

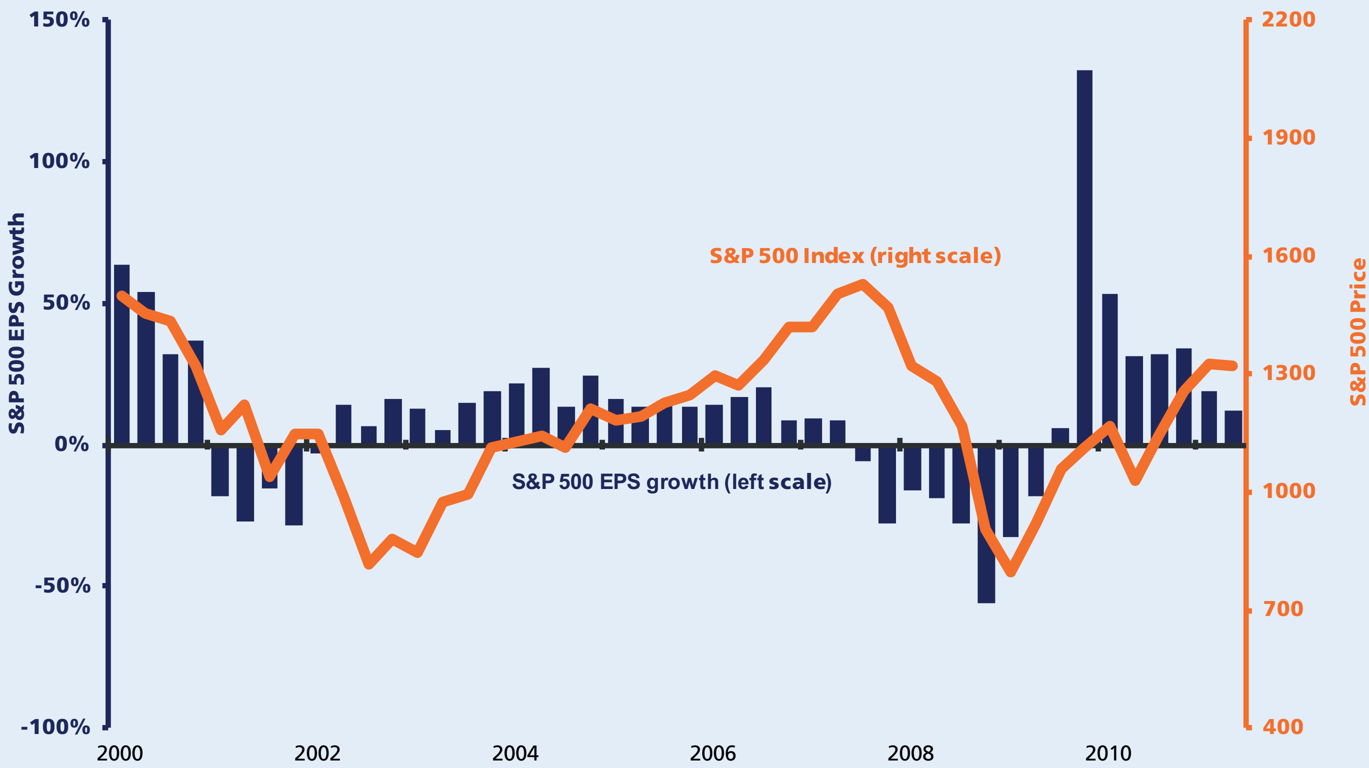
In our note published following S&P's downgrade of the U.S. credit rating ("Trimming the Sails After the Unprecedented U.S. Credit Downgrade"), we advocated decisive action, noting that the world — not just the U.S. — was in uncharted waters and the ramifications of a downgrade of the global reserve currency were unfathomable. We also opined that the European financial system was undercapitalized and in serious trouble. While all of this remains true, we have subsequently witnessed several powerful remedial actions by the Federal Reserve and by the "troika" of the International Monetary Fund, the European Central Bank and the European Union:

- The Fed committed to maintaining the federal funds rate at the record-low range of 0–25 basis points until at least mid-2013.
- The Fed has enabled liquidity in Europe by loaning much-needed dollars to the ECB and other central banks, which will in turn make these dollars available to financial institutions at low interest rates.
- European leaders continue to be publicly supportive of a united euro zone and have ratcheted up talks to bolster the European Financial Stability Facility and to capitalize a special purpose vehicle that would buy distressed European sovereign debt.

In light of these actions, we have renewed confidence in the U.S. dollar as the global reserve currency and in fundamentals continuing to endure in the face of great uncertainty. We now advocate a return to "full sail" and a normal, broadly diversified global portfolio.

Although the European, U.S. and developed world debt crises are far from over, they are moving toward containment as strong policy actions continue to materialize on both sides of the pond. We anticipated that politicians would need to gaze into the abyss before acting; ultimately they had no choice but begin to address the issues head-on. In the meantime, as we wait for policy to overcome paranoia, successful investing demands a choice between prudent risk control and outright risk avoidance. Attempting to escape all the risks is capitulation, a course that leaves much of the future rewards for others. ■

Fundamentals: Corporate Profits Remain Firm



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

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