ING Global Perspectives October 5, 2012

Market Update • October 5, 2012

Third Quarter Surge Caps 12-Month Relentless Risk Rally

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Remember a year ago? The U.S. debt rating was downgraded, meaning, the stability of the world's reserve currency, around $3 trillion of which trades per day, was called into question. What could be worse than that? How about the other pillar of the developed world, the European Union, imploding under the weight of the PIIGS — err, we mean, the sovereign debt crisis of the peripheral nations. In response, investors of all stripes perversely herded into U.S. Treasuries and out of any risky asset, especially equities. Did these events represent an unmitigated disaster for investors or an opportunity? After the Dow's worst quarter since 2009, price levels were clearly signaling Armageddon, to run for the exits, and investors obliged and capitulated. But the fundamentals, the primary driver of markets, ultimately were signaling an enormous buying opportunity, as they remained firm.

The investor who had the foresight to buy into a globally diversified portfolio with moderate risk could have accumulated a king's ransom over the following year. Equities were the sweet spot, but even fixed income — not that fake short-duration cash stuff, but real bonds — performed spectacularly. The S&P 500 surged over 30%, bonds were up 10%, volatility measured by the VIX plummeted 70%, and the aforementioned moderate risk portfolio was up 19%, an astounding number compared to the anemic, near-zero cash rates being offered over this time frame.

Given this raging bull market, investors no doubt stayed disciplined and committed to risky assets to realize these extraordinary returns, right? Gaming diversification — trying to outwit the markets by outrunning risk or outsmarting it on return — is folly. We pointed out the right approach a year ago, and it remains relevant today: "Successful investing demands a choice between

Executive Summary

- **Despite the rally of the past year, equity markets still look cheap.**
- **Weakening manufacturing data suggest the 12-quarter streak of positive earnings growth may come to an end in the third quarter.**
- **Housing has turned the corner, providing consumers with cause for confidence.**
- **Though fundamentals have wavered a bit, we are constructively bullish on risky assets, as "successful investing demands a choice between prudent risk control and outright risk avoidance".**

Returns for a globally diversified strategy over the last ten years refute the notion of a "lost decade".

Index	Wgt	Sept-12	QTD	YTD	2011	2010	2009	2008	2007	1 Year	3 Years	5 Years	10 Years
Equity													
S&P 500	10%	3.1	6.4	16.4	2.1	15.1	26.5	(37.0)	5.5	30.2	13.2	1.1	8.0
S&P MidCap 400	10%	2.5	5.4	13.8	(1.7)	26.6	37.4	(36.2)	8.0	28.5	14.3	3.8	10.8
S&P SmallCap 600	10%	2.7	5.4	13.8	1.0	26.3	25.6	(31.1)	(0.3)	33.4	15.1	3.3	10.7
Global REITs	10%	2.6	6.1	22.1	(8.1)	20.0	41.3	(48.9)	(4.7)	30.4	11.9	(2.5)	8.9
EAFE	10%	3.6	7.0	10.6	(11.7)	8.2	32.5	(43.1)	11.6	14.3	2.6	(4.8)	8.7
Emerging Markets	10%	6.4	7.0	7.7	(22.7)	9.8	93.5	(59.3)	59.1	12.4	0.3	(4.7)	21.0
Average		3.5	6.2	14.1	(6.9)	17.7	42.8	(42.6)	13.2	24.9	9.6	(0.6)	11.3
Fixed Income													
Corporate	10%	1.1	3.8	8.7	8.1	9.0	18.7	(4.9)	4.6	10.8	9.1	8.1	6.6
U.S. Treasury 20+	10%	(1.4)	0.1	4.3	33.8	9.4	(21.4)	33.7	10.2	6.3	12.2	11.3	7.9
Global Aggregate	10%	1.6	3.3	4.8	5.6	5.5	6.9	4.8	9.5	5.1	5.0	6.2	6.4
High Yield	10%	1.5	4.5	12.1	5.0	15.1	58.2	(26.2)	1.9	19.4	12.9	9.3	11.0
Average		0.7	2.9	7.5	13.2	9.8	15.6	1.9	6.5	10.4	9.8	8.7	8.0
60/40 Porfolio		**2.4**	**4.9**	**11.4**	**1.1**	**14.5**	**31.9**	**(24.8)**	**10.5**	**19.1**	**9.7**	**3.1**	**10.0**

Source: ING U.S. Investment Management/Global Perspectives, FactSet, FTSE NAREIT Index

No "Lost Decade"

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."

It was true then, in a widely mispriced market, and it remains so today even though mispricing has narrowed, with the VIX recently hitting a low of 13, a world of difference from the near-50 levels that weighed on markets last year. Markets continue to look cheap; the end-quarter S&P 500 P/E ratio of 13.7 remains well below the historical average of 15.5. With the P/E ratio — the price paid for earnings — now based on a forecast all-time record high of $105/share, opportunity abounds. In particular emerging markets, written off as too volatile, surged 6.4% in the month of September alone.

So what does an investor do from here? Can the markets deliver another 30% over the next year? For the typical investor, the risky-asset gap has been extraordinary; the benchmark should not be last year's return, it should be the risk of getting the near-zero return the Federal Reserve has all but guaranteed through 2015. By this riskless benchmark, there remains tremendous opportunity despite an almost certain rise in risk levels from here.

As we start the final quarter of what by any measure has been an extraordinary year, it is imperative to assess the current fundamentals, the global risks, the long-term trends we call tectonic shifts and the recent extraordinary global monetary stimulus.

Fundamentals Press on Amid Signs of Weakness

Advancing corporate earnings. Earnings are the most important coincident indicator to a bullish market. As the market rally progressed, corporate earnings grew 6.5% in second quarter 2012 over the year-ago quarter despite many dour Wall Street predictions of negative growth; this marked the 12th consecutive quarter of positive earnings growth. With third quarter earnings season, however, we face the risk that the S&P 500 will suffer the first negative year-over-year quarter since third quarter 2009. This is profoundly meaningful for our future outlook. U.S. corporate earnings have marched through extraordinary global risks to defy negative forecasts before, and they may do so again; however, to borrow a phrase from Apollo 13, "Houston, we have a problem." We will continue to monitor events very closely until all 500 companies have issued their reports.

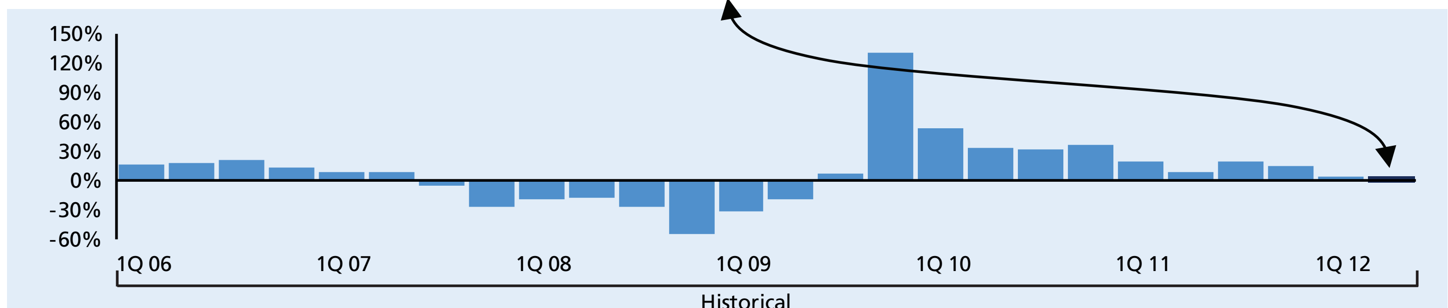
Broadening manufacturing. This premise began to break down through the summer, and global manufacturing indexes have also significantly weakened. The contraction over the last few months is a serious concern even though September's expansionary 51.5% ISM reading defied the trend. Perhaps the latest round of QE3 is enough to help manufacturing get back on track. But one month of good news is not a trend, and we see that China is already bumping along in a "hard landing" pattern and may further frustrate the potential for future manufacturing expansion here at home.

Consumer as a game changer. The consumer once again took retail sales levels to all-time highs — rising 0.9% for the month and topping $406 billion. However, consumers had to dig into their savings to accomplish this, and the savings rate dialed back from 4% to around 3.7%. We also see consumers gaining confidence as their most important asset — housing — improves across the board. We believe that housing has legitimately turned a corner and will provide vital support to consumer balance sheets and resilience.

Developing Economies. Philippines, Indonesia, Vietnam; the news is awash with stories about "new tigers," an unstoppable

Second quarter 2012 earnings reports are complete with positive earnings surprises for 60% of those reporting.

Sector	Reported			Earnings Growth			Earnings Surprise		
	Actual	/	Total	Percent	Positive	Negative	Percent	Positive	Negative
Financials	81	/	81	62%	38	35	10%	47	29
Industrials	61	/	61	12%	46	13	5%	45	11
Information Technology	70	/	70	6%	41	28	3%	48	12
Telecommunication Services	8	/	8	6%	6	1	3%	4	3
Utilities	33	/	2	5%	20	11	8%	19	10
Health Care	52	/	52	3%	36	16	5%	41	9
Consumer Staples	41	/	41	2%	26	13	2%	30	6
Consumer Discretionary	81	/	81	2%	45	32	8%	53	18
Materials	30	/	30	-15%	14	16	-2%	15	11
Energy	43	/	44	-19%	14	29	-3%	23	19
S&P 500	**500**	**/**	**500**	**7%**	**286**	**194**	**4%**	**325**	**128**



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 & Poor's, FactSet, ING U.S. Investment Management/Global Perspectives

wave of Asian countries queuing up to become the next generation of middle-class consumers. And so it should be. Southeast Asia is a vibrant region of young, educated populations, low debt-to-GDP ratios, stable banks and plenty of room to run, filling the gaps resulting from slowdowns in China, India, Brazil and Russia. The trajectory is not always a straight line, but the potential for growth is staggering.

Risks on the Horizon

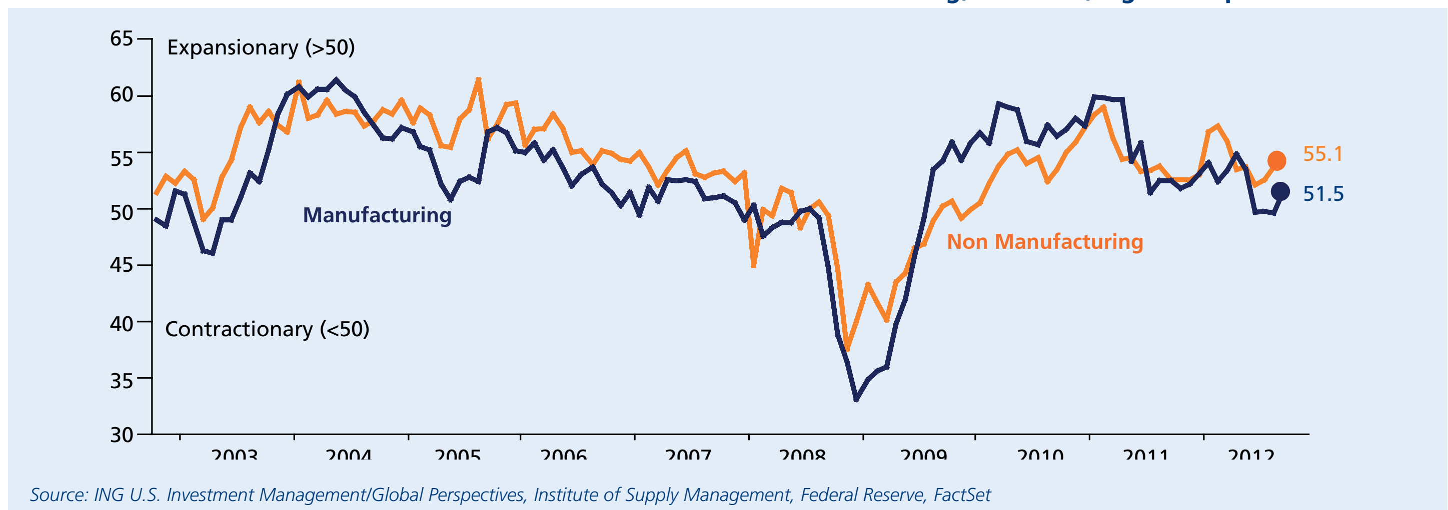
Here are several, but not all, impending risks that the market is trying to assess:

- U.S. elections: While the presidential election gets most of the attention, one-third of the Senate and all of the House of Representatives are up for grabs this November.
- Fiscal cliff: Draconian tax increases and spending cuts that, in the absence of other action, will automatically be implemented on January 1, 2013.
- European crisis: Attention will turn from debt containment to growth prospects as peripheral countries and perhaps certain core economies enter recession.
- China's hard landing: An adverse impact on global manufacturing already is evident.
- Iranian nuclear threat: There is a risk that Israel unilaterally launches a military strike against Iran.

These risks are all serious but there are many forces that can offset or counteract them.

One is September's coordinated global monetary stimulus most notably from the European Central Bank's OMT, to buy unlimited Spanish and Italian bonds, in particular, on the secondary market and the U.S. Federal Reserve's QE3 to purchase $40 billion per month of Agency mortgage-backed bonds in perpetuity subject to their discretion. The effect was an immediate gap up in global markets. The second is

U.S. factory activity slipped into contraction territory based on economic uncertainties in the euro zone and China and fears of the effects of the "fiscal cliff" here at home. The latest reading, however, signals expansion.



Source: ING U.S. Investment Management/Global Perspectives, Institute of Supply Management, Federal Reserve, FactSet

China's declining industrial and electricity production as well as stalled export growth raise fears about the likelihood of a "hard landing" from its enviable recent growth. China GDP growth is now reported to be 7.9%.

Source: ING U.S. Investment Management/Global Perspectives, FactSet

long-term drivers we call "tectonic shifts"; these explosive long-term trends have clearly impacted the "unpredictable" market rallies we have seen this year, adding fire to already hot fundamentals and a soothing chill to overheated global risks. These tectonic shifts can be found in four broad areas: global trade, technology, frontier markets and energy.

Together, they have helped support upside surprises in corporate earnings and manufacturing but cannot assure a positive impact on each data point.

The Good, the Bad and the Ugly

The good is the consumer. We argue that consumers are the game changer because they comprise about 70% of the economy. The Fed's latest round of quantitative easing, which sounded warning bells, may certainly support forward growth momentum but by how much is unknown. Manufacturing is a puzzle, and, notwithstanding September's surprise uptick, recent weakness puts third quarter year-over-year corporate earnings growth at risk of being negative. Yes, for the past 12 quarters, most analysts have underestimated earnings growth — but not us. We are long-term bulls, but we are not irrationally exuberant about the risk of a negative earnings print. It is not a certainty, and the severe mispricing that markets have exhibited over the past three years, while still evident, has substantially narrowed.

We are constructively bullish on risky assets at this time and as always prefer an economic backdrop of rising corporate earnings. We reiterate once again, "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."

Except for Japan, one year returns have been exceptional across the globe especially in the U.S. where a third quarter surge capped a 12-month relentless risk rally.

Index	Currency	Sept-12	YTD	2011	2010	2009	2008	2007	2006	2005	1 Year	3 Years	5 Years	10 Years
Global Markets														
International	USD	3.6	10.6	(11.7)	8.2	32.5	(43.1)	11.6	26.9	14.0	14.3	2.6	(4.8)	8.7
	local	1.6	9.6	(11.7)	5.3	25.4	(39.9)	4.0	16.9	29.5	14.1	1.7	(5.7)	5.4
Emerging Mkt	USD	6.4	12.3	(18.2)	19.2	79.0	(53.2)	39.8	32.6	34.5	17.3	6.0	(1.0)	17.4
	local	4.3	11.4	(12.5)	14.4	62.8	(45.7)	33.5	28.9	35.8	16.8	6.1	0.3	15.3
Regions														
Euro x-UK	USD	5.2	12.8	(14.5)	2.4	33.9	(45.0)	17.5	36.4	11.3	16.7	0.1	(6.1)	9.9
	local	2.5	13.1	(12.1)	5.1	29.0	(42.7)	6.6	22.5	28.6	20.5	2.5	(5.4)	6.5
UK	USD	2.6	10.7	(2.5)	8.8	43.4	(48.3)	8.4	30.7	7.4	20.8	7.9	(3.2)	8.5
	local	0.5	6.5	(1.8)	12.2	27.7	(28.5)	6.6	14.6	20.1	16.5	7.5	1.4	8.3
Pac x-Japan	USD	4.3	17.6	(12.7)	17.1	73.0	(50.0)	31.7	33.2	14.8	24.7	8.1	0.5	15.4
	local	3.4	15.5	(12.8)	6.1	45.8	(41.6)	21.6	25.9	20.3	18.1	3.5	(2.1)	9.9
Japan	USD	0.9	2.4	(14.2)	15.6	6.4	(29.1)	(4.1)	6.3	25.6	(1.5)	(0.4)	(6.4)	3.9
	local	(0.0)	3.6	(18.6)	0.7	9.3	(42.5)	(10.1)	7.3	44.7	(0.6)	(5.0)	(13.4)	(0.7)
S&P 500		3.1	16.4	2.1	15.1	26.5	(37.0)	5.5	15.8	4.9	30.2	13.2	1.1	8.0

Emerging market returns have surpassed by far the developed world equity markets over the past 10 years

Source: ING U.S. Investment Management/Global Perspectives, MSCI, Standard and Poor's, FactSet

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