ING Global Perspectives May 2011

Market Update • May 24, 2011

Much Ado About the Euro II

Douglas Coté, CFA
Chief Market Strategist

In May 2010, with markets in the grip of the euro crisis, a media rampage touted the virtual certainty of another global financial meltdown equal to, if not worse than, the debacle triggered by the collapse of Lehman Brothers. It seemed as though each and every article in the financial press felt compelled to refer to Greece or any of the other challenged peripheral European nations using the pejorative PIIGS. So it was not just contrarian, it was downright heretical when we pointed out in a May 24 article titled "Much Ado About the Euro" that not only were we in the midst of a "synchronized global expansion", but the bond market was pricing risk so astonishingly low (as reflected by the TED spread) that it appeared to be dismissing any notion that a crisis existed at all.

What a difference a year makes. Here in May 2011 there is little talk of the euro dissolving; in fact, the currency is strong once again, and GDP growth for the 17-member euro bloc surged last year and into the first quarter of 2011 at a rate better than the U.S., with a report of 3.3% annualized. Germany, in particular, has been growing at an incredible pace — 6.1% annualized — due in part to exports to emerging markets; its unemployment rate, meanwhile, is at the lowest level since reunification. Add France (growing at a still-respectable 3.9% annualized rate) and the other northern economies, and you have well over half of the euro bloc countries — a dominant force in the region. Meanwhile, the three countries accepting bailouts — Greece, Ireland and most recently Portugal — make up a mere 4.8% of total euro zone GDP (2009).

The markets have more than generously rewarded this economic growth. In fact, as you can see in the table below, the MSCI EAFE Index — which derives more than half of its weighting from Europe — has returned a remarkable 30.5% since May 24, 2010. The Barclays Global Aggregate bond index returned 10.5% over the same period. The U.S. was not far

Risk Amply Rewarded in the Year of the Euro Crisis

Index	Wgt	May 1-May 20	YTD thru May 20	2010	2009	2008	2007	2006	1 year 5/24/10-5/20/11	3 years	5 years	10 years
Equity												
S&P 500	10%	(2.1)	6.8	15.1	26.5	(37.0)	5.5	15.8	26.7	1.7	2.9	2.8
S&P MidCap 400	10%	(2.8)	8.8	24.9	35.0	(37.3)	6.7	9.0	33.0	6.6	4.8	7.1
S&P SmallCap 600	10%	(3.2)	6.6	25.0	23.8	(32.0)	(1.2)	14.1	28.5	6.5	3.0	7.6
U.S. REITs	10%	(2.2)	9.0	23.5	21.0	(41.5)	(20.2)	30.2	28.3	(3.0)	(1.6)	8.6
EAFE	10%	(4.7)	4.6	8.2	32.5	(43.1)	11.6	26.9	30.5	(2.4)	2.0	5.7
Emerging Markets	10%	(5.4)	(2.0)	9.8	93.5	(59.3)	59.1	56.6	22.1	(1.5)	11.0	19.2
Average		(3.4)	5.6	17.7	38.7	(41.7)	10.2	25.4	28.2	1.3	3.7	8.5
Fixed Income												
Corporate	10%	1.0	3.6	9.0	18.7	(4.9)	4.6	4.3	8.2	7.8	6.9	6.4
U.S. Treasury 20+	10%	2.2	2.6	9.4	(21.4)	33.7	10.2	0.9	1.4	4.5	6.7	6.7
Global Aggregate	10%	(1.1)	3.3	5.5	6.9	4.8	9.5	6.6	10.5	5.7	7.2	7.4
High Yield	10%	0.6	6.1	15.1	58.2	(26.2)	1.9	11.8	18.5	11.9	9.3	8.9
Average		0.7	3.9	9.8	15.6	1.9	6.5	5.9	9.7	7.5	7.5	7.4
60/40 Portfolio		**(1.8)**	**4.9**	**14.5**	**29.5**	**(24.3)**	**8.8**	**17.6**	**20.8**	**3.8**	**5.2**	**8.0**

Source: FactSet

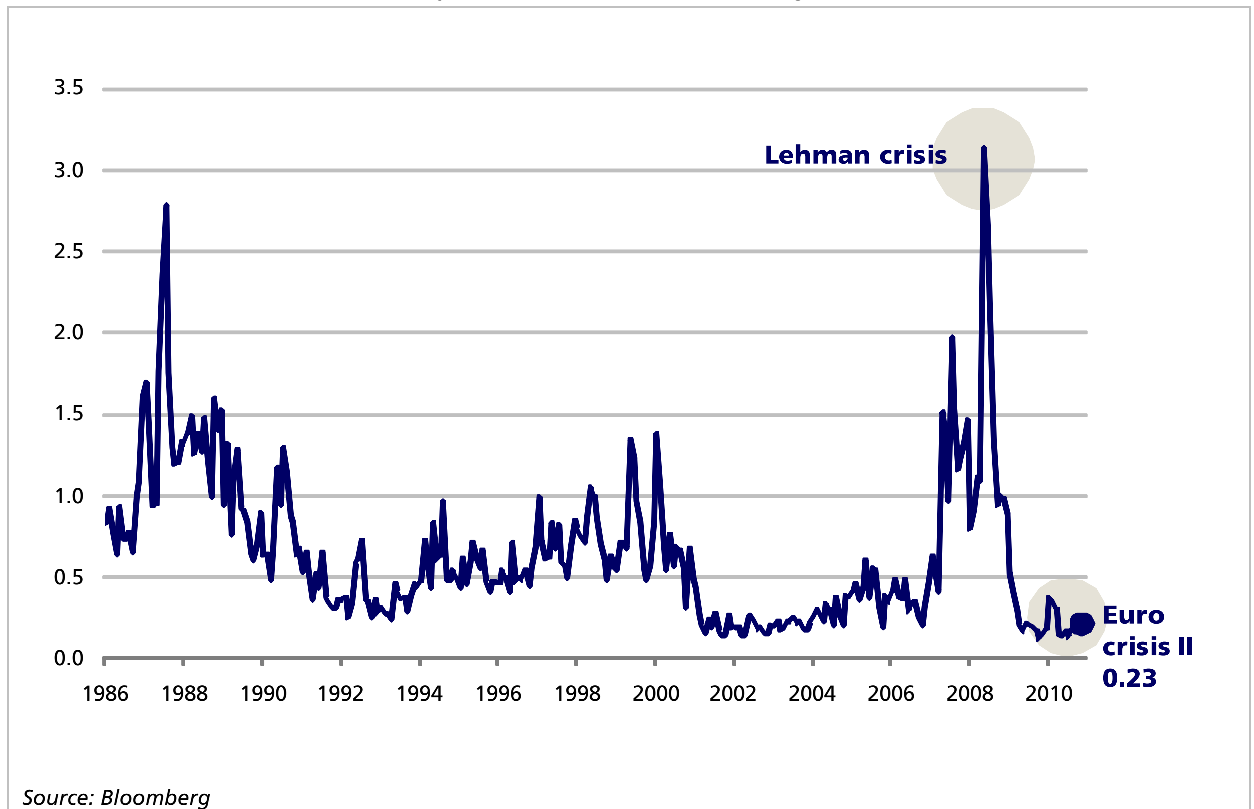
behind: the S&P 500 has returned 26.7%. Meanwhile, a diversified portfolio of stocks and bonds returned a respectable 20.8%. If investors had sunk everything they owned into the markets (equity or fixed) at the very moment the media predicted financial Armageddon, they would have done very well indeed.

Again looking back to this time last year, the bond market was fairly sanguine while the U.S. equity markets were being pummeled as volatility surged. In 2011, the equity markets have taken a page from the bond market's book; for example, world markets rallied broadly earlier this month when Standard & Poor's cut Greece's debt rating. True to form, TED spreads also stayed remarkably tame. Why have equity markets behaved so differently this time? Today, corporate America just finished delivering its seventh consecutive quarterly profits surprise, manufacturing is growing at four times the rate of general economic growth, and the consumer is setting records in personal income, personal consumption and retail sales. In 2010, corporations were only three quarters into the current string of upside earnings surprises and there was much consternation about a "double dip" recession.

In our original article we declared that "this recovery will ultimately be driven by the strong fundamentals seen in manufacturing, consumer retail sales, job growth and corporate earnings. Corporate earnings give the clearest indication of progress…earnings truly drive markets — accelerating and positive earnings drive markets up, and decelerating and negative earnings drive markets down, albeit with a reporting lag." Ultimately, that was how the scene played out, and we believe this year will follow suit as fundamentals continue to surprise on the upside and the recovery has been reclassified as an expansion.

This year — just as last year — we believe the best course of action is to focus on the fundamentals. Whenever fundamentals are marching forward, risks tend to fade into the background, just as they have this year during the Japanese nuclear catastrophe and the Middle East/North Africa authoritarian regime changes. A fresh look at the same

TED Spread (LIBOR Minus U.S. Treasury Bill): Debt Market Is Not Pricing in a Debt Crisis from Europe or U.S.



Source: Bloomberg

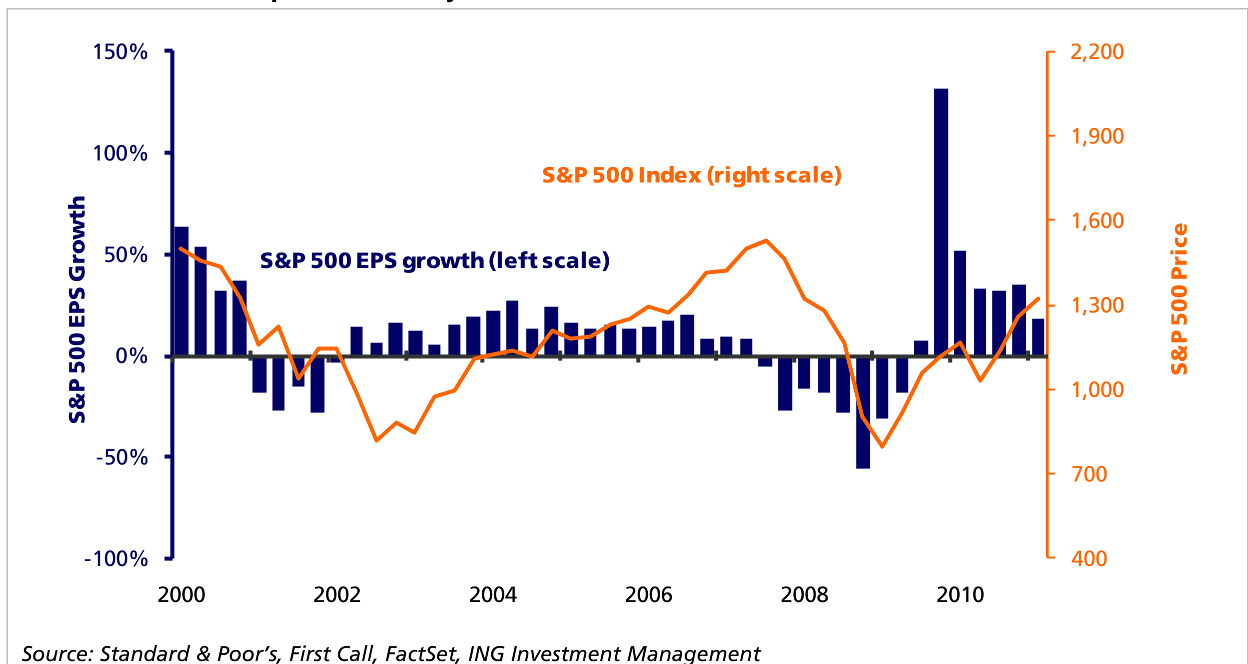
fundamentals chart (below) illustrates the point just as clearly, as corporate profits continue to rise.

Nothing is ever exactly the same, and this year we are faced with a unique set of risks. While Greece takes a turn for the worse — a recent three-notch credit rating downgrade from Fitch makes a debt restructuring more likely — attention has now turned to the U.S. Beyond its emerging Greece-like debt crisis, with federal debt at 100% of GDP, the U.S. is facing myriad issues: Congressional approval needed to raise the debt ceiling has taken a backseat to partisan bickering; a palpable fear of inflation has taken hold in light of the commodity rally of the past few years; oil has breached the $100 barrier; the U.S. dollar has plummeted; and Fed Chairman Ben Bernanke has been the subject of rampant criticism. Despite these problems, our preeminent debt market indicator, the TED spread, still is not flashing crisis.

With such widespread second-guessing of the Fed by Wall Street, our FOMC-consistent view that inflation is contained is a contrarian one. Like the Fed we believe that inflation is primarily a wage-driven phenomenon, and with so much slack and unemployment in the economy, wage pressure is not imminent. But the Fed has made it clear that it has changed direction on monetary stimulus and will enter a de facto tightening phase as it brings QE2 to a close in June. This has already impacted the bubble in commodities prices and all inflation bets, starting in earnest with silver and moving quickly to oil and gold. Equity prices have been affected mainly in the energy and materials sectors, but in an expanding economy it bodes well to stay invested there. The negative S&P ratings outlook for U.S. debt also shows that the market is a stern taskmaster and will demand fiscal austerity through spending cuts rather than new taxes. This fiscal austerity to rein in government is a positive for the private economy as confidence in this restraint builds, as do the prospects of a more capital-friendly environment.

Last year we proclaimed, "To paraphrase Shakespeare, we are seeing much ado about the euro and not enough about the global economic recovery." To update that for this year, we would say that we're seeing much ado about the dollar and inflation and not enough about the global economic expansion. ■

Fundamentals Drive Equities: Profits Cycle Indicative of a Multi-Year Bull Market



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

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.

©2011 ING Investments Distributor, LLC • 230 Park Avenue, New York, NY 10169.