ING Global Perspectives

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Weathering Storms in Uncharted Territories

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As the events of August proved, risk cannot be truly forecast; as such, it is mandatory that investors be prepared for the unexpected.

Although widely telegraphed, the August 5 downgrade of the U.S. credit rating by Standard & Poor's hit woefully unprepared markets like a Category 5 hurricane. In a perfect example of the phenomenon of "gaming diversification" that we have discussed previously in these pages, long U.S. Treasury bonds — the very asset class many investors sold last year to protect themselves against the much less onerous risk of inflation — were the top performers in the immediate aftermath of the downgrade in a perverse risk-aversion trade.

Gaming diversification often entails short-sighted and typically self-defeating attempts by investors to protect their portfolios from risks that can be easily identified and addressed. By overprotecting against one risk, however, portfolios are left defenseless against other "unknown and unknowable" risks. We would equate the current investment environment — highly compelling but fraught with risk — to sailing around the world: exposed to unpredictable elements, success goes to those who are prepared for the worst, whatever it may be.

It is rare to see such a bifurcation of market drivers. Bottom-up fundamentals — corporate profits in particular — are the primary driver of markets; from this perspective it has been smooth sailing. The second quarter saw S&P 500 companies outperform earnings expectations at a 71% clip, and we have even seen massive strength in the critically important metric of top-line revenue driven by robust worldwide demand.

Global risk, on the other hand, is a secondary driver of markets — at least until a major breach occurs and sends investors running for cover irrespective of the fundamental landscape. Since the 2008 credit crisis, extraordinary measures have been instituted to give the financial system and government balance sheets time to heal. The struggles of "peripheral" countries like Greece were not deemed indicative of a renewed credit crisis. In fact, lending activity has been almost boringly normal since the euro zone troubles emerged 18 months ago, especially compared to the freeze in inter-bank lending that followed the Lehman Brothers failure. It wasn't until larger countries like Italy and Spain started to waiver and the U.S. was downgraded by Standard & Poor's that global risk, especially

Global Diversification Mitigated Risk in a Difficult Month

Index	Wgt	Aug-11	YTD	2010	2009	2008	2007	2006	1 year	3 years	5 years	10 years
Equity												
S&P 500	10%	(5.4)	(1.8)	15.1	26.5	(37.0)	5.5	15.8	18.5	0.5	0.8	2.7
S&P MidCap 400	10%	(7.3)	(3.6)	24.9	35.0	(37.3)	6.7	9.0	21.3	2.4	3.1	5.9
S&P SmallCap 600	10%	(7.8)	(4.6)	25.0	23.8	(32.0)	(1.2)	14.1	23.1	0.8	1.5	5.9
U.S. REITs	10%	(5.8)	3.5	23.5	21.0	(41.5)	(20.2)	30.2	14.5	(2.9)	(4.6)	6.8
EAFE	10%	(9.0)	(5.7)	8.2	32.5	(43.1)	11.6	26.9	10.5	(2.5)	(1.0)	5.4
Emerging Markets	10%	(9.5)	(11.3)	9.8	93.5	(59.3)	59.1	56.6	1.7	1.0	8.6	19.4
Average		(7.5)	(3.9)	17.7	38.7	(41.7)	10.2	25.4	14.9	(0.1)	1.4	7.7
Fixed Income												
Corporate	10%	0.1	5.8	9.0	18.7	(4.9)	4.6	4.3	4.9	9.5	6.9	6.2
U.S. Treasury 20+	10%	10.0	17.0	9.4	(21.4)	33.7	10.2	0.9	3.7	9.1	8.7	7.6
Global Aggregate	10%	1.3	7.9	5.5	6.9	4.8	9.5	6.6	9.0	7.8	7.3	7.2
High Yield	10%	(4.0)	1.9	15.1	58.2	(26.2)	1.9	11.8	8.4	12.0	8.1	8.4
Average		1.8	8.2	9.8	15.6	1.9	6.5	5.9	6.5	9.6	7.8	7.3
60/40 Portfolio		**(3.8)**	**0.9**	**14.5**	**29.5**	**(24.3)**	**8.8**	**17.6**	**11.5**	**3.8**	**3.9**	**7.5**

Source: FactSet

Updates to Year-End 2011 Forecast

Whereas 2010 was a lesson in volatility, we expected 2011 to be a "banner year in economic activity" driven by accelerating corporate profits, booming manufacturing, the consumer as a gamechanger and developing markets as a source for continued U.S. corporate sales and profits.

In our August 8 report, we lowered our estimate for U.S. GDP to 2%, though we still expect economic activity in the second half of 2011 to be stronger than it was in the first. We hiked our year-end target price for gold to $1,700/oz, as interest in an alternative reserve currency continues to increase. A few other points about our 2011 forecast:

- We have affirmed our forecast for corporate earnings. Our S&P 500 earnings per share estimate of $96.50 looks solid given that second quarter earnings came in at $100 per share annualized.
- We have lowered our year-end target for the S&P 500 to 1350 from 1450. Driven solely by risk aversion, we lowered our target price-to-earnings multiple to 14 from 15.
- With the Fed guaranteeing low interest rates for at least the next two years, we have reduced our target yield on ten-year Treasuries to 3.0% from 3.8%.
- Somewhat counterintuitively given the credit downgrade, we think the U.S. dollar may strengthen on a trade-weighted basis due to the risk-aversion trade. While we did not previously maintain a specific forecast for the currency, expectations generally had been for it to move higher.
- Our five main risks[1] remain the same, though debt risk breached crisis levels following the U.S. credit downgrade.
- We have added a sixth risk: credit-rating risk, which includes the possibility of further downgrades to U.S., Europe or a major Asian country.
- We have added an additional risk: Congressional action, which may prove to be a strong positive or a strong negative. Fed Chair Bernanke's Jackson Hole speech passed the buck to the administration and Congress to make meaningful progress on fiscal restraint and fixing the economy.

[1] At the beginning of the year we identified five macro risks to our forecast: 1) rising bond yields hurt housing markets; 2) aggregate debt levels trigger a crisis in the U.S.; 3) unemployment stays above 9%; 4) the European sovereign debt crisis spreads; and 5) emerging markets lose momentum. Please see Global Perspectives 2011 Forecast for details.

Year-End 2011 Forecast

S&P 500 Level	1350
Dow Jones Industrial Avg. Level	12400
S&P 500 Earnings Per Share	$96.50
S&P 500 Price/Earnings Ratio	14x
U.S. Ten-Year Treasury Yield	3.0%
Inflation	1.5%
Unemployment Rate	8.5%
EAFE Return*	6.0%
Emerging Markets Equity Return*	9.0%
S&P MidCap 400 Return*	11.0%
S&P SmallCap 600 Return*	12.0%
Crude Oil	$80/bbl
Gold	$1,700/oz
GDP Growth	2.0%

Source: ING Investment Management

**Reflects our forecast for full-year 2011 return.*

credit rating risk, became a primary driver of market performance.

The credit downgrade of the largest economy in the world and the issuer of the global reserve currency introduced incredible uncertainty and sent markets reeling in one of the worst one-day selloffs since the 2008 credit crisis. In this report, we survey the aftermath of the downgrade, concluding that although risks have increased significantly, powerful catalysts for growth remain intact. This suggests to us that fundamentals may continue to defy expectations — just as they have for the past two years.

Historic Downgrade Results in Historically Tumultuous Markets

Our view, as expressed in our August 8 special edition of Global Perspectives, was that this "storm" was sufficiently unpredictable as to warrant a "trimming of the sails", especially out of equities. This proved true out of the gate; for four consecutive trading days beginning August 8, the Dow Jones Industrial Average closed more than four hundred points from where it opened, the longest such streak in the index's 115-year history.

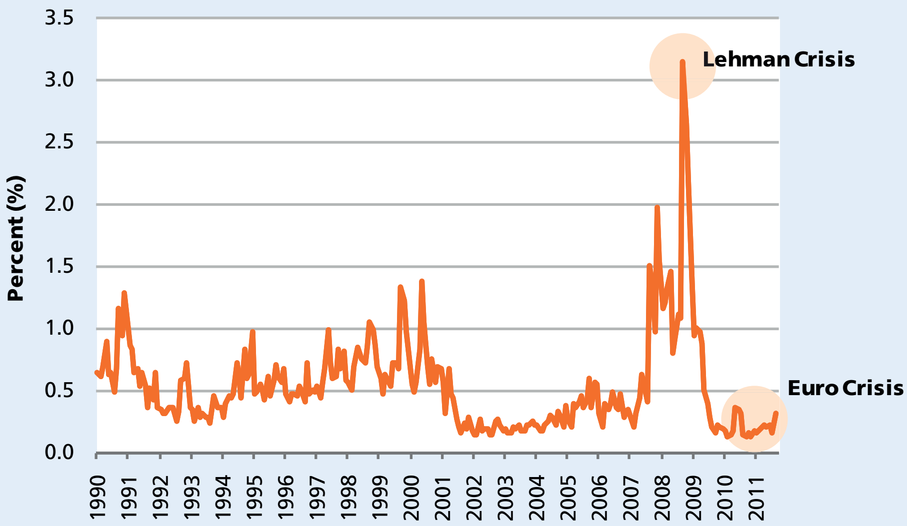
While we were encouraged by the fundamentally driven advances in the market in the face of significant macro shock, we remain troubled that it took extraordinary outside measures, namely the Fed's public commitment to low rates for two years and the European ban on short selling, to really move the needle in terms of attracting a bid. We are also concerned that little has been done to address the root cause of U.S. credit downgrade and — worse — that the same politicians whose bumbling precipitated the downgrade are charged with devising a solution.

Meanwhile, most economic data in the U.S. continue to disappoint. The latest consumer price index came in higher than expected, while the Philadelphia Federal Reserve Index of Manufacturing Activity posted its worst reading since March 2009 and is at a recessionary level. Although the timing of the survey (right around the time of the debt downgrade) may have colored responses to some degree, it does not discount its message about the deteriorating state of the U.S. economy. One bright spot in the recent economic data flow was a measure of leading economic indicators published by The Conference Board, which came in above expectations for July. In contrast to the Philly Fed number, the LEI suggest that the economy should continue to expand, if at a modest pace. Consumer spending, which hit multimonth highs in July, is also supportive of this position, as we will discuss later.

The situation in Europe is even more precarious, with serious debt contagion engulfing the bigger economies of the region, including Italy and Spain. Federal and state regulators — including the Federal Reserve Bank of New York — have intensified their scrutiny of the U.S. operations of Europe's largest banks. In a thinly veiled vote of no confidence, the Fed now feels compelled to protect the U.S. financial system from the possibility that strapped European banks could be forced to withdraw funds from their U.S. subsidiaries and affiliates.

The European Central Bank's (ECB) intervention thus far — primarily the purchase of Spanish and Italian debt — is viewed as a temporary solution at best. It seems clear to most investors that the ECB should ease monetary policy aggressively and also establish its own quantitative easing program; however, the central bank seems more concerned with fighting inflation than staving off recession. Meanwhile, concerns over fiscal solvency have weighed on consumer and business confidence in the region, leading to slower growth not only in the peripheral countries but in France and Germany as well. Slower growth results in lower tax revenue and makes the fiscal situation even harder to resolve.

A Relatively Low TED Spread Suggests Interbank Lending Is Healthy



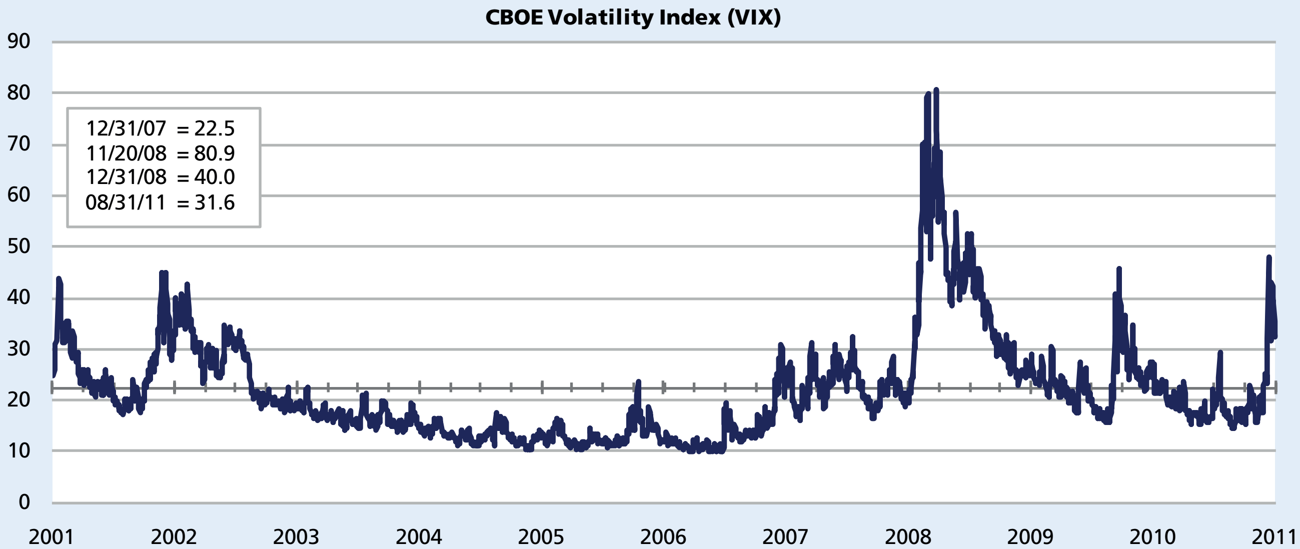
Source: Moody's, Reuters, Federal Reserve, Bloomberg, FactSet

While the European banking system has begun to show signs of stress — the TED spread, which is the difference between three-month T-bills and Libor and considered a measure of banks' willingness to lend to one another, has trended higher throughout 2011 — banks continue to lend with one another freely, suggesting that we are far from a circa-2008 crisis.

Despite Risks, Catalysts for Growth Persist

We can expect more volatility until we get transparent solutions to the debt problems of both the U.S. and Europe. But the catalysts for growth are many and significant, and these fundamentals will drive the longer-term performance of the markets. Below, we examine two of these catalysts.

Market Volatility Spiked Following the Downgrade



Source: Standard & Poor's, Chicago Board Options Exchange, FactSet

Emerging and Frontier Markets. Fortunately, the world is no longer just the U.S. and Europe. As we discussed at great length in the July issue of Global Perspectives, the emerging and major frontier markets are also supporting global growth. We believe the strength of these markets has been woefully underestimated and that they will continue to represent a great source of demand for the world in general and U.S. corporations in particular. In addition, the global economy recently got a big boost from Japan, a virtual "re-emerging market" only a few months removed from the earthquake and tsunami that devastated the country. Recent data showed that the Japanese economy contracted a meager 0.3% in the second quarter, much less than the 2.7% that had been expected.

Consumer as the Gamechanger. Global Perspectives has been out in front of the Street in terms of predicting positive surprises from the consumer. While recent consumer sentiment data have been less than sunny, these surveys are highly correlated with stock market performance; spending is the key to determining the true attitude of the consumer. Retail sales have climbed 8.2% over the past three months relative to a year ago, reaching a new record level of $390.4 billion; high-end luxury stores have been a particularly bright spot. Both personal income and spending rose smartly in July, and the savings rate ticked down. If consumers are able to stage a repeat of 2010's blockbuster "back to school" season — and we believe they will — markets should respond enthusiastically. And though the recovery in employment remains sluggish, there have been some encouraging signs; new unemployment claims are at their lowest level since mid-April, and the latest nonfarm payrolls report came in well above expectations.

But it is not just the U.S. consumer that is changing the game. Emerging and frontier market consumers are doing their share to support global demand. China, for example, has emerged as the top market for auto sales in the world. Meanwhile, in Chennai, India — aka "Detroit of the subcontinent" — major global auto companies are building cars not for export, but for the middle-class Indian consumer.

Conclusion

We correctly anticipated the volatility that ensued following the downgrade; however, even longtime diversification advocates like us were caught off guard by the benefits that diversification was able to deliver during this extreme period. Though the travails of large-cap stock indexes tend to dominate the popular mindset, there were a number of asset classes that provided shelter from the storm for those who take a global perspective with their portfolios. As mentioned earlier, U.S. Treasury bonds were the best performing asset class for the five trading days after the downgrade. Global aggregate bonds and corporate bonds did what they do best during times of unpredictable markets, exhibiting low volatility and negative correlation or capital gains. With performance second only to Treasuries, U.S. REITs were a big surprise. Even midcap stocks were down only slightly for the week once the dust had settled.

Though markets pulled back from the extreme volatility exhibited in the immediate aftermath of the downgrade, it wasn't long before another shock hit stocks — the Dow plunged 420 points on August 18. We think this rollercoaster ride is far from over; as we said in our August 8 note, "markets likely will be slow to react to the real implication of the debt downgrade". One upside of the downgrade is that politicians are now under pressure to make meaningful changes, with an election cycle — and thus the judgment of their constituents — looming. In addition to spending cuts, we would urge our representatives in Washington to adopt such pro-growth policies as free trade and a reduction in corporate income taxes to bring us in line with such business-friendly jurisdictions as Canada.

In the meantime, as we navigate these uncharted waters, a broad, globally diversified portfolio will help ensure that the swells on the horizon lift your boat instead of swamping it. ■