Revue hebdomadaire 31 août 2011

Houseview

Global Strategy

Buying Buffet

Strategy Recommendations

	+	=	-
TAA	FI		EQ
			REIT
			COMM
EQUITY			
- Sectors	HLTH	ENERGY	INDUS
	IT	UTIL	MATS
	STAPLS		FIN'L
	TELCO		DISCRET
- Regions	GEM	ASIA	EUR
	JPN	US	
- Size	LGE		SML
- Style	GRWTH		VALUE
FIXED			
- Markets	GOVT	IFL	SPREAD
- Markets	EM FX	SBL	IGC
	EMD HC		ABS
	EM Rates		EPT
	HY		

Economic Outlook

- Magneto trouble for US and Eurozone economies
- Unconventional tools available, but unlikely to be used
- Declining growth momentum in the emerging world

Can we solve our "magneto trouble"?

At the start of the Great Depression John Maynard Keynes remarked "We have magneto trouble". What he meant was that the economy had a significant amount of unutilised resources and could not kick start output of its own device to regain full employment again. Currently, we find ourselves in exactly the same situation. One way to look at the recent sell off in risky assets is that until recently markets believed that the engine had been started (even though its power to propel the economy forward was more limited than in normal times), but now it is showing signs of sputtering again. As a result expectations of future nominal growth have been lowered. The other big factor behind the rise in risk premia is the issue we discussed last week: Markets are realising that the mechanics (policymakers) are in a state of paralysis and cannot agree between themselves on the diagnosis of the problem, let alone the cure.

The multitude of explanations for "magneto trouble" can be divided into two broad groups. First of all, there are those who believe that the problem is largely structural because of which expansionary fiscal and monetary policies will do more harm than good, i.e. they will eventually lead to higher real rates and inflation and a crowding out of productive private investment. The prescription according to this view is fiscal austerity and structural reform. Regular readers will know that we do not agree with this view of the world because the evidence (low real rates and wage growth, broad based weakness in employment, etc.) clearly points in the direction of a lack of demand.

Yet even in this second broad group there is a lack of consensus about the underlying cause of the demand deficiency. Some economists suggest that the main cause is a decrease in real spending due to balance sheet problems: Profligate agents are forced to increase their savings while the frugal ones are unwilling to increase spending because of a combination of a large degree of uncertainty and the inability of real interest rates to fall sufficiently. The latter problem stems from the fact that central bank policy rates hit the zero lower bound, an issue that can be aggravated if inflation expectations start to fall. In this view of the world, the effectiveness of monetary policy is severely impaired and the burden of kick starting spending falls on fiscal policy and an increase in foreign demand.

Other economists of a more monetarist persuasion acknowledge there are balance sheet problems, but believe the main problem stems from a large increase in the demand for safe and liquid assets induced by a very large degree of economic uncertainty. Money is in a sense the oil in the economic engine so if less of it is circulating around, nominal spending growth will fall. A concrete example of how this works in practice is that a portfolio shift away from risky towards liquid assets tightens financial conditions and induces negative wealth effects (which are what we have been seeing over the past few weeks). In short, the true cause of excess supply on the market for goods and services resides in excess demand for money and the solution is therefore to supply more of the latter (i.e. expand QE).

Our own view is that there is some degree of truth in both positions. In particular, spending shocks generally tend to induce a change in money demand[1]. We now have negative spending and positive money demand shocks "on steroids" and as far as the latter is concerned there is plenty of evidence that the demand for liquidity is even much higher than warranted only by the increase in savings.

In other words, rising economic uncertainty and low confidence have induced a flight to safety (i.e. money and AAA Treasuries) in investor portfolios which has become more pronounced over the past few weeks. This is why Treasury yields have fallen while credit spreads and equities have sold off. Another piece of evidence supporting this notion is that cash holdings in private portfolios are still well above levels seen before the Lehman crisis. Also, the banking system still puts a large amount of the reserves created over the past 3 years on deposit at the central bank.

[1] To illustrate this we assume there are only two financial assets in the economy: Money and bonds. Money is held because it has a "convenience yield", i.e. it is needed for transaction purposes and it is a safer asset than bonds. In fact the only risk of holding money in the portfolio is an unexpected rise in inflation. All else equal, a rise in the interest rate will thus make bonds more attractive relative to money.
In the event of a negative spending shock the demand for financial assets will increase and the new portfolio equilibrium will be characterised by an increase in the demand for money. This is not only because of the initial allocation towards money but also because higher demand for bonds lowers the interest rate. The conclusion is then that a fall in spending induces an "endogenous" tightening of monetary policy, i.e. with less money circulating nominal spending will fall unless "something" offsets the rise in money demand.
In the case of fully flexible prices, this "something" comes in the form of a fall in the price level which reduces the amount of money needed for transaction purposes. In a sense this allows the interest rate to fall sufficiently to restore full employment again. However, in the real world prices are sticky and then it is up to the central bank to mimic the effect of a fall in the price level by expanding the money supply until the increase in money demand is fully satisfied and the rise in savings is fully absorbed by increased investment.

This then brings us back to our "magneto trouble". If increased liquidity demand is an important part of the problem can the engine then be started by monetary policy alone? The answer to this is extremely important because fiscal policy (the traditional answer to a spending shock) is definitely out of the picture in the DM universe.

Historical evidence indeed seems to suggest that monetary policy can induce a sustained increase in nominal spending even when the policy rate has hit the zero lower bound. For instance, between 1933 and 1936 US consumer debt fell by around 20 pp in real terms while the economy grew by around 8% per annum. More recently, Swedish nominal GDP recovered very strongly and has by now probably risen back to or even somewhat above trend which is why the Swedish Riksbank was one of the first DM central banks to start hiking rates again.

The problem is of course that these are not controlled experiments, i.e. lots of other things were going on at the same time. In both cases there was also a good deal of fiscal stimulus and the Swedish economy is much more open than the US, while its exports are relatively geared towards fast growing Asia. Yet, there are some common features which suggest that the monetary policy strategy may have been helpful in generating robust nominal income growth.

President Roosevelt explicitly stated that he wanted the US price level to be restored to its pre-Depression level and backed this statement up with action. The link between the dollar and gold was severed and substantial currency depreciation as well as a large and permanent increase in the monetary base were allowed. Meanwhile, in Sweden the Riksbank expanded its balance sheet by 25% of GDP (for the Fed this was 15% of GDP). One of its board members, Lars Svensson, publicly stated that the effectiveness of monetary policy could be further enhanced through price level targeting or targeting substantial exchange rate depreciation via large increases in the monetary base.

The common features of these successful unconventional monetary expansions are thus twofold. First of all, the central bank gave a very clear indication of what exactly it set out to achieve and was prepared to set itself a bold target. Secondly, it signalled it was prepared to do whatever was necessary to reach this target. In particular, it had no reservations about expanding the supply of base money and maintaining this as long as necessary. Essentially, these central banks made very efficient use of the expectations channel of monetary policy and succeeded in boosting the private sector's future nominal growth expectations.

In doing so they managed to diminish the negative effects of both the money demand as well as the spending shock. Money demand was reduced because higher expected nominal growth makes it more attractive to hold risky assets while higher expected inflation reduces the incentive for holding safe and liquid assets. Meanwhile, current spending was stimulated because higher expected future profit and wage income growth propelled the private sector into a more expansionary mode.

There is no reason why the G4 central banks could not apply the same principle today. They could set a target for the price level or the level of nominal income based on the trend in pre-crisis growth and promise to increase the supply of base money until this target is reached. All this is of course a far cry from what they have been doing until now.

Yes, QE and other unconventional measures were implemented so central banks embarked on the journey but they did not clearly specify the destination. What's more, G4 central banks at least implicitly voiced doubts about the effectiveness of QE and started fretting about the possible inflationary consequences while of course an increase in inflation is just what the doctor ordered! Hence, while QE certainly exerted a `mechanical` effect in the sense that it lowered long-term yields and thus loosened financial conditions, its effect on expectations was much less than it could have been.

In this respect, Bernanke´s much-awaited Jackson Hole speech last week more or less fit into this pattern of a timid attitude towards unconventional policy. He did not spell out any new policy options, but signalled that these would be more elaborately discussed during the September FOMC meeting. Hence, especially if the data flow and/or financial markets deteriorate further from here, there is still a significant chance that further policy action will be taken.

The main problem with timid QE attempts is of course that then the central bank loses some degree of credibility every time it fails to generate the desired effect. This then weakens the potential for shaping expectations of future nominal growth. Yet it would be too easy to blame central bankers entirely for this. Surely, for some central banks (most notably the ECB) it is true that they are in a sense still fighting the last war, i.e. the one against inflation, and that unconventional policy thus very much runs counter to their intuition of how the world works.

However, regarding the Fed there is also an important political element. Even though the US central bank is independent, it knows that this can be taken away and in fact some US politicians have been very vocal in their resistance against QE. Bernanke thus faces a trade-off between being able to stabilize the economy now, on the one hand, and in the future, on the other. While we do have mechanics who know how to solve our magneto trouble it very much seems that they are being held back from doing so by some of their colleagues…

Declining growth momentum in the emerging world

South Africa reported its Q2 GDP growth numbers. The annualised, seasonally adjusted growth rate fell to 1.3% from 4.5% a quarter earlier. Consensus was looking for a higher number, although a sharp slowdown was factored in. Manufacturing and mining were particularly weak in the second quarter.

In the emerging markets universe, South Africa does not stand out. The EM growth momentum has been slowing fast in recent months. Annualised GDP growth in the emerging world, excluding the less volatile China and India, fell from 7% in Q1'11 to 4% in Q2'11. The steepest declines we have seen in the most open economies, such as Taiwan, Thailand, Singapore and Hong Kong, and in the economies that were most overheated at the beginning of the year (Brazil and Turkey). With global trade growth only starting to slow, we see more downside for the open economies, particularly those with the tightest relations with the US and Europe. The more closed economies, such as India and China, are also slowing, but here the downside risk is more limited, due to more solid internal dynamics of growth, particularly strong disposable income growth.

Including China and India, we expect average EM GDP growth of 6.5% in 2011 and 6.0% in 2012. The low point in EM growth we expect in Q2 2012, at 5.7%.

Willem Verhagen
Senior Economist

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Forecasts

Global macro

The global economy is currently slowing down again. This is most evident in those DM economies characterised by household and financial sector deleveraging. Nevertheless, core Europe as well as EM space is affected as well through a slowing of external demand. There are two broad reasons behind this. First, the oil and Japan disaster shocks have taken a greater toll on DM domestic demand growth than previously anticipated. Furthermore, there are increasing concerns about the competency of policymakers on both sides of the Atlantic to deal with the challenges facing them. In the US this has raised the prospect of more near-term fiscal tightening without a solution for the long-term fiscal problems while in Europe it implies a heightened degree of systemic risk.
Risk aversion has risen considerably over the past few weeks. This potentially opens the door to a self-fulfilling negative feedback loop between financial conditions and confidence, on the one hand, and growth, on the other.

All this once again underscores that an economy remains in need of policy support during the process of deleveraging. Unfortunately, fiscal policy in much of DM space will be tightened, particularly so in the US. The burden is thus once again on monetary policymakers. The Fed has signalled that it expects to keep rates near zero until mid-2013 whilst also adopting an easing bias, i.e. some form of QEIII is now a clear possibility. Meanwhile, the ECB has stepped up its unlimited liquidity provision again and we no longer expect a rate hike this year. While this should be helpful, one should bear in mind that the effectiveness of monetary policy is still impaired.

Our base case is now one of positive, but below potential growth in DM space for the next 6 quarters and we see a 30-40% probability of a double-dip. The reason for holding on to our base case is threefold: First of all, recent data show some improvement which suggests that the impact of the oil and Japan shocks is abating. Moreover, employment as well as spending on capital and consumer durables goods are still (well) below pre-recession levels. This implies that the room to slash spending on these items is much more limited than it was in 2008. Finally, policymakers could still come up with a comprehensive solution to the problems facing them. History indeed suggests that they will once a certain pain threshold is reached. However, whether or not we are close to this threshold is still an open question.

Valentijn van Nieuwenhuijzen
Head of Strategy

Willem Verhagen
Senior Economist

ING IM Global Economic Outlook

	Real GDP					Inflation					Policy Rates (%, YE)				
	2010	2011		2012		2010	2011		2012		2010	2011		2012	
World	5,0	3,6	-	3,5	-	3,0	3,9	+	3,0	=					
Developed	2,6	1,3	=	1,6	=	1,4	2,5	=	1,7	=	0,45	0,62	=	0,70	=
US	3,0	1,6	=	1,9	=	1,6	2,8	=	2,0	=	0,13	0,13	=	0,13	=
Euro	1,7	1,7	=	1,0	=	1,6	2,6	=	1,9	=	1,00	1,50	-	1,75	-
Japan	4,0	-0,3	=	2,2	=	-1,0	0,4	=	0,1	=	0,10	0,10	=	0,10	=
UK	1,8	1,0	=	1,5	=	3,3	4,4	=	2,5	=	0,50	0,50	=	0,50	-
Emerging	8,1	6,5	-	6,0	-	5,2	5,8	+	4,6	=					
China	10,4	9,2	=	8,5	=	3,0	5,5	+	3,8	+					

	Unemployment rate					Budget balance					Current account				
	2010	2011		2012		2010	2011		2012		2010	2011		2012	
Developed	9,1	8,8	=	8,5	=	-8,1	-7,7	=	-6,0	=	-1,3	-1,4	=	-1,3	=
US	9,7	9,0	=	9,0	=	-9,1	-9,4	=	-7,4	=	-3,5	-3,8	=	-3,6	=
Euro	10,3	10,3	=	9,5	=	-6,4	-4,5	=	-3,5	=	0,0	0,3	=	0,1	=
Japan	5,1	4,8	=	4,5	=	-8,0	-9,3	=	-7,0	=	3,5	2,3	=	2,8	=
UK	7,9	7,8	=	8,0	=	-10,1	-8,8	=	-7,8	=	-2,2	-1,8	=	-1,3	=
Emerging															
China	6,1	6,5	=	6,4	=	-2,2	-1,7	=	-1,6	=	6,1	4,3	=	3,9	=

Source: Forecasts from ING IM, historical data from IMF (GDP, inflation) and Economist Inteligence Unit (rest data)

Global markets

Bond yields (10y)

quarter end (%)

Countries	Q1'11	Q2 '11	Q3'11	Q4'11
US	3.5%	3.1%	2.0%	2.5%
Eurozone (bunds)	3.4%	3.0%	2.0%	2.3%
Japan	1.3%	1.1%	1.0%	1.1%
UK	3.7%	3.3%	2.3%	2.7%

Corporate bond (IG) yields

quarter end (%)

Countries	Q1'11	Q2 '11	Q3'11	Q4'11
US	4.1%	3.8%	4.0%	4.3%
Eurozone	4.2%	4.1%	4.6%	4.7%
Japan	0.7%	0.8%	0.7%	0.9%
UK	5.5%	5.4%	5.5%	5.6%

Equity

quarter end

Countries	Q1'11	Q2 '11	Q3'11	Q4'11
S&P 500	1326	1320	1050	1150
Euro stoxx 600	276	273	225	235
TOPIX	869	849	800	850
FTSE 100	5909	5945	5500	5400
MSCI EM Free	1171	1146	1000	1050

Foreign exchange rates

quarter end

Currencies	Q1 '11	Q2 '11	Q3'11	Q4'11
EUR/USD	1.40	1.45	1.35	1.25
USD/JPY	80	81	90	95
GBP/USD	1.56	1.61	1.63	1.56
EUR/JPY	0.90	0.90	0.83	0.80
EUR/GBP	112.00	117.45	121.50	118.75

Source: ING IM (31/08/2011)

Fixed Income Strategy

- Fiscal tightening supportive for treasuries
- Spread exposure remains underweight
- Within spreads tilted towards EM

Difficult to Remain Rational

Outside of European peripheral markets, treasury yields are still trading around all-time lows. In Germany yields are back at last year's Euro crisis 1.0 level, while US treasury yields are in Great Depression territory and UK GILT yields at their lowest point in the last 200 years. Systemic scares and growth fears have conspired to reach this impressive result.

For those still convinced that unprecedented easy monetary policy will lead to large upward inflation risks or that stretched public finances will trigger near-term solvency fears (both pushing treasury yields up) recent market behaviour should provide clear evidence that they have been wrong in anticipating market drivers. However, some will probably argue that higher yields will still arrive at some future point on the back of inflation and/or solvency worries and that Mr. Market is just temporarily irrational in his behaviour.

At least it seems very hard to justify the current behaviour of these fiscal policy makers in any other way. Fiscal policy makers in Core Europe, the UK and the US are all preparing for a significant round of fiscal tightening. If the market was fully rational in its current pricing then policy makers could actually see current low levels of bond yields as a vote of confidence in their long-term credibility. It would then be rational for policy makers to exploit the lowest funding costs ever to stimulate final demand at a time that their economies are flirting with a recession again. So the market must be irrational in the eyes of fiscal policy makers who pursue aggressive fiscal austerity over the next two years to prevent them from the being hit by much higher funding costs once the market gets its sanity back.

But wait, if the market is *irrational* in its pricing today then a unique opportunity has to be in place to exploit this mispricing of risk. A rational borrower would realise that the most effective way to profit from this opportunity was to combine *temporary* higher borrowing at irrationally low costs with credible measures to lower *future* expected borrowings. The obvious examples of the latter for the Euro, UK and US governments are efforts to diminish funding gaps for liabilities related to future pension and healthcare schemes.

By taking this approach average borrowing costs over the long-term would actually fall, which on its own would already contribute positively to the solvency outlook for the government involved. Moreover, short-term temporary borrowing can be employed for fiscal stimulus of the economy which will probably prevent a renewed recession or make it less severe. The stronger economic backdrop and utilisation of productive resources which will otherwise be left idle will actually help to mitigate the negative impact of additional borrowing on government finances. It will lead to lower unemployment benefit outlays and higher corporate and household income that will at least dampen the negative impact of stimulus borrowing for the next two years[2].

This underscores the puzzling response that fiscal policy makers are currently displaying to combat deteriorating public finances and rising recession risks. Either they believe that markets are rational and use the vote of confidence from Mr. Market to support the economy or they are convinced that markets are irrational and exploit the cheap funding opportunities this creates to support the economy for at least as long as the market remains irrational. Whatever the diagnosis it seems difficult not to conclude that another round of temporary fiscal stimulus is the best way forward.

The fact that fiscal policy makers in core Europe, the UK and the US are coming to a different conclusion is therefore a bit confusing and contributing to the recent increase in recession probabilities in these regions. The confusion stems from the assumption that policy makers are expected to respond rationally to the market environment that they're faced with. Maybe that assumption is actually the irrationality in our own analysis.

Whatever, the explanation might be for the behaviour of policy makers; it helps to push cyclical risks further down and depresses risk appetite amongst investors. Since these two factors are still much more dominant for the direction of treasury markets that inflation and solvency fears, it remains preferable to be positive on treasury paper (outside of the European peripheral markets).

Still it does not take away the impressive rally in treasury yields in recent weeks that has reduced the attractiveness of the asset class somewhat. Treasury yields are now trading at or close to their historic low points in Germany, the UK and the US. This is not to say they could not fall further towards Japanese levels, but the risk-reward of the treasury bet seems to have deteriorated. Also, remember that below-2%

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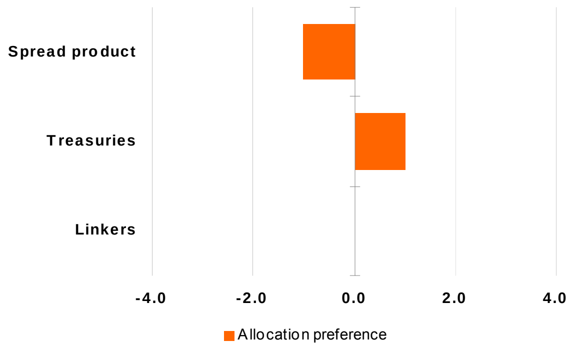
[2] The degree to which this happens is dependent on the assumption one makes about the "multiplier"-effect that fiscal stimulus has on final demand. This is hotly debated amongst economists and is probably state dependent and influenced by the openness of an economy. However, recent research by the IMF (Guajardo, Leigh and Pescatori, "Expansionary Austerity: New International Evidence", Working Paper 11/158, July 2011) confirms that such multiplier effects have a positive sign and thereby disputes that fiscal consolidation efforts have a positive impact on economic growth (as suggested by a number of pundits and policy makers).

yield levels on 10-year treasury paper were only established in Japan after that economy had fallen into a deflationary environment. It remains difficult to see either the US or Europe falling into deflation over the next 12-18 months, even if a recession would materialise in H2'11. All in all, we decided to reduce the overweight in Treasuries from +2 back to +1.

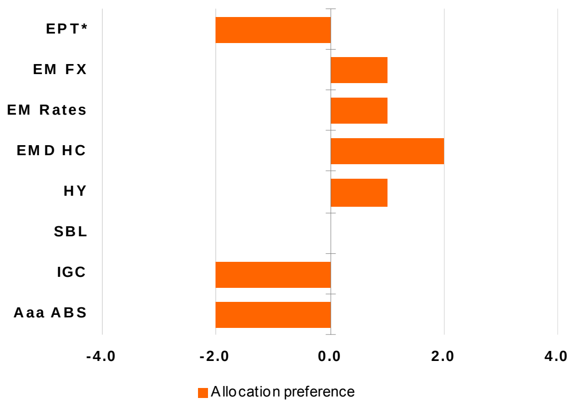
Top Down Preference



Source: ING IM (31/08/2011)

For spread products it also hold that significant market developments have taken place over the last three weeks. For example, HY spreads have widened by over 150 bps and IG spreads have risen a possibly even more remarkable 70bps to well above 200bps. For spreads it is also important to stress that TAA signals have improved to 'only' at -0.6 recently on the back of modestly stronger cyclical signals (PMI's bottoming) and market signals (risk aversion, sentiment - pointing to mean reversion).

Spread Preference



Source: ING IM (31/08/2011)

Within spread products, we remain most cautious on exposure to the European 'risk zone' and therefore keep our European peripheral treasury, investment grade corporate credit and Aaa ABS in underweight stance. Thematic trends, valuation and return momentum trends are also providing clear signals to underscore the qualitative assessment of caution in these areas.

Meanwhile, our most notable preference within spread product space remains for emerging market exposure as these assets are supported by strong underlying fundamentals and supportive investment themes, are the preferred asset classes from our bottom-up analyst teams and relative return momentum.

Valentijn van Nieuwenhuijzen
Head of Strategy

Equity Strategy

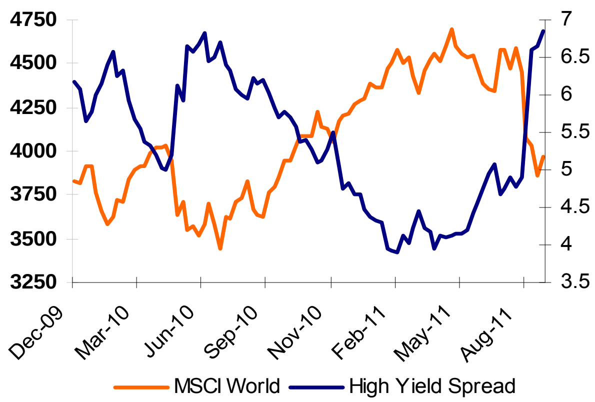
- Equity markets are rapidly catching up with the reality of lower earnings growth
- Further economic downside and systemic risks are not priced in
- We do not expect a sustainable rally in equities unless data and/or policy improves

Equity outlook – stumbling myopic investors

August has been an awful month for global equities posting almost double-digit declines. This ranks August '11 performance in the bottom 5% since 1973. No single sector escaped this sell-off but Financials and Cyclical sectors were particularly hard hit. This observation clearly indicates the main issues investors are currently worried about: The Euro-debt crisis transforming into a systemic risk for the entire financial sector and an economic slowdown that goes beyond a soft patch. To make things worse, both elements are interrelated and can launch or even reinforce a negative spiral. The transmission mechanism into the real economy flows in two ways: through the globalized financial system and through a negative impact on consumer and corporate confidence, the so-called negative feedback loops. This drop in confidence comes at an unfortunate time with heavily indebted developed market governments having very limited firepower to stimulate growth; on the contrary, fiscal austerity is the new codeword. Monetary authorities on their part are running low on options to support growth. Continued low rates are a certainty, but not helpful in a liquidity trap.

One observation is the divergence between equity markets and credit markets. The latter seems to be leading in pricing a recession or systemic risk. Equities are catching up but in our view, valuations are not at recession levels. Only one of these markets can be right and if 2008 acts as a guide, equity market prospects are rather bleak.

Divergence between credit and equity market



Source: Datastream, INGIM (August'11)

September will be an important month with many hurdles to take. National Parliaments have to approve the broadening of the EFSF. The IMF will conduct its quarterly audit of the budgetary progress in Greece (and the country will probably miss its target). Italy has to tap the market for government bonds for large amounts. Each of these elements can bring the Euro sovereign crisis and the lack of political leadership back to the forefront.

The US budgetary problems are not out of the way either despite the agreement Congress reached on the debt ceiling. If by November, the 12-member bi-partisan committee does not come up with a credible proposal to tackle the deficit, automatic cuts in Defence spending and Medicare will kick in. This should act as a stick behind the door, but short-term electoral interests may - as is proved already too often - prevail to the long-term common interest.

At this point, it is worthwhile to assess to what extent markets are already pricing in these risks. We look at earnings and valuations as medium-term anchors.

Earnings

Following the downward revision of our economists' global growth outlook for 2012, we cut our earnings forecasts in a meaningful way. We currently expect 0% earnings growth in 2012. This outcome is based on 4-5% revenue growth coupled with a 50bp decline in the net margin.
Japanese companies on the other hand may still be capable to show double-digit earnings growth, provided the real exchange rate of the Yen does not appreciate too much. This relative earnings dynamic is the prime reason of our overweight Japanese equities.

The following table illustrates the sensitivity of earnings to changes in revenues and changes in the net profit margin. We think that as companies have little room to cut their cost base aggressively, the margin sensitivity to revenue has increased. In other words, the operational leverage which has driven margins to record highs over the past 2 years is very high and may start to work in reverse once revenue growth drops below 2-3%.

Evolution of Net Profits (US example)

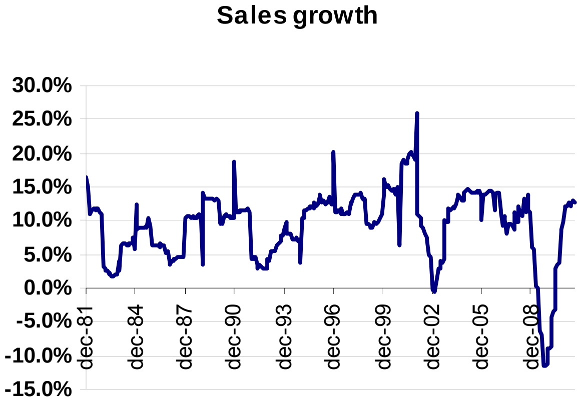
		Net margin					
		4%	5%	6%	7%	8%	9%
Sales growth	0%	-51%	-39%	-27%	-15%	-3%	10%
	2%	-50%	-38%	-25%	-13%	-1%	12%
	4%	-49%	-37%	-24%	-11%	1%	14%
	5%	-49%	-36%	-23%	-10%	2%	15%
	6%	-48%	-35%	-23%	-10%	3%	16%
	8%	-47%	-34%	-21%	-8%	5%	18%
	10%	-46%	-33%	-20%	-6%	7%	21%

Source: INGIM (August'11)

To put things into perspective, the long-term average margin of US companies is 6.5% and 5.2% for European companies. A decline towards these levels would imply a 20%+ decline in earnings.

The average long-term sales growth for both regions is 10%. During the credit crisis the bottom in the 12-month sales growth was -12% (US) and -9% (Europe).

This evolution is illustrated in the following chart.



Source: Datastream, INGIM (August'11)

We do not expect a similar revenue outcome this time as global growth will remain close to 4%, driven by emerging markets. In addition, consumers and companies are not facing a credit and liquidity crunch as they did then. As the previous graph illustrates, it is very unusual for sales growth to turn negative and 2008 was in this respect a clear outlier.

The following table illustrates our new earnings estimates. It is important to note that these are far below bottom-up estimates, which are still pointing towards double-digit earnings growth. This seems unrealistic to us and we do expect acceleration in downgrades in the run up to the Q3 earnings season. In addition, companies in their outlook statements may announce deterioration in the business environment.

Top Down earnings estimates

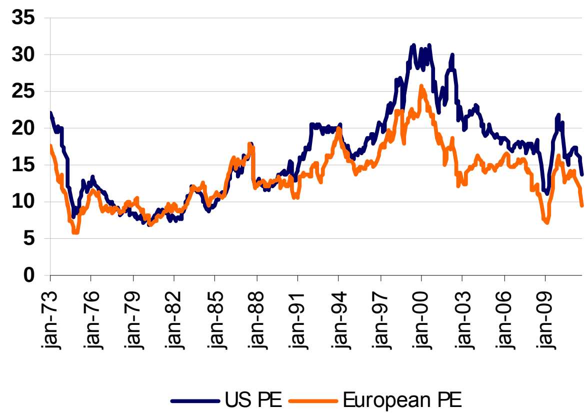
	2011	2012
United States	9%	0.0%
Europe	6%	0.0%
Japan	10%	15.0%
Emerging Markets	18%	10.0%

Source: INGIM (August'11)

Valuation

We look at valuations in an absolute sense and relative to other asset classes.

The following graph illustrates the trailing price earnings ratio. These are close to the levels we saw in the mid-eighties and are 15% to 30% below the long-term average.



Source: Datastream, INGIM (August'11)

However, we do not think it is correct to assume mean-reversal in the PE. We need to make a correction for two things: a reduction of the long-term growth rate and the increased vulnerability of developed economies to external shocks.

On the first point, a permanent 0.5% reduction in the growth rate would theoretically reduce the "normal" PE for the US to 13.7 (versus 16.3 as LT average) and for Europe to 12 (versus 13.6).

The following table illustrates the upward/downward potential for the market under different assumptions on earnings growth and PE. We estimate 0% growth in 2012. Based on this the US market seems fairly priced. However, it does not take into account the risk of recession or systemic risks. During the Lehman crisis, the trailing PE fell back to 11.

Upside/downside potential US market

Earnings growth	Target Price Earnings ratio US: 11	12	13	14	15	16
-30%	-44%	-39%	-34%	-29%	-23%	-18%
-20%	-36%	-30%	-24%	-18%	-12%	-7%
-10%	-28%	-21%	-15%	-8%	-2%	5%
0%	**-20%**	**-12%**	**-5%**	**2%**	**9%**	**17%**
10%	-12%	-4%	4%	12%	20%	28%

Source: Datastream, INGIM (August'11)

Upside/downside potential European market

Earnings growth	Target Price Earnings ratio Europe: 8	9	10	11	12	13
-30%	-42%	-34%	-27%	-20%	-13%	-5%
-20%	-33%	-25%	-17%	-8%	0%	8%
-10%	-25%	-16%	-6%	3%	12%	22%
0%	**-17%**	**-6%**	**4%**	**15%**	**25%**	**35%**
10%	-8%	3%	15%	26%	37%	49%

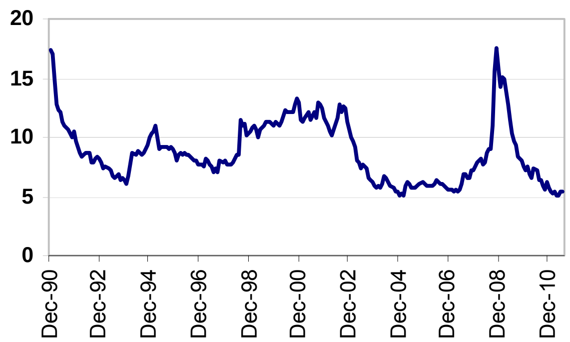
Source: Datastream, INGIM (August'11)

In Europe, combining a 0% earnings growth with a fair PE of 12 indicate a 25% upside for the market (by end 2012). In other words, European investors already seem to discount a deeper 20% earnings downturn. The trough in the trailing PE in March '09 was 7.2.

Compared to the government bond market equities are attractively priced. Equity risk premiums are high even if we take into account a 20% cut in dividends next year followed by 0% dividend growth in 2013. These are severe assumptions given the good health of corporate balance sheets. The US equity risk premium is 4.5% and the European risk premium is 4.1% (on top of a market cap weighted average of European government bond yields).

Also compared to the high yield market, equity valuations are at their most attractive level over the last 20 years.

High yield minus US Dividend yield



Source: Datastream, INGIM (August'11)

Other drivers

- Loose monetary policy

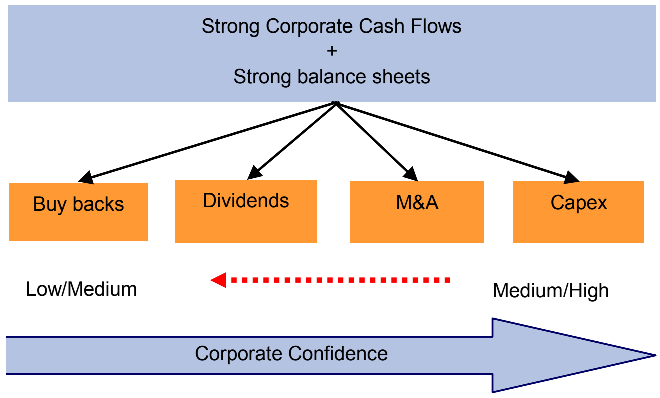
The Fed has indicated to remain conditionally on hold until mid-2013. Even the ECB hinted at a change in interest rate strategy after a reassessment of the Eurozone inflation risks. At Jackson Hole, Bernanke hinted at more Fed support to maintain the stalling US economy.

- Strong balance sheets

Contrary to the situation in 2008, companies are cash-rich and have a lot of spending power. The way companies spend this money will be an important force on the economy and financial markets. These high cash levels could also act as a buffer and increase our comfort level regarding the dividend payments, even if earnings growth would disappear.

However, we have become less confident that companies will embark on high-risk capital investments and M&A. These are decisions that can be postponed in the light of the increased economic uncertainty.

With this respect, we would like to recall the relation between the way corporate cash is spent and corporate confidence. In our view, confidence is waning hence the bigger focus on buy backs and dividends and less on M&A and capex. The IT sector may be an exception.

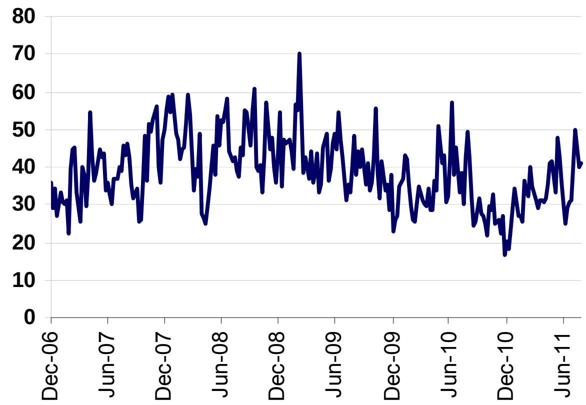


Source: INGIM (August'11)

- Market dynamics

Despite the at best mediocre medium-term outlook, there are some short-term support factors. Risk aversion is high, equity flows have turned negative and according to the latest surveys, investors are generally cautiously positioned in equities.

%-number of bears



Source: Datastream, INGIM (August'11)

Conclusion

After this months' sell-off, equities are quickly catching up with the reality of lower earnings growth. Although valuations are becoming attractive, we think that these do not offer enough downside protection yet against a recession (30/40% probability and rising) and/or an increase in systemic risks the Euro sovereign debt crisis may provoke. Only an improvement on at least one of these two fronts could lead to a sustainable upward move in equities.
In the meantime, volatility will remain high with myopic investors focussing on the latest data and policy statements.

Patrick Moonen
Senior Equity Strategist

Real Estate

- RE disconnects from rates amid systemic risk environment
- Overweight Japanese REITs

RE disconnects from rates amid systemic risk environment

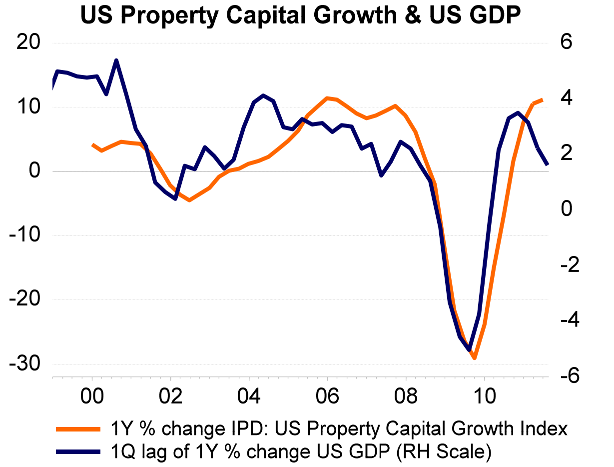
In-line with the economic recovery that followed the severe slump during the subprime crisis, the fundamentals of RE in developed markets have been improving. Unfortunately, the recovery process witnessed has been frustratingly slow. For RE companies and by extension for RE equities the relationship with economic growth is well established. Fundamental drivers of the real estate market like vacancy rates and rents tend to follow the fortunes of economic growth with a lag (of a few quarters). As a consequence thereof returns in the direct RE market and earnings at RE companies equally show a tight relationship with economic growth.

Global leading economic indicators over the short-term had become less of a support for RE recently. The 3 months momentum of global leading economic indicators has turned negative since May this year. It fell further in June and as economic data disappoint recently, in particular in developed markets, may very well continue to decline in the coming months. For RE this continues to pose a risk even after the correction in (RE) Equity markets.

To get some perspective of this risk one can compare the return of direct RE markets with economic growth. In the graph below we relate US economic growth to US Capital growth in the direct US RE market. A risk of downward correction in the US capital growth index is present as it reacts with a lag of one quarter (best fit) to economic growth.

Returns in the direct RE market and earnings for (listed) RE companies tend to react with a lag to economic developments. Reaction time is usually a function of lease lengths. As such apartments tend to react fastest as the sector has the shortest leases whereas the lag in the industrial and office segments is longer, in-line with the respective longer lease lengths in these segments.

Global economic growth already was expected subdued but recent developments are likely to lead to further downward revisions in the near future. This would put the recovery in fundamentals in the direct RE market and in RE earnings further out in time as well as below the already subdued expectations. A key factor in this respect is that RE lease renewals will have to take place in difficult economic times and will have to be reset at levels (far) below earlier peaks.



Source: Thomson Reuters Datastream, ING IM

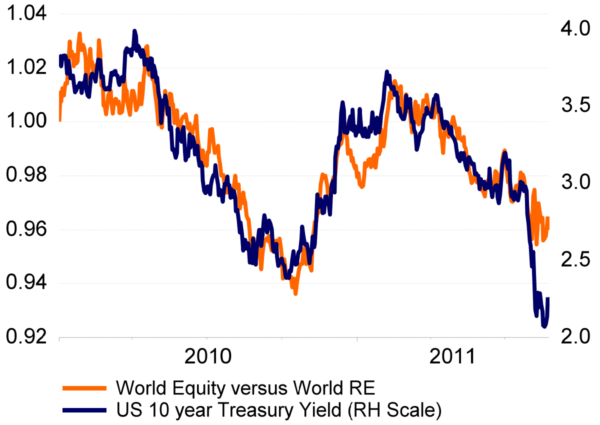
Apart from the "real economic" drivers, interest rates are a key determinant for the RE market. They tend to be an offsetting force as rates are inversely related to the economic cycle and RE remains the relatively more leveraged asset class. Because of the latter, RE equities have tended to outperform Equities recently during periods of falling long-term rates in developed markets and inversely during interest rate rises. This is highlighted in the graph below.

What appears to be happening this time around is that RE equities did not outperform equities in the most recent downward correction in markets and interest rates.

A disconnection between the evolution of long-term interest rates and relative RE performance has materialized. An explanation hereto may be that the cyclical downturn has been accompanied by renewed fears of severe systemic stress. During the subprime systemic crisis RE equities did underperform equities.

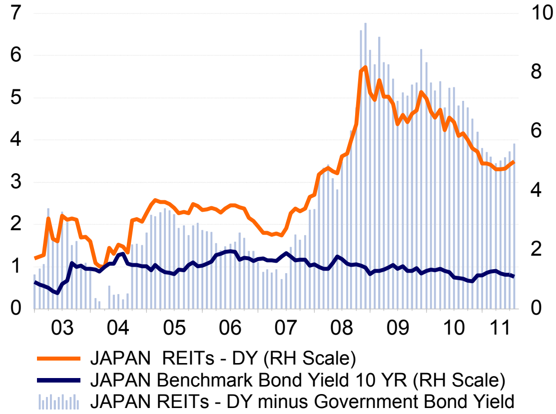
Investors not only discount the cost of financing for RE companies but equally the availability (or the lack thereof) of financing for RE projects. What the subprime crisis has learned is that RE companies tend to be quickly shut off from financing when financial markets enter systemic crisis territory. It therefore may not be before these systemic crisis fears abate that RE may renew the trend of outperformance that has characterized the major part of this year.

Equity relative to RE and 10 year rates



Source: Thomson Reuters Datastream, ING IM

Dividend Yield Japan REITs vs Government



Source: Thomson Reuters Datastream, ING IM

Overweight Japanese REITs

Japanese RE so far this year has been a distinct underperformer. While emerging markets at large were the biggest underperformer, Japanese RE was second in line, being the worst performer of major developed regional markets. The dramatic earthquake in March explains the bulk of this underperformance. Several factors have become more supportive to the region recently.

A first one is the economic recovery that is currently taking place. The “rebuilding” phase is underway and economic data so far have surprised positively. This tendency is likely to have legs over the following months. A second factor that may become supportive is related to the overall defensive nature of the Japanese RE market. During recent periods of systemic stress like the first Greek crisis in 2010 or the subprime crisis, Japanese RE has been systematically outperforming in EUR terms. An appreciation of the JPY as a result of a reversal of carry trades explains a (large) part of this outperformance.

Dividend yields of Japanese REITs stand out favourably for the region. This is applicable both in comparison to the bond yields as versus the dividend yield in the equity market. This applies specifically to REITs and much less to non-REITs in Japan. It is therefore specifically REITs that we want to be exposed to currently in Japan (J-REITs). In the graph below we plot the dividend yield of J-REITs (5%) in comparison to the government bond yield (1.08).

Price earnings ratio of broad Japanese RE is marginally above the one of the equity market. On a cyclically adjusted PE basis however Japanese RE still trades attractive. The relative cyclical adjusted PE is equally below the 5-year moving average of that ratio. Price-to-book ratio relative to the equity market is about in-line and conforms with its historic average.

Relative to expected net asset value, Japanese RE furthermore trades at a considerable discount (over 40%). This compares to a historical discount of around 28%.

Since its initial announcement December 15, 2010 (for an initial target of 50 bn JPY of purchases of J-REITs) the Bank of Japan upped the target twice, in March and early August of this year. The target J-REITs purchases are currently at 110 bn JPY till the end of 2012. The meter by mid-August stands at 39.2 bn JPY purchases, about in-line with the time elapsed since announcement.

By mid-July this year the BOJ reengaged in purchases after having been silent for 3 months. These future purchases will form a downward protection for J-REITs, in particular as they are likely to be accelerated in times of stress.

J-REITs moreover are also expected to benefit from a trend towards new buildings in Japan, with higher earthquake resistance standards. REITs tend to own a bigger share of these prime buildings.

Finally property transactions in Japan are returning to pre-earthquake levels. Occupancy, primarily at Office REITs, is equally on the rise. The central business district office vacancy rate in Tokyo fell to 8.76% in July, after having peaked in March of this year at around 9.20.

Conclusion

The sovereign crisis casts a cloud over the RE outlook. Long-term interest rates (DM) disconnected from relative RE performance. It will likely not be before these concerns subside that RE may renew the trend of outperformance.

Several factors may reverse the underperformance of Japanese REITs. We move J-REITs to overweight.

We have an underweight position to the RE asset class currently.

Koen Straetmans
Senior Strategist, Real Estate and Commodities

Commodities

- Commodities start discounting cyclical downturn
- Profit taking on corn

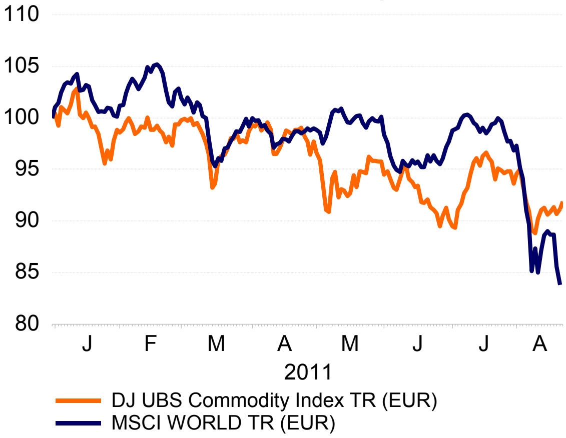
Commodities start discounting cyclical downturn

What during the beginning of 2011 still was disregarded as unlikely has over the last weeks decisively started being discounted in commodities markets. Both the likelihood of an early cyclical downturn and the risk of a renewed systemic crisis have started to weigh on the complex. This is broadly in line with other risky assets (most notably equities) that suffered from the same concerns.

The commodity universe however has certain characteristics that set it apart from other asset classes. These differences mostly stem from two factors. The first one is related to the composition of the complex that is broadly diversified over different segments and commodities within the segments. This provides offsetting forces in times of stress. The second refers to the drivers of commodity demand that have changed over time with emerging markets, most notably China, taking the lead role.

In the graph below we plot the evolution of commodity and equity prices in EUR since the beginning of this year. Global equity markets outperformed commodities until end July. This corresponded with the hope that sovereign risks in Europe would be contained (and ultimately appropriately dealt with) and the prospects of a continued albeit slow economic recovery in developed markets. Both have decisively turned for the worse recently and commodity markets have started to discount this.

Commodities & Equities



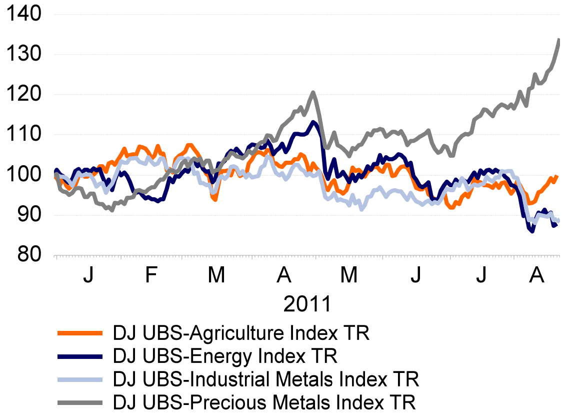
Source: Thomson Reuters Datastream, ING IM

MSCI World and the S&P 500 fell by about 15% from their most recent peaks, whereas commodities (DJ UBS) fell less, by about 5%. Since the peaks on the year the correction of S&P and world equity markets is more than 15% whereas the correction in commodity markets amounts to over 10%. For commodity markets this corresponds to corrections that historically tended to be associated with starts of a recession.

With respect to the sector performance within commodities the pattern that appears seems to correspond to the early stages of the subprime crisis. Precious metals started outperforming with Energy and Industrial Metals taking a dive recently. The Agricultural segment, led by its own dynamics, held up relatively well, performing in between the precious metals segment and the more cyclical segments.

Commodity sector performance in USD

2011



Source: Thomson Reuters Datastream, ING IM

The relative performances of commodity sectors were broadly matched by investment flows within the commodity segment. Precious metals, both silver and gold, witnessed the sharpest increase in investment flows since several months while industrial metals saw outflows. With systemic risks rising gold in particular attracted renewed inflows whereas the cyclical concerns started weighing on the industrial metals segment. The overall correction of the commodity markets however so far remains relatively contained, in particular thanks to the solid performance of the precious metals segment and to a lesser extent the agricultural segment.

A re-run of the subprime crisis would leave considerable further downward potential in especially in the more cyclical segments Energy and Industrial Metals. Agriculture and Precious Metals may equally fall victim to profit taking putting further downward pressure on the commodity complex in such a scenario. In the agricultural segment some outflows have already been seen over recent weeks signalling some form of profit taking. At this point in time a full-fledged systemic crisis and sharp economic slowdown is not our central scenario but it is a risk that cannot be disregarded i.e. as policy options both fiscal and monetary are diminishing and willingness to engage in credible medium term plans seems further away than at the beginning of the year.

Another factor that so far did form a cushion to the downward correction in the commodities markets is related to the structural changes that become increasingly present in the complex. Emerging markets and China in particular become increasingly dominant in the fundamental market balance. BRIC countries meanwhile represent more than 40% of global consumption of the bulk of commodities, taking up a (more than) 100% contribution of demand growth over the last years in certain cases (industrial metals). China in particular may therefore form a counterweight against an economic slowdown in developed markets.

For commodities this may continue to be supportive even as Chinese economic growth slows down further. The reasons therefore are twofold. Firstly, a distinction has to be made between demand growth and level. Despite slowing economic growth and resulting demand growth for commodities, levels of demand for commodities (like oil, copper or certain agricultural commodities) are still expanding on an annual basis. It may therefore be premature to become outright bearish on commodities because economic growth is slowing, at least in a soft landing version. The second reason is that broad commodity supply is still heavily constrained. The supply constraints take different forms and shapes resulting from years of underinvestment, geopolitical risks, falling resource grades, weather disruptions, power constraints, labour disputes or currency rises in producing countries. The marginal production cost of commodities has therefore shifted upward providing a higher floor for medium term commodity prices. As long as demand growth for commodities remains positive and levels expand while supply remains constrained the commodity complex will be fundamentally underpinned.

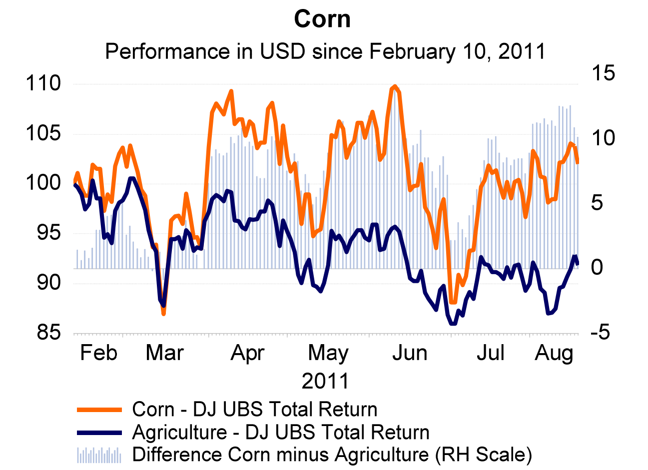
As a result of above structural demand shifts (with emerging markets being in the more commodity-intense phase of expansion) and supply constraints, has the sensitivity of commodity demand and commodity prices to global economic growth increased over the last decade. As such is the estimated global income elasticity of oil demand currently around 1, twice as high as during the 90s. A further consequence of above supply and demand characteristics is that a lower level of global economic growth is needed to still exert upward commodity pricing pressure than in the past, although it remains difficult to put a number to this "breakeven" level of global economic growth.

Meanwhile have the latest data out of China continued to show a deceleration in economic growth as witnessed by PMI manufacturing or industrial production data. With the approaching peak in inflation however an end of monetary policy tightening nears which, in combination with fiscal firing power already in the pipeline (social housing in particular) or left over if things deteriorate further, should protect on the downside.

Profit taking on corn

The Agricultural segment, as said above, did hold up relatively well during the latest sell-off. Corn in particular did well. The WASDE report was the latest catalyst to corn's performance. US corn yields were sharply revised down for the 2011-12 season leading to an expected US stock-to-use ratio for corn of only 5.4% which can be classified as critically tight. On the global corn balance, adjustments were minor as the downward US corn production was compensated by higher expected Brazilian and Ukrainian crops.

The current climate however is one where profit taking is likely as is equally indicated by the latest investment flows within the commodity universe. We therefore prefer to lock-in the relative outperformance of corn (see graph) and revert the position from overweight back to neutral.



Source: Thomson Reuters Datastream, ING IM

Conclusion

Concerns over an early cyclical downturn and the risk of a renewed systemic crisis have started to weigh on commodities recently. The correction so far however remains contained thanks to the solid performance of precious metals and to a lesser extent agriculture.

With demand levels for commodities still expanding and commodity supply constrained, some protection on the downside remains even as global growth decelerates (at least in mild form).

We have an underweight allocation to commodities currently as well as an overweight to the precious metals segment. We took profit on corn.

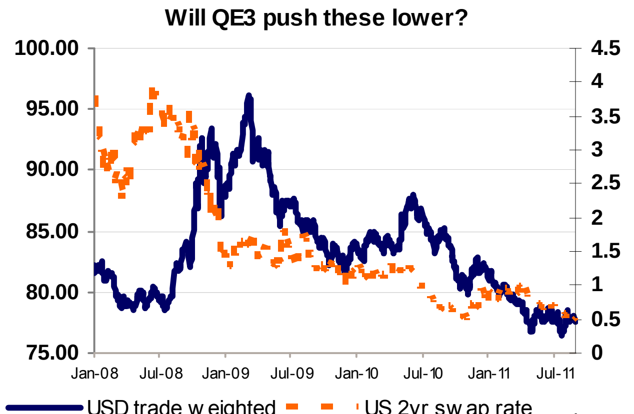
Koen Straetmans
Senior Strategist, Real Estate and Commodities

FX

- USD not impacted by 'Jackson Hole'
- Commodity/EM FX recovers in line with S&P

The major crosses – EUR/USD and USD/JPY – were almost unchanged from the levels a week earlier. Markets had been busy anticipating Bernanke's Jackson Hole speech. However, it turned out that there were no major surprises.

The Fed chairman decided not to explicitly discuss the prospect for asset purchases. Most noteworthy was the remark that the September FOMC meeting has been expanded to two days to allow a fuller discussion of easing options. This suggests that there is a probability of additional easing measures.



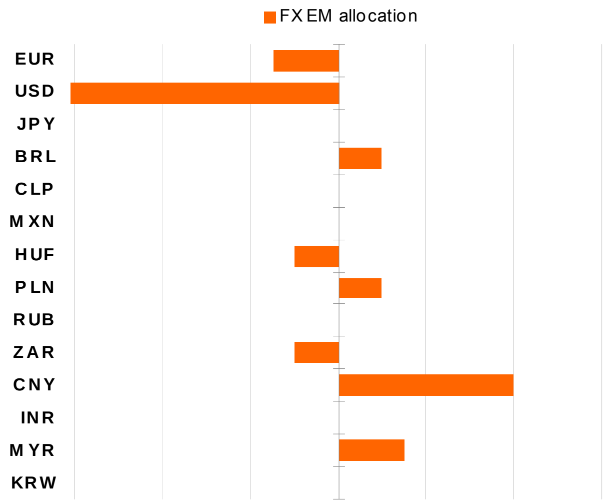
Source: Bloomberg

The question is what the impact will be on the US dollar. As can be seen in the chart below, US 2-yr yields have already dropped back to the lows of early November 2011 (just before the Fed started QE2). Currently, the markets are not pricing in any Fed rate hikes for the next 12 months.

Moreover, it is not inconceivable that the economic background, which will convince the Fed to implement additional easing, will also induce other central banks to ease monetary policy. The net result on the US dollar is therefore not clear, in our view.

Apart from the Jackson Hole conference, the major development on currency markets was a recovery of commodity and Emerging Market currencies. In general, currencies that had suffered the most – like TRY or ZAR – also saw the strongest recovery last week.

In view of the uncertain cyclical outlook and potential risks surrounding the European sovereign debt issue, a cautious investment stance still seems warranted.



Source: ING IM (31/08/2011)

Jaco Rouw
Senior FX strategist

Thibault Lair
Investment Manager STAAG

Asset Allocation

- Double-dip probability at 30-40% and rising
- Political risks and EMU sovereign concerns not over yet
- Equities, commod. & Real estate UW, Fixed Income OW

Increasing double-dip probability

Recent economic indicators while mixed connote a cyclical pause in global economic growth. Adding to supply chain disruptions from Japan's earthquake and purchasing power reduction from earlier commodity price rises, growth slowdown is now more apparent in the US and also in a number of European economies. While a "double-dip" in world growth is not the base case yet, risks for such have intensified. We attach a 30%-40% probability to this and the probability is rising.

Global PMI's are falling back although still signalling growth rather than contraction of the manufacturing sector (barely) and the service sector (more headroom). However, labour markets remain sluggish, spare capacity remains evident across the major Western economies and general confidence levels are undermined by sovereign debt and policy concerns.

Monetary policy tightening is well underway across a number of emerging economies, in response to rising demand and inflationary pressures. Policy tightening is at its early beginnings in Europe but with European stresses again unfolding these will be put on hold. In addition, the US has conditionally indicated no rate hike before mid-2013 and also the BoE turned more dovish.

Fiscal policy retains central focus for key economies albeit with political populism weighing on efforts to move towards more sustainable budget paths. This is evident in the US, the UK and a number of countries in Europe.

European sovereign debt concerns were only temporarily alleviated following EU Summit announcements made in respect of the smaller peripheral countries. Contagion beyond the peripheral countries into Spain and Italy re-emerged quickly and the ECB re-initiated the SMP buying Spanish and Italian bonds (EUR 22 billion!) in an attempt to bring bond yields back to more sustainable levels. A medium to longer-term solution is not yet provided and may imply an extension of the EFSF, the issue of Eurobonds and/or the loss of fiscal sovereignty of peripheral states.

Elsewhere the US debt ceiling issue appears to have been resolved, again appealing to the near term but not the long term resulting in the downgrade of its long-term debt rating by S&P. Fiscal drag, growth restraint and debt sustainability are concerns likely to linger well into 2013.

Risk off

Flattening economic growth, less accommodative fiscal policy settings, populist political overtones and sovereign stress combine to keep risk at low levels.

Our qualitative asset allocation assessment is becoming more cautious as regards risk, due mainly to increased conviction about cyclical decline. Reduced consumer and corporate confidence, stemming from labour market weakness, debt concerns and political populism are key near-term headwinds.

Our Quantitative assessment remains directionally constructive towards fixed income and commodities, negative for equities and neutral for real estate.

In view of the interplay between qualitative and quantitative inputs, European sovereign stress, US economic slowdown and a softening in the economic outlook in H2'2011, our tactical positioning is underweight commodities, equities and real estate, and overweight fixed income (overweight AAA Treasuries, UW spread products).

Asset allocation context

Equity market support has been evident in robust corporate earnings but is again overwhelmed by sovereign debt issues and double-dip fears. Companies have been applying cash on their balance sheet to pursue further buy-backs, M&A & capex, however outlook statements and guidance has turned cautious and a tapering of these supports is in prospect. Consensus earnings expectations for 2012 are unrealistically high (+15% versus our own 0% estimate). Softness in leading indicators, broad-based downturn in forward earnings momentum across the key global equity markets, removal of policy accommodation and sovereign stress and debt are strong headwinds. Emerging markets are preferred to developed markets but are not immune to growth concerns and a sharp increase in risk aversion.

Fixed income spreads are more constructively positioned towards emerging markets assets, supported by fundamentals and relative momentum indicators. Prospects are more mixed in respect of corporate and household exposures in credit space, and the attractiveness of high yield and senior loans has fallen back somewhat.

Eric Siegloff
Global Head, Strategy & TAA Group

Valentijn van Nieuwenhuijzen
Head of Strategy