

ING Investment Management Market Perspective

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Figure 1. ISM PMI* indicates that a broad economic contraction started in September.

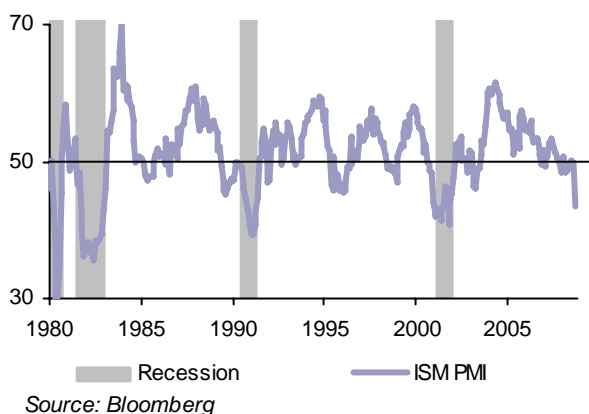
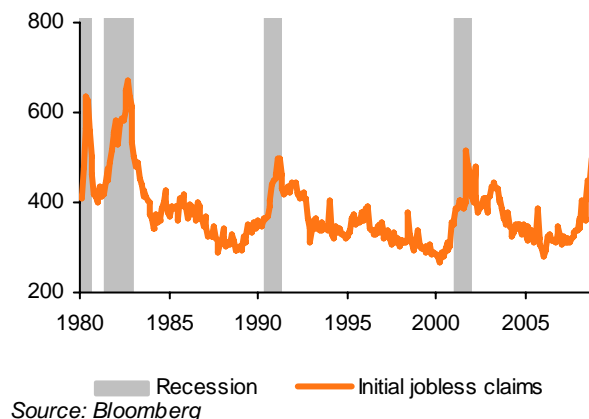


Figure 2. The level of initial jobless claims is now consistent with last two recessions.



Has the market started pricing in a deeper recession?

Dramatic developments in the last months and weeks, as the financial crisis deepened and spread globally, have diverted media and investor attention away from more mundane macroeconomic matters.

In the weeks preceding the final Congressional vote there has been at times an almost euphoric anticipation in the equity market, rehearsed over several false starts in the previous two weeks, of an imminent relief rally once the House of Representatives approves the rescue bill. All this changed on October 1, when the September ISM manufacturing survey data (PMI) were released. It took investors another day to digest the news and on October 2 the market went down in a non-dramatic fashion (S&P 500 declined 4% and Dow Jones index declined 3%) with the weakness broadly spread among materials, industrials and energy sectors. The market, previously fixated on financial stocks in anticipation of the final Congressional vote, finally turned its attention to the consequences of the current crisis to growth and earnings in the real economy. Sober realization that recession has arrived and that financial crises take time to be resolved started sinking in.

Why did it take so long for the market to start pricing in a serious recession? The current U.S. recession, if one uses the NBER definition of broadly spread decline in economic activity, probably started in January 2008. Our proprietary recession model dates the beginning of the recession to that month. Initially, however, the economic slowdown was milder than in previous cycles and seemed to unfold in slow motion. That gave investors a false sense of security in feeling that the economy was probably skirting a recession. This mood prevailed during every bear market rally since the beginning of the year – an almost astonishing optimism in the face of the gravest financial crisis since the Great Depression.

The initial weakness of the economy seemed to be well contained to just two sectors both badly affected by the deflation of the housing bubble: a contracting housing industry, and a financial sector struggling under a crumbling superstructure of real estate-related derivatives.

* Formerly known as the Purchasing Managers' Index, PMI is an indicator of the economic health of the manufacturing sector. PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and employment. A PMI reading over 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.

Manufacturing (outside industries directly hurt by high oil prices such as autos and airlines) – the place where recessions traditionally start – remained in reasonably good shape through the first half of the year and seemed immune to the travails of domestic banks and consumers. Corporations were perceived as being protected from the unfolding credit crunch by healthy balance sheets, large amounts of accumulated cash (\$638 billion as of June), and lean inventories. The continued buoyancy of the overseas economies and a more competitive U.S. dollar gave support to manufacturing in the first half of the year. The 2.8% real GDP growth in Q2 was largely attributable to net export growth.

The picture changed abruptly during the summer. European economies, affected by uncompetitive currency, high interest rates, high commodity prices and the financial contagion from the United States, started a precipitous slide into recession. Evidence of declining trade volumes in Asia and other emerging markets followed.

The September PMI reading of 43.5 points to the start of a broad contraction in the U.S. economy, and confirms that global recession is on the way and is worse than expected. Some other indicators that were weakening from the beginning of the year have now also reached levels consistent with full-blown recession. Initial jobless claims increased to 497,000 in the last week of September — a level consistent with previous recessions. With payroll losses of 159,000 in September, the unemployment rate is expected to rise in the next two quarters over the current elevated rate of 6.1%. A decline in housing starts from 954,000 July to 895,000 in August (the latest data available) and an accelerated annual decline in the Case-Shiller housing price index (16.4% in July compared to 15.9% in June) dampen hopes of housing market stabilization any time soon.

Finally, the spillover from the financial crisis has started affecting weaker corporations. The Citigroup High Yield index shows that the spread over U.S. Treasury yields that non-investment grade companies have to pay to borrow in financial markets has increased by 200 basis points in September to 10.6% — higher than in the last recession.

We now expect the market to turn its attention to corporate earnings, where consensus forecasts for 2009 remain unrealistic and practically unchanged since the beginning of the year, and start pricing in a deeper recession.

Figure 3. Funding costs have become prohibitively high for weaker corporations.

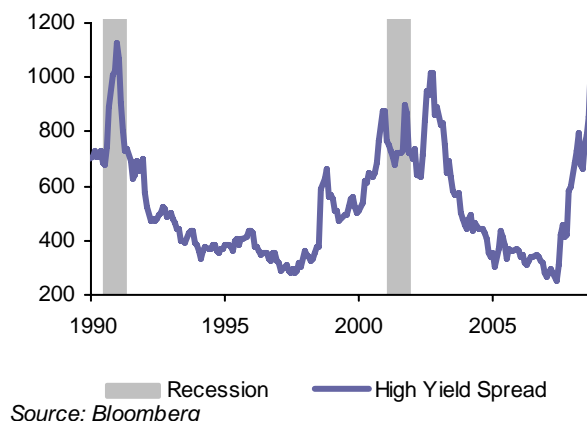
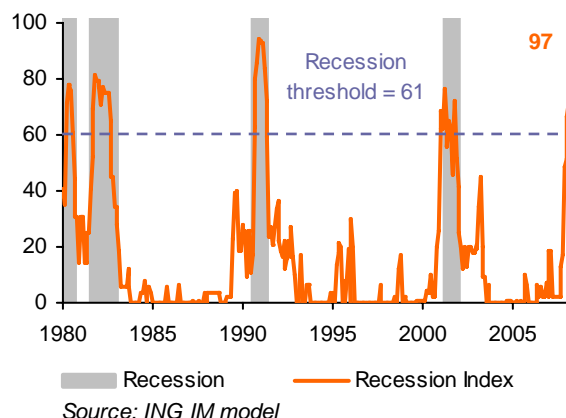


Figure 4. Our proprietary recession model suggests that the current recession could be deeper and longer than the last one.



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