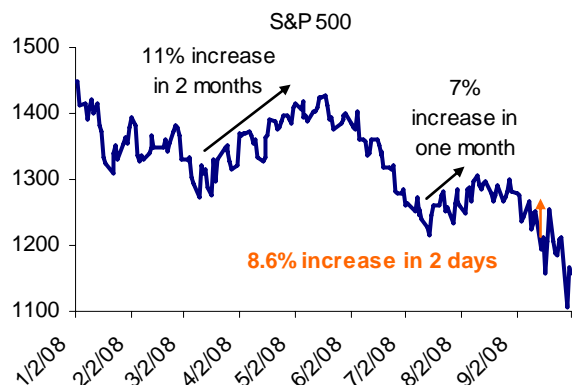


ING Investment Management Market Perspective

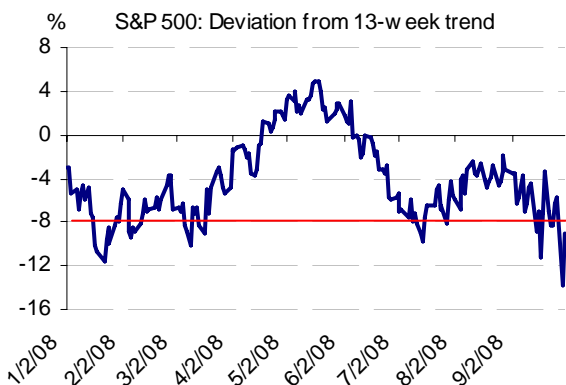
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Figure 1. Market upswings have become larger in magnitude and shorter in duration.



Source: Bloomberg

Figure 2. Oversold condition pre-shadowed previous bear rallies.



Source: Bloomberg

Contrarian indicators are not signaling a conclusive bottom

This year as the financial crisis unfolded, market sentiment indicators have become an increasingly valuable tool for gauging the degree of prevailing pessimism and identifying turning points for intermittent bear market rallies.

We have found that market bottoms often occur when three indicators go past a threshold value: A deviation of the S&P 500 below trend by 8% or more (an oversold condition), a VIX index of implied stock market volatility above 30% and a put/call ratio greater than 1.0.

As the crisis deepened this year broader measures to quell the crisis were required from the government. At the same time, the temporary boost these measures were providing to the market became shorter in duration and market swings more violent.

The first market “capitulation” happened at the beginning of March. The sentiment or contrarian indicators we follow gave a clear and sustained signal of an intermittent bottom on March 14. The oversold condition as measured by the deviation of the S&P 500 index from its 13-week trend persisted for two weeks. The VIX index of implied stock market volatility breached the 30% threshold for several days and the put/call ratio spiked above a neutral level several times during two weeks. On March 17, the announcement of Bear Stearns bailout gave the market a boost that lasted two months during which the market rose by 11%.

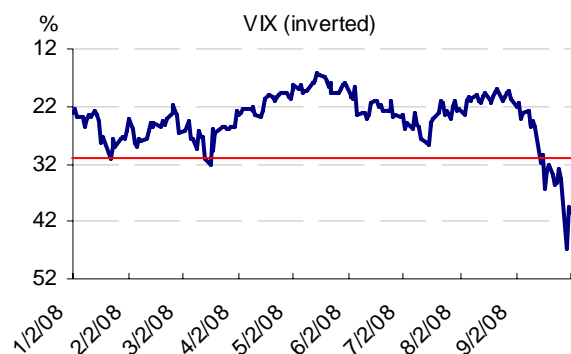
The second episode happened around mid-June. The market displayed a brief oversold condition, but two other indicators did not register the required level of doom: The VIX, although coming close to its threshold in intraday trading, did not breach that level. The put/call ratio never came even close to surrender level. We did not make a bottom call at that point. On July 15, however, Congress approved a plan to shore up troubled Fannie Mae and Freddie Mac, which effectively converted the implicit government guarantee of their debt into an explicit one. That gave the market another shot in the arm. Enthusiasm lasted for a month – and the market rose 7%.

The following months were full of bailouts and failures of increasing proportions – nationalizing the GSEs, Lehman’s bankruptcy and the AIG bailout. The market was sliding down and on September 15 seemingly reached a bottom of gloom: All three indicators signaled surrender. But it was short-lived. Within two days the government came up with a proposal for a comprehensive solution to a systemic problem: The \$700 billion financial-rescue package. The market shot up by 8.6% in two days but has been sliding down since and dropped again on September 29 when the House of Representatives rejected the plan.

So where are we now with regard to market sentiment?

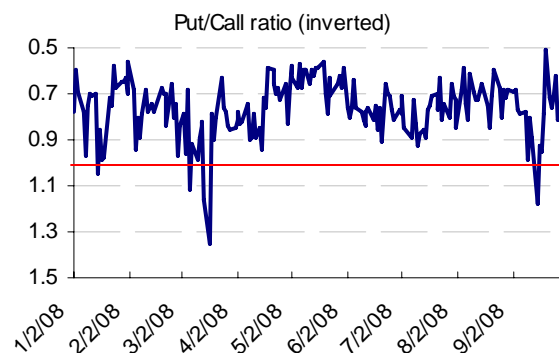
An oversold condition persists; volatility is historically high, overshooting the 30% and 40% thresholds for two weeks now. Market cautiousness, however, as measured by the put/call ratio, has not returned to market-bottom levels after one day of a desperate spike on September 15. This does not seem like a bottom in sentiment. High implied volatility, in our view, is a market response to increasingly violent mood swings of the market – an indication that option writers require higher option premiums. But the fact that there are more calls than puts bought on each day during the past two weeks of exceptionally high volatility points to the unrelenting optimism which has been characteristic of this year’s bear market. The tendency to expect higher degrees of government intervention formed into an almost perverse dependency. Investors seem to believe that the government protects the downside (no need to buy a put protection). At the same time upswings have become so large and short-lived that to make a profit requires turning on a dime, which in itself could be dangerous. To protect themselves against a violent upside and to capture a longer lasting upswing if one materializes, investors bought call options and are now basically waiting on the sidelines. This sentiment does not look like a classical capitulation or surrender at the bottom.

Figure 1. Options implied volatility has remained above 30% for two weeks.



Source: Bloomberg

Figure 2. More call options than put options were bought over the last two weeks in anticipation of a possible rally.



Source: Bloomberg

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