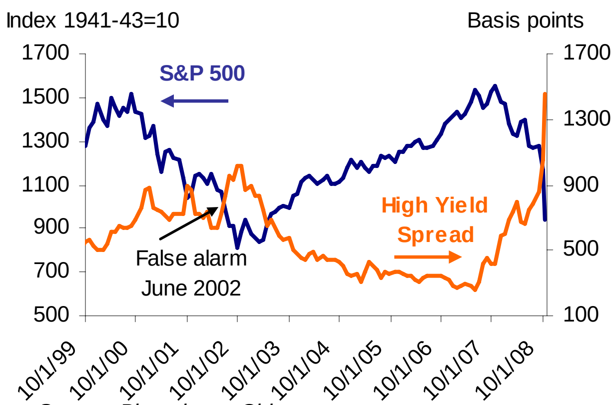
ING Investment Management Market Perspective

For more information, please contact:

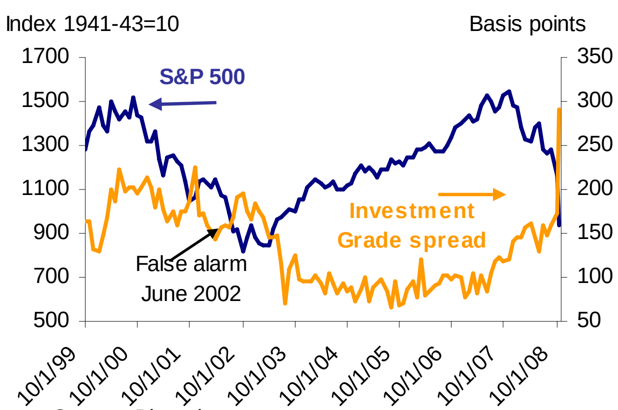
Nora Omarova
Senior Quantitative Analyst
212.309.6582
Eleonora.omarova@inginvestment.com

Figure 1. The stock market mirrors the stress in the high yield credit market.



Source: Bloomberg, Citigroup

Figure 2. The investment grade credit market is at an extreme stress level.



Source: Bloomberg

Perils of a bottom call: Comparison of the 2002 and 2008 bear markets

In a bear market such as the one we find ourselves in now everyone wants to know: Have we hit bottom? We have developed a contrarian indicator model[1] that signaled on October 10 that the market had reached a bottom. How reliable are those signals? And what kind of turnaround are they signaling? To provide some perspective, we take a look at how reliable those signals were in the last bear market.

During the 2001-02 bear market the model signaled five episodes in which the stock market bottomed out. Three of them turned out to be strong bear rallies, one was a false alarm, and the last call correctly predicted the ultimate bottom of the bear market in September 2002. While that is arguably a respectable performance, the single episode of false alarm gives a valuable historical perspective into what could go wrong with a prediction based on usually reliable quantitative measures solely tied to an equity market.

The second bear rally, correctly predicted by our model, started in September 2001 and continued until the end of March 2002, producing an 18% return. This intermittent rally coincided with substantial spread compression in both high yield and investment grade bonds. The economy had just reached its trough and was turning around; by March 2002 it was obvious that a sharp upswing was happening in industrial production. Valuations, however, remained expensive and the rally fizzled.

By mid-June 2002 the market, after having declined 30% from the peak, was oversold again and conditions were forming for another bottom or a bear rally. The economy had started to grow, industrial production was up, and the trough of the 2001 recession had occurred seven months before.

At that time our contrarian indicator model produced the only false alarm in a 10 year sample. The expected rally was derailed by a sudden worsening of credit conditions as evidenced by sharp spread widening: Both high yield and investment grade spreads widened by 385 and 50 basis points during six months from April to September 2002 at the peak of corporate and accounting fraud scandals. This was accompanied by a decline in the equity market by another 24% from May to September, when the final bottom was reached.

The market gyrated close to the September bottom for another six months before finally taking off in March 2003, precisely when credit spreads started to compress. This episode strongly suggests that stabilization in credit markets is a necessary condition for the equity market to have a sustained rally, even with all other signs of a bottom in place.

This year the model has produced two bottom calls. The first one, on March 14, was followed by a two-month-long bear rally with the market rising 11%. The second one, on October 10, while still holding on as of this writing, nevertheless warrants comparison to the summer 2002 episode.

Right now the equity market is in a more vulnerable spot than it was in June 2002 when the model produced a false alarm. The economy is at an earlier point in the business cycle, with a sharp decline in industrial production just starting in September 2008, and the intensity of the stress in credit markets surpasses the 2002 extremes.

Credit conditions, as reflected in credit default swap spreads of financial institutions, overnight LIBOR[2] rates, and the TED[3] spread, have shown some signs of improvement. Longer-term credit conditions, however, remain extremely tight. The high yield spread over U.S. Treasuries increased to an unprecedented 14.5% on October 20, with 390 basis points of widening having occurred since the end of September. Investment grade companies' borrowing costs have also been rising fast: the AA corporate bond spread over Treasuries has reached 2.9%.

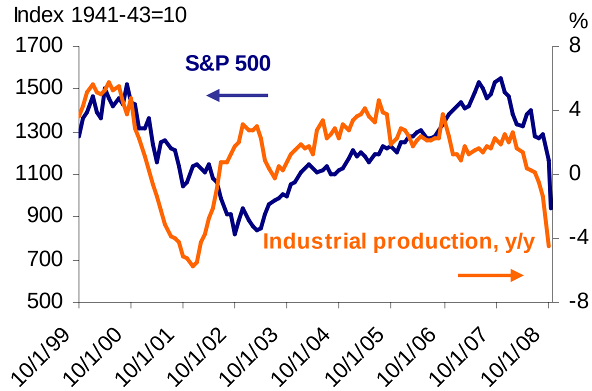
History has shown that equity markets, looking at attractive valuations, can withstand a stream of bad economic news in anticipation of a turnaround in the economy. But stress in credit markets can dampen any attempted rally. This time it seems to be as likely to occur as ever.

1 Our contrarian indicator model signals a bottom 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. For more details see *Market Perspective* as of October 2 and October 13.

2 London Interbank Offered Rate is the interest rate banks charge each other for short-term loans. LIBOR is used as a reference rate for borrowing costs all over the world.

3 The difference between 3-month LIBOR rate and 3-month T-bill yield.

Figure 3. The recent decline in industrial production is indicative of an early stage of a downturn.



Source: Bloomberg