

ING Investment Management Market Review

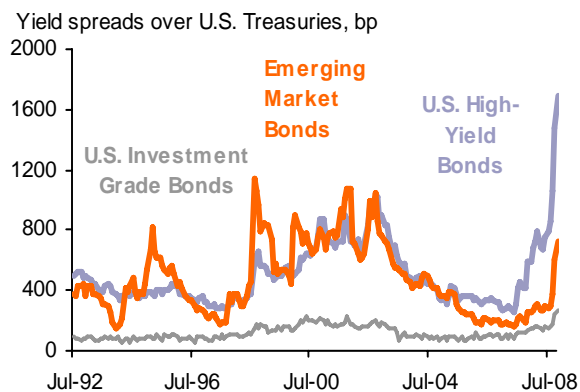
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The Great Debt Unwind

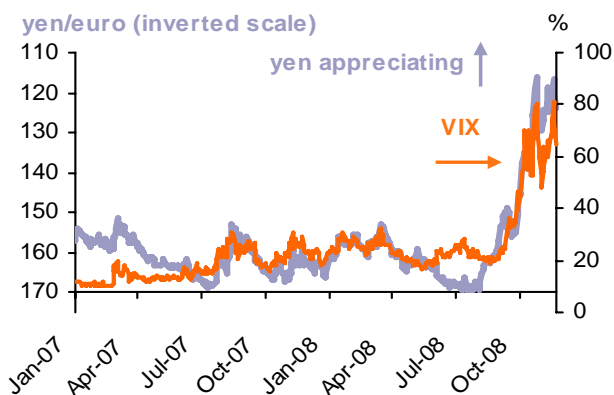
Markets have obviously been behaving in some truly unusual ways recently. Volatility in the U.S. stock market has risen to unprecedented levels for the Postwar period, with the VIX index of expected future stock market volatility rising to an all-time high of 81% on October 10. It has not come down much since then and in recent days has averaged about 70%; historically it has averaged around 20%. Spreads on credit-sensitive bonds of all varieties have risen to all-time highs, with spreads over Treasuries on investment-grade bonds reaching levels at which low-rated high-yield bonds traded just months ago. In a matter of weeks the yen has skyrocketed against the dollar even as the euro has fallen relative to the dollar. What is going on?

Figure 1. Credit spreads have widened in recent weeks to historically high levels.



Source: Citigroup and JPMorgan

Figure 2. Yen/euro and implied volatility in the S&P 500 have been tracking one another closely.



Source: Bloomberg

At first glance it might appear that these extreme market movements reflect growing worries about the credit crisis, a looming global recession and instability in the financial system. But stock market volatility is now much higher than during the severe 1981-82 recession, and it is hard to see how recession concerns can explain recent movements in currency markets, such as the sharp rise in the yen relative to the dollar and the euro. A more plausible explanation is the unwinding of leverage in financial markets, especially hedge funds.

Hedge funds got their name from the practice of going long in assets the funds expected to rise in value and selling short assets whose prices they expected to fall. Theoretically, this practice hedges the fund against overall market movements: in the event of a market decline, losses on the long positions would be offset by gains on the short positions. But it is no secret that in recent years many hedge funds have instead followed a strategy of borrowing heavily to fund long positions in stocks or fixed income instruments. Such strategies are generally not neutral with respect to movements in equity and fixed income markets. Indeed, Professor Jeremy Siegel of the Wharton School has pointed out that as of late October hedge fund returns were about minus 20%, about half of the loss on the S&P 500. This implies a beta of 0.5, indicating a substantially greater sensitivity to market movements than would be the case if the funds were hedged (October 25, 2008 *Weekly Commentary* found on Jeremysiegel.com).

One especially popular strategy with hedge funds has been the carry trade, in which a fund borrows in a low interest-rate currency such as the yen and invests in higher-yielding assets. For carry trades to work, however, prices of the

assets and currencies used in the trades need to be stable. The trouble is that markets have been anything but stable lately.

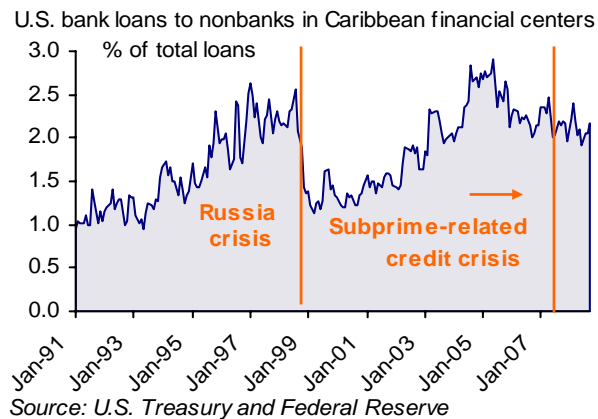
De-leveraging: The common thread

The VIX index of expected future volatility on the S&P 500 implied by options prices had been trading at or slightly above its historical average of about 20% since June of this year. It wasn't until the weekend of September 13-14, when Lehman Brothers failed and Merrill Lynch was hastily merged into Bank of America, that the VIX began its relentless rise to new historical highs, closing at 81% on November 20 — a period over which the S&P 500 fell by 40%. Falling asset prices and rising volatility triggered selling orders by hedge funds' risk models, and led to redemptions by clients worried about looming losses. As hedge funds and other leveraged investors sold assets and unwound their leverage, the selling triggered further price declines and further efforts to unwind leverage. As liquidity diminished this boosted yields and spreads over Treasuries on credit sensitive bonds, arguably well beyond what could be justified by expected default rates — even in the face of what appears to be a severe global recession developing. (Investors require a higher yield on a bond they believe has become less liquid to compensate them for the lessened ability to sell that bond promptly and economically.) Hedge funds and other investors that had put on carry trades involving borrowing in yen drove up the value of that currency relative to the dollar and the euro as they bought yen to repay their debt. Thus, it is this de-leveraging process that explains the wide credit spreads, high VIX and rising yen-euro visible in Figures 1 and 2 all at once.

Are we there yet?

At the outset it has to be acknowledged that accurate data on hedge fund leverage do not exist. The largely unregulated hedge fund industry has no obligation to report its balance sheet to the public or regulators. Perhaps the most widely followed proxy for hedge fund borrowing is loans made by U.S. banks to nonbank entities in Caribbean financial centers. Hedge funds often organize themselves in financial centers such as the Cayman Islands or the Bahamas. These data, unfortunately, are available only with a fairly long lag. The most recent data are from September 2008. In dollar terms these loans peaked in April 2007, about two months after it became apparent that defaults on subprime loans were rising, and have been trendless since then. But as a portion of total loans and leases at U.S. banks these loans have declined by 25% from their peak in May 2005 and are now at early 2004 levels.

Figure 3. A proxy for hedge fund borrowing shows a pronounced downward trend in debt.



While the data on loans to nonbank entities in Caribbean financial centers indicate that quite a bit of de-leveraging has already occurred, there is no way to know from these figures alone whether that process is over or close to being done. A survey of clients taken in the first two weeks of November by Sanford C. Bernstein & Co., however, suggests that considerable de-leveraging has already occurred. Most respondents to that survey (63%) thought that the hedge fund de-leveraging process is at least half over, while 23% thought that the process was at least three-quarters complete. This provides some cautious grounds for hope that correlated extreme market movements of the past few months may be coming to an end before too long.

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