

ING Investment Management Market Perspective

December 9, 2008



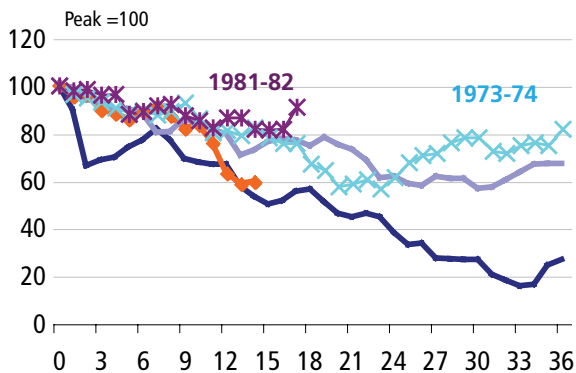
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In the crystal ball of history

With the bear market in its fourteenth month, and the equity market up 21% from its November 20 low, everybody wants to know: Have we reached a bottom? How long could the current bear market persist? To provide a historical perspective we decided to take a look at comparably long bear markets, particularly those that were accompanied by financial crises: The bear market of the Great Depression and Japan's bear market in the first three years following the burst of its equity and real estate bubbles.

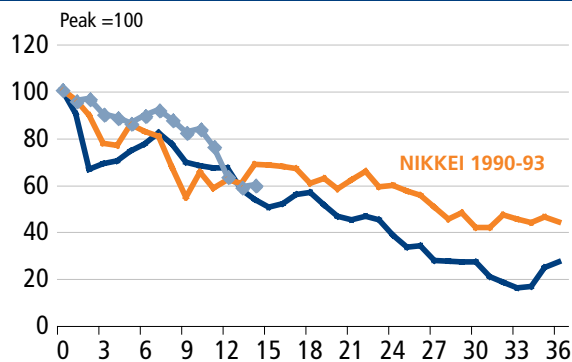
These two episodes are especially relevant because both reflect market- and economic downturns that coincided with a deep financial crisis. Academic studies have shown that economic slowdowns or contractions are particularly deep and prolonged when preceded by or coinciding with a banking crisis.¹ In terms of pricing in both a severe recession and unprecedented countercyclical measures on the part of the government, these two episodes could provide some useful benchmarks for market performance going forward.

Figure 1: The current bear market has priced in deeper than usual recession in October 2008.



Source: Bloomberg, R. Shiller, ING IM estimates

Figure 2: The market has followed the Great Depression pattern for two previous months.



Source: Bloomberg, R. Shiller, ING IM estimates

To put these recessions in perspective the relevant stock market indices — the S&P 500 Index, the Composite S&P of Robert Shiller and the NIKKEI 225 Index — have been rebased to equal 100 at the peak that preceded the equity market slump. The pattern evident in Figure 1 suggests that for 12 months following its peak in October 2007 the current bear market has closely tracked the usual pattern of major recession-triggered bear markets. Since October 2008, however, when financial stress became acute, the market has priced in a deeper and longer recession.

The chart in Figure 2 shows that in the past two months (October and November 2008) the equity market has aligned itself with the pattern similar to the Great Depression bear market. By comparison, following its peak in December 1989 the NIKKEI 225 did not display a comparably deep decline 12 to 14 months later (it actually had a bear market rally at that point). Following the burst of its stock market bubble and a slide in land- and housing prices, Japan managed to engineer a “soft landing” — the economy did not contract (although there was virtually no real growth for three years).

The current stock market may fluctuate in the “performance corridor” between the Japan 1990–93 and the U.S. 1929–33 experiences. That would imply an S&P 500 Index level some-

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¹ *World Economic Outlook*, Chapter 4 - Financial Stress and Economic Downturns, IMF October 2008, pages 129-158; Reinhart, Carmen M., Rogoff, Kenneth S., “Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison”, NBER Working Paper No.13761 (2008).

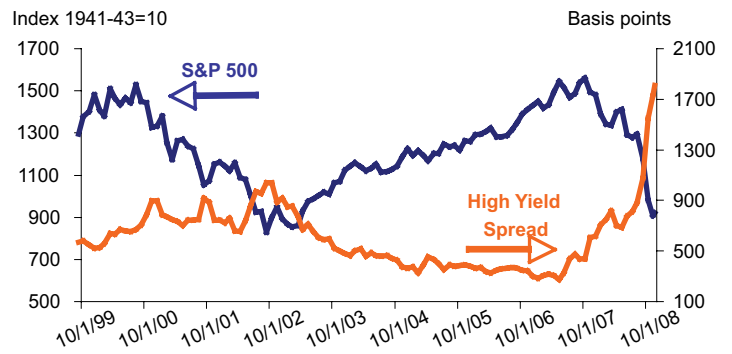
where between 770 (Great Depression experience) and 1050 (Japan's experience) in the next two to three months. If the U.S. market were to follow Japan's trend, its mild economic slowdown following the bursting of its bubble implies a 35–40% market decline from the peak. Japan's prolonged economic slump, however, suggests that a flat market could persist for another 6–12 months, followed by a further 20% decline if there is no significant turnaround in the economy at the end of that period.

The U.S. bear markets of 1973–74 (23 months long) and 2000–03 (30 months long) had peak-to-trough declines of approximately 40% — exactly where the current market is now from its peak. These markets, however, went through prolonged consolidation phases at the bottom before entering a sustained rally. On the other hand, both the Great Depression and Japanese bear markets had rallies between their twelfth and eighteenth months before declining further.

Given the uncertainty about how long the current recession will last, the market might be entering a consolidation phase at the bottom and trade sideways for a while. Whether this would be another intermediary bottom before the market declines further, or a final consolidation before the market takes off will depend on how much impact the coming government stimulus package and unprecedented recent monetary easing will have on the real economy.

We believe, however, that financial stress in credit markets will continue to dampen equity market performance. That stress has yet to subside: Since November 20, for example, Citigroup's high yield spread index has widened by another 120 basis points to 1800. We are tactically positioned to take advantage of a bear rally, if one materializes, but remain cautious until there is sufficient evidence that financial stress is subsiding.

Figure 3: Historically, the stock market does not rally while credit spreads are widening.



Source: Bloomberg, Citigroup

The NIKKEI 225 Index is a stock market index for the Tokyo Stock Exchange (TSE). It is a price-weighted average (the unit is Yen), and the components are reviewed once a year.

The Standard & Poor's 500 Index is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Investors cannot invest directly in an index.

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