

ING Investment Management Market Review

Fourth Quarter 2008



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A Tough Row to Hoe

In the fourth quarter global de-leveraging continued to exacerbate volatility across asset classes, none of which were immune. Uncertainty and risk aversion remained elevated but represented an improvement from the state of constant fear evident early in the fourth quarter. Most economic releases revealed pronounced weakness at home and abroad.



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The U.S. residential real estate crisis remained the epicenter of the storm, and the advent of numerous loan modification and foreclosure avoidance programs increased uncertainty. Car sales plummeted. Domestic manufacturing contracted, and total job losses for 2008 should easily top 2,000,000. Flight to quality trades resulted in a negative T-bill rate reported by traders, and the auction of the three-month bill in December yielded 0.005%, the lowest since 1941.

Home prices declined precipitously across major metro areas. In December the National Bureau of Economic Research officially declared that the United States has been in recession for a year, adding to the holiday cheer. Core Consumer Price Index turned negative for the first time since 1982, igniting fears of deflation. Commodities prices dropped with declines in gasoline prices, the one positive note for stressed-out, indebted, U.S. consumers. That tapped-out consumer may have finally rediscovered thrift, as evident in a dramatic upswing in the savings rate in November and the poor automobile, apparel, and electronic sales.

Oil rallied late in December on tension in the Gaza Strip; nonetheless, retail gasoline prices slipped to five-year lows and full supertankers idled in many ports.

At one point late in the quarter, investment grade corporate debt spreads blew out to a level that implied default rates of 30%, which tops the experience of the Great Depression when corporate defaults were about 20%. A number of financial institutions such as GE Credit issued new debt under the Temporary Liquidity Guarantee Program, bearing FDIC guarantees.

The auto companies won the Fed's approval of TARP aid in an effort to restart the stalled auto sector. GM received a \$14.4 billion loan package, and Chrysler drove home with \$4 billion. Ford declined government assistance. Foreign automakers have not been immune from the sour economic conditions; Toyota announced its first ever loss and idled plants in Japan, while Japanese industrial production dropped 8.1% in November.

Central banks around the globe frantically reduced short-term rates in the face of rapidly deteriorating economic conditions. Here in the United States, the Federal Open Market Committee (FOMC) reduced the Fed funds rate at each meeting, eventually settling at 0.25% by year-end; moreover, they established a 0.00% to 0.25% target.

A Merrill economist now estimates that the Federal Reserve balance sheet has topped \$2 trillion and will likely expand to \$3 trillion before the financial crisis abates, and Goldman Sachs forecasts that the U.S. government will need to raise about \$2 trillion of new debt in 2009 in order to fund its normal activities, underwrite bail-outs, fund upcoming fiscal stimulus programs, and offset maturing debt.

The Federal Reserve initiated innovative confidence building tactics; domestic policy-makers infused fresh equity into AIG, FNMA, FHLMC, and Citigroup, and redefined the role of TARP, leaving market participants wondering what else to expect going forward.

The U.S. equity market, as measured by the S&P 500 Index, lost 22% of its value during the quarter as the financial crisis continued to be a problem for equity markets both domestically and abroad. For the year, broad equity market averages declined about 37%, with some industries faring much worse: natural resources dropped 50%, communications 48%, technology 44%, financials about 43%. Healthcare was the market-leading economic sector at -25%.

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Growth stocks, on average, have narrowly outperformed value, and large-cap outpaced small-cap, but no style group was immune from the carnage. Measures of overall equity market volatility made tentative steps toward more reasonable levels. U.S. consumer spending, representing 70% of GDP, has been particularly hard hit due to asset deflation (housing and stock prices), rising unemployment, and credit availability.

All economic sectors had negative equity returns for the quarter. Perhaps fittingly, the financial sector was the weakest performer, with a 37% decline. Diversified financial services companies led the drop. In part reflecting commodity price deflation, the materials sector lost 31%, with paper and forest products being the worst-performing industry. The information technology sector was off 26% with the electronic equipment industry being the biggest drag.

Defensive sectors held up relatively better. These included telecommunication services (-1%), utilities (-11%) and health care (-12%). The better-performing industries included diversified telecom, electric utilities, biotechnology and pharmaceuticals.

Markets may now take heart in the appearance of synchronized global economic initiatives and the apparent unwillingness of governments to let the global financial system fail. The president-elect's transition team is working with Congress on a reported \$800 billion stimulus package, and sizeable stimulus plans were announced or are expected in Europe in the weeks to come. Indeed, even China joined other major economies and announced a \$586 billion stimulus program. ■

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