

# Market Review

## Markets Heat Up

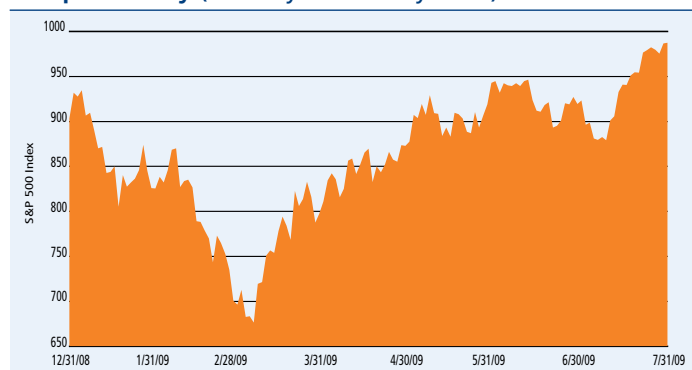
July saw robust performance in both equity and fixed income markets, as data continued to support our expectations for a gradually healing economy. We expect the U.S. economy to continue to strengthen into the second half of 2009, with positive GDP growth in the third quarter and near-trend growth in the fourth. That said, there is a lot of skepticism in the market — skepticism about the true recovery power of the economy, about the effectiveness of monetary and fiscal policy, about the recent strong earnings reports, and about current equity market valuation.

### Equity: Earnings Surprise to the Upside

Thus far, second quarter earnings have been supportive of our expectations for an earnings recovery. Of the S&P 500 companies that have reported 2Q09 earnings through July 21, 77% have surpassed analyst expectations. This is well above the 55.5% trend going back to the first quarter of 1993 and is a positive sign for the equity market. The common denominator in the upside surprises is the presence of strict corporate cost controls. Cost cutting has been very aggressive in all sectors and the majority of earnings surprises were the result of lower than expected costs as opposed to higher than expected revenues.

Many equity market participants don't believe that earnings can recover this year and are forecasting flat earnings into 2010. However, we are taking a more constructive position; we expect earnings of around \$50.00/share for the S&P 500 this year and see a very good chance for \$70.00-plus for 2010. Despite the skepticism that appears to exist, the market has done its usual job of rapidly pricing in the improved earnings environment, rallying approximately 45% off of March lows to end July just shy of 1000 and bringing equities closer to fair value (see Figure 1). So while the market may still be underestimating the near-term earnings potential of U.S. equities, stocks may not be the screaming buy that they were earlier this year.

**Figure 1: Equities (S&P 500 Index) Close to Fair Value after Sharp Recovery (January 2009 - July 2009)**



Source: Bloomberg. **Past performance is no guarantee of future results. The performance quoted represents past performance.**

July's strong equity market performance was led by the materials and consumer discretionary sectors. Defensive sectors — like telecoms and utilities — were relatively weak but still posted positive returns.

We recently performed research about equity market behavior during the early stages of an economic recovery. Our analysis showed that cyclical sectors — materials, energy, industrials, consumer discretionary and, to a lesser extent, technology and financials — outperformed in a recovery environment, while defensive sectors — telecommunications, utilities, consumer staples, and healthcare — typically lagged. Market performance in July was more or less consistent with these trends; we believe it will likely continue if the economy has truly bottomed out and recovery is underway. That's a big if, but investors who are confident the economy is on the upswing may be well served by rotating their exposure into cyclicals and out of defensive sectors.

### Fixed Income: Government Programs Spur Rally in Risk Sectors

The risk-based sectors of the U.S. fixed income markets rallied with renewed vigor in July, while U. S. Treasuries posted a slight rise in yields across the yield curve. Investors were inspired by the perceived slowing of economic deterioration, as GDP came in better than expected for the second quarter. While unemployment surprised on the upside early in the month, many housing metrics are improving and industrial production may have turned the corner. Economic results from Japan and China also suggest that we have seen the worst. Inflation anxiety was once again reduced, as core CPI came in at a modest 1.7% year over year.

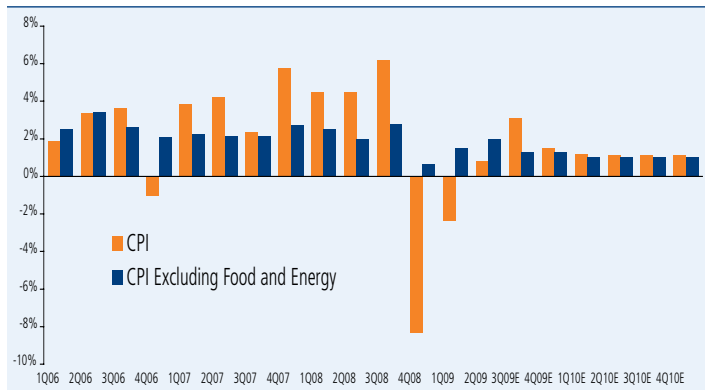
The advent of Public-Private Investment Program (PPIP) as a new source of funds for the capital-starved securitized markets — such as non-agency residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) — produced significant rallies in these sectors. Investment-grade corporate bonds also posted strong excess returns, with industrials, utilities and financials leading the way. Fixed-rate agency RMBS continued to benefit from the Fed-sponsored purchase program; out of the \$1.25 trillion in purchases targeted for 2009, \$700 billion has been spent. High yield bonds continued to perform very well as mutual funds witnessed large inflows, and emerging market debt also rallied.

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Looking ahead, we expect range-bound U.S. Treasury rates and a low probability of Fed tightening given expectations for continued high unemployment and significant slack in the domestic economy. Although concerns about inflation may resurface, we still believe deflation is a bigger near-term issue. Recessions — and depressions — that result from de-leveraging tend to be longer and deeper than those prompted by simple inventory corrections. Aggressive policy responses over the last year or so have helped to prevent a worse outcome, and the recent consumer response to the “cash for clunkers” auto program demonstrates that at least a few consumers are willing to open their wallets when incented to do so.

Despite the recent rally, we believe that value can still be found in spread sectors, though security selection is likely to play a greater role in the months to come. And while the advances in CMBS, ABS and non-agency RMBS have been stoked in part by government programs, certain of these securities appear to represent a discount to their intrinsic values. In short, investors in these securities are being adequately compensated for the risks given the generous spreads and low dollar prices. ■

**Figure 2: Recession and Weak Recovery Should Restrain Inflation through 2010**



Source: Bureau of Labor Statistics, ING Investment Management forecasts.

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. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an index.**

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