Key points

- Political risks and sovereign concerns not over yet
- Double-dip probability around 40%
- Equities downgraded to medium underweight. Real estate and commodities also underweight.
- Preference for AAA treasuries, precious metals and EMD

HOUSEVIEW

ING Investment Management Asia Pacific September 2011

positive (+), neutral (=), negative (-)

Asset Classes	Current Month	Previous Month
Equities	-	-
Fixed Income	+	+
Real Estate	-	-
Commodities	=	=

Equity Sectors	Current	Previous
Energy	+	+
Materials	=	=
Industrials	-	-
Durable consumer goods /services	=	=
Consumer staples	=	=
Health care	+	+
Financials	=	=
Technology	+	+
Telecommunications	=	=
Utilities	-	-

Equity Regions	Current	Previous
United States	-	-
Europe	-	-
Japan	+	+
Asia Pacific (ex Japan)	=	=
Emerging markets	+	+

Bonds	Current	Previous
Investment grade credits	-	-
High yield credits	+	+
Emerging market debt		
Hard currency	+	+
Asian HC	+	+
Local currency	+	+
Asian LC	+	+
	Forecast	**Current**
10-y bond yield (6m forecast)		
US	2.6%	1.9%
Germany	2.4%	1.7%
Japan	1.1%	1.0%

A confidence collapse

August was a horrible month for financial markets with a raft of disappointing economic news. So far, both US and European politicians have done very little to tackle the debt problems structurally, which has negative consequences for consumer and corporate sentiment. Fears of a renewed recession and sovereign debt issues scared investors away. The credit rating agency S&P downgraded the US long-term sovereign rating from the prestigious AAA rating to AA+. Concerns also persist about sovereign debt in peripheral Europe. Markets believe that the size of the EFSF emergency fund needs to be increased.

Despite a strong bounce in the final week led by hopes for a new round of QE, global equities lost around 7% in USD. US equities outperformed, confirming their safe haven status in times of trouble. Europe was the worst equity region as sovereign debt problems took centre-stage. Sector wise, defensives outperformed while cyclicals were hit by double dip fears. Consumer Staples (-1%) and Utilities (-2.6%) held up relatively well while Financials (-9.4%) suffered most. Energy (-9.1%) also underperformed, on lower growth and lower oil prices. Looking at styles, growth slightly outperformed value last month. Large cap companies outperformed small and mid caps.

After a speculative attack the ECB subsequently provided relief by buying up large numbers of Spanish and Italian bonds, which led to a decline in peripheral yields. Government bonds were clearly the best asset class, as US and German bonds rallied strongly. Spread products within fixed income were hit by rising systemic risks. High yield bonds especially declined strongly, but Emerging Market Debt HC managed to print a positive result.

View: Market turbulence will persist for the time being

We expect markets to remain turbulent for the time being. We believe there is little chance of a structural solution to the European debt problems in the short term. Neither do we expect a substantial improvement in economic indicators over the next few months. Our forecast is for the current slowdown in growth to persist for the rest of this year, but for now we do not anticipate a recession. As long as the two situations described above continue to exist, we will not expose ourselves to a large amount of risk, being cautious on equities, real estate and commodities. We are focusing on AAA government bonds, precious metals and Emerging market debt.

Economy

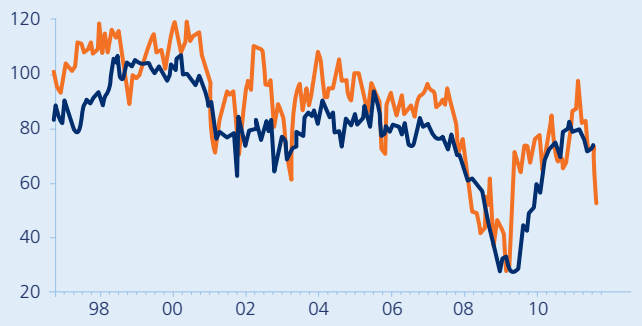
DM recession as a real risk, but insufficient evidence to make it base case

The global economy is clearly slowing down again. This is most evident in those developed economies characterised by household and financial sector deleveraging. Nevertheless, core Europe as well as the EM space is affected through a slowing of external demand.

There are two broad reasons behind all this. First, the oil and Japan disaster shocks have taken a greater toll on domestic demand growth than previously anticipated. Furthermore, there are increasing doubts about the competency of policymakers on both sides of the Atlantic to deal with the challenges facing them.

Risk aversion has risen considerably over the past few weeks. This potentially opens the door to a self-fulfilling negative feedback loop between financial conditions and confidence, on the one hand, and growth, on the other.

US consumer confidence more volatile than spending



conference board consumer confidence: expectations
yoy %change real consumer spending (RHS)
Sources: Thomson Reuters Datastream, ING IM

All this once again underscores that an economy remains in need of policy support during the process of deleveraging. Unfortunately, fiscal policy in much of DM space will be tightened, particularly so in the US. The burden is thus once again on monetary policymakers. The Fed has signalled that it expects to keep rates near zero until mid-2013 whilst also adopting an easing bias, i.e. some form of QEIII is now a clear possibility. Meanwhile, the ECB has stepped up its unlimited liquidity provision again and we no longer expect a rate hike this year. While this should be helpful, one should bear in mind that the effectiveness of monetary policy is still impaired.

Our base case is now one of positive but below potential growth for the next 6 quarters. The reason for holding on to our base case is threefold. First, most hard data still point to a standstill rather than a recession. Moreover, room to slash spending for the corporate sector is much more limited than it was in 2008. Finally, policymakers could still come up with a comprehensive solution to the problems facing them. We see a 30-40% probability of a double dip.

Declining growth momentum in emerging world

South Africa reported its Q2 GDP growth numbers. The annualised, seasonally adjusted growth rate fell to 1.3% from 4.5% a quarter earlier. Consensus was looking for a higher number, although a sharp slowdown was factored in. Manufacturing and mining were particularly weak in the second quarter.

In the emerging markets universe, South Africa does not stand out. The EM growth momentum has been slowing fast in recent months. Annualised GDP growth in the emerging world, excluding the less volatile China and India, fell from 7% in Q1'11 to 4% in Q2'11. The steepest declines we have seen in the most open economies, such as Taiwan, Thailand, Singapore and Hong Kong, and in the economies that were most overheated at the beginning of the year (Brazil and Turkey).

With global trade growth only starting to slow down, we see more downside for the open economies, particularly those with the tightest relations with the US and Europe. The more closed economies, such as India and China, are also slowing, but here the downside risk is more limited, due to more solid internal dynamics of growth, particularly strong disposable income growth.

Including China and India, we expect average EM GDP growth of 6.5% in 2011 and 6.0% in 2012. The low point in EM growth we expect in Q2 2012, at 5.7%.

Sticky emerging markets inflation

So far, August inflation numbers in the emerging world have been worse than market expectations. Of the seven countries that have reported, two have been better than expected (Russia and Colombia), one in line (Brazil) and four worse than expected (Turkey, Korea, Thailand and Indonesia).

Turkey, Korea, Thailand and Indonesia all reported higher inflation than consensus was expecting. Important is that in all four countries, both food and core inflation were adding to the disappointing numbers. China will report with its August CPI number next Friday. But last week, in the August PMI, the input price index rose for the first time since February, suggesting that inflation in China is remaining at elevated levels. Overall in the emerging world, core inflationary pressures remain high due to high money supply growth in recent years, tight labour markets and loose fiscal policies in most countries. Meanwhile, food price pressures have not really come down since the spring – against expectations – and recently pressures have risen again due to disappointing US corn harvests and rising pork prices in China.

The global and emerging markets economic growth slowdown should help to reduce inflationary pressures in the next few months and quarters, but inflation is likely to remain an issue as EM authorities have not been decisive enough. The aggressive monetary policy approach by the US and Europe is making it increasingly difficult for EM monetary authorities to keep a steady, inflation-targeting course.

Asset Allocation

Flattening economic growth, less accommodative fiscal policy settings, populist political overtones and sovereign stress combine to keep risk at low levels. Our qualitative asset allocation assessment is becoming more cautious as regards risk, due mainly to increased conviction about cyclical decline. Reduced consumer and corporate confidence, stemming from labour market weakness, debt concerns and political populism are key near-term headwinds. Our Quantitative assessment remains directionally constructive towards fixed income and commodities, negative for equities and neutral for real estate.

In view of the interplay between qualitative and quantitative inputs, European sovereign stress, US economic slowdown and a softening in the economic outlook in H2'2011, our tactical positioning is underweight commodities, equities and real estate, and overweight fixed income (overweight AAA Treasuries, UW spread products).

While a "double-dip" in world growth is not our base case yet, risks for such have intensified. In view of the interplay between qualitative and quantitative inputs we implemented a defensive positioning across asset classes, regions and sectors in recent weeks. Due to the lingering European sovereign debt and policy concerns as well as a softening in the economic outlook in H2'2011, we reduced the equity exposure to medium underweight early August. The proceeds of this move were invested in fixed income (AAA government bonds). Real estate remains a small underweight.

Early August we increased further the precious metal allocation within commodities. As a consequence, our current commodity positions are mainly allocated in the precious metal segment. Gold has once again proven to be a good hedge in periods of severe stress. Key factors that have been driving investment demand –sovereign debt burdens, low real interest rates – are unlikely to disappear in the near term. The potential for further net gold purchases by central banks could also be supportive of prices, while we see little sign of any material increases in production.

Equity market support has been evident in robust corporate earnings and strong balance sheets, but is again overwhelmed by sovereign debt issues and double-dip fears. Company outlook statements have turned cautious. Consensus earnings expectations for 2012 are unrealistically high (+12% versus our own 0% estimate). Softness in leading indicators, the falling earnings momentum and high sovereign stress are strong headwinds. Equity markets currently price an earnings standstill, but not a recession scenario. We remain, however, tactically cautious for equities due to the weak cyclical context and rising systemic risks.

Equity

In the equity portfolio, we continue to prefer Japanese equities. The main reason is the faster than anticipated recovery in industrial production. Japanese companies are also adapting to the power shortages by, among other things, shifting production to night-time or the weekend. The reconstruction effort can now start in earnest. This all implies that at a time when other developed markets are slowing down, the Japanese economy actually may accelerate. This will also be reflected in the relative earnings growth. This remains an important dynamic in the relative performance of the market.

We also continue to like Emerging markets, but have reduced our allocation somewhat. Long-term structural positives for Emerging markets are still valid. They show not only consistently stronger and more stable economic growth, but also have much lower debt ratios in both the public and private sectors. Although earnings growth is comparable (17.4% EM versus 16.4% global) we have more confidence in the EM data given the economic momentum. Price earnings ratio is still at a slight discount relative to developed markets (11.2 versus 12.7). Furthermore, relative momentum in leading indicators is holding up better in China than in the US or Europe (outside Germany).

We have a neutral position on Asia ex Japan. Loose US monetary policy combined with high Asian growth underpins these markets. Australia is driven by high commodity prices but this positive impact may fade as global growth slows. Valuation is comparable to other developed markets. Hong Kong is still benefitting from high liquidity as this market couples lower-for-longer (US)-like interest rates and exchange rate with a higher (China)-linked economic growth.

Because of the sharp deterioration in the US and European growth outlook, the EM domestic demand growth theme has moved to the forefront again. In emerging Asia, we have a clear preference for markets where growth is not primarily driven by global trade growth or developed markets capital flows. For this reason we have overweight positions in China and India, where domestic demand growth looks relatively solid, as it is driven primarily by endogenous factors. In the more open economies, such as Korea, Taiwan, Malaysia and Thailand, we have neutral or small underweight positions. On Indonesia, we remain cautious given the large foreign holdings of rupiah-denominated debt.

In August defensive sectors strongly outperformed cyclicals and financials. We think this move has still not run its course. We therefore now have a clear preference for defensive sectors. In the defensive arena, we see internationally exposed food and beverage producers and pharmaceutical companies as best positioned, and prefer telecoms over utilities.

We maintain our preference for high dividend underscoring the increasing importance of dividends in the total return of a portfolio. The low pay out ratio, healthy cash rich balance sheets and the strong cash flow generation limit the downgrade risk for dividend payments.

Fixed income

Treasury yields are now trading at or close to their historic low points in Germany, the UK and the US. This is not to say they could not fall further towards Japanese levels, but the risk-reward of the treasury bet seems to have deteriorated. It remains difficult to see the US and European economy falling into deflation over the next 12-18 months, even if a recession would materialise. However, for short-term tactical reasons it remains preferable to be neutral on treasury paper (outside of the European peripheral markets), as cyclical risks are still alive and risk appetite amongst investors remains depressed.

Fixed income spreads remain constructively positioned towards emerging markets assets, supported by relative momentum indicators and underlying fundamentals. Prospects are more mixed in respect of corporate and household exposures in the credit space, and the attractiveness of high yield has recently increased enough to bring it back to a small overweight within spread product. European Investment grade credit and ABS remains underweight due to its exposure to the Euro system

crisis. Although fundamental trends continue to provide medium term support, we are currently underweight in spread products overall. Main factors behind this tactical position are the uncertainty surrounding global growth and event risk in Europe due to sovereign stress.

The outlook for Asian hard currency debt remains attractive on the back of strong regional credit fundamentals and declining default expectations. The impact on Asian issuers by events in MENA and higher oil prices is manageable. Monetary policy normalization and inflation concerns continue to exert downward price pressure on Asian local currency debt markets. However the expected policy tightening has been priced in by now, and we expect inflation to peak in the region over the next few months. Local currency bond returns will benefit from controlled FX appreciation.

Foreign Exchange

The US fiscal outlook is very troubling. Although the debt ceiling issue has been resolved for now, more fiscal tightening will be needed, which will have a negative impact on US growth in the next few years. Also, the Fed will be one of the more dovish central banks around the globe. In the longer term, this implies further US dollar weakness can be expected, especially against many emerging market currencies where fundamentals are much sounder and central banks more hawkish. In the short-term, with markets becoming increasingly risk averse, the outlook for EM currencies is less positive.

Regarding the euro zone, we continue to be concerned about the lack of a comprehensive long-term solution on the sovereign debt issue, and see room for further EUR weakness versus a range of currencies. Euro weakness versus the USD will be restrained by the weak US fundamentals, but on balance we see EUR/USD lower in the next several months.

Finally, the Japanese yen has been quite strong versus the US dollar recently (or: US dollar has been weak versus the yen). Early August the BoJ intervened to weaken the yen. For more sustained weakness of the JPY versus the USD, a clear improvement in US economic data will be needed. The uncertainty about such an economic recovery has increased, and a sideways to lower USD/JPY is expected for the next several months.

Global Markets Performance

Equity: Selected Indices	1M	3M	YTD	1Y
MSCI AC World NR USD	-7.30	-10.25	-4.54	13.72
MSCI AC Asia Ex Japan NR USD	-9.89	-10.98	-7.79	9.53
DJ Industrial Average TR USD	-3.96	-6.96	2.14	19.03
S&P 500 Composite	-5.49	-9.00	-2.05	18.01
NASDAQ Composite PR USD	-6.42	-9.02	-2.77	22.02
FTSE 100 TR GBP	-6.62	-8.97	-6.14	6.73
FSE DAX TR EUR	-19.19	-20.69	-16.33	-2.37
S&P/ASX All Ordinaries TR	-2.00	-7.60	-7.23	2.61
Nikkei 500 PR JPY	-7.21	-6.98	-10.42	1.55
Hang Seng HSI PR HKD	-8.49	-13.30	-10.86	-0.01
KSE KOSPI Korea PR KRW	-11.86	-12.25	-8.33	7.88
TSEC 50	-9.05	-14.18	-13.55	3.11
FTSE ST All Share PR SGD	-9.91	-9.67	-11.91	-3.93
Shanghai SE Composite PR CNY	-4.97	-6.42	-8.57	-2.71
Shenzhen SE Composite PR CNY	-3.00	2.83	-11.43	-1.99

Bond: Selected Indices	1M	3M	YTD	1Y
BarCap Global Aggregate TR USD	1.27	3.44	7.89	8.96
JPM EMBI Global TR USD	0.53	3.64	7.70	7.49
HSBC Asian USD Bond TR	0.39	2.44	5.51	4.43

Source: Morningstar Direct as of 31 August 2011, measured in the base currencies

ING IM 2011 Market outlook

Bond yields (10y)		
quarter end (%)	Q3'11	Q4'11
Countries		
US	3.6%	3.7%
Eurozone	3.6%	3.8%
Japan	1.3%	1.3%
UK	3.9%	4.0%

Corporate bond (IG) yields		
quarter end (%)	Q3'11	Q4'11
Countries		
US	4.1%	4.1%
Eurozone	3.9%	4.0%
Japan	0.9%	1.0%
UK	5.7%	5.8%

Equity		
quarter end	Q3'11	Q4'11
Countries		
S&P 500	1380	1400
Euro stoxx 600	307	310
TOPIX	1025	1050
FTSE 100	6450	6600
MSCI EM Free	1250	1300

Foreign exchange rates		
quarter end	Q3'11	Q4'11
Currencies		
EUR/USD	1.30	1.25
USD/JPY	90	95
GBP/USD	1.57	1.56
EUR/JPY	117	119
EUR/GBP	0.83	0.80

Source: forecasts from ING IM.

ING IM Global Economic Outlook

	Real GDP			Inflation			Policy Rates (%, YE)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
World	5.0	4.2	4.3	3.0	3.2	3.0			
Developed	2.6	2.3	2.5	1.4	1.7	1.5	0.45	0.74	1.31
US	2.9	3.1	3.2	1.6	1.7	1.5	0.13	0.13	0.75
Euro	1.7	1.8	2.0	1.6	2.1	2.0	1.00	1.75	2.50
Japan	4.0	1.5	2.0	-1.0	-0.2	-0.1	0.10	0.10	0.10
UK	1.8	1.8	2.1	3.3	3.5	2.0	0.50	1.00	1.50
Emerging	8.1	6.7	6.5	5.1	5.1	5.0			
China	10.1	9.0	9.0	2.9	4.1	4.0			

	Unemployment rate			Budget balance			Current account		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Developed	9.0	8.6	8.1	-8.0	-7.4	-5.8	-1.3	-1.3	-1.4
US	9.7	9.0	8.5	-8.9	-9.0	-7.0	-3.5	-3.9	-3.9
Euro	10.0	9.7	9.4	-6.4	-4.8	-3.7	0.0	0.1	-0.2
Japan	5.1	4.7	4.3	-8.0	-7.9	-6.1	3.5	3.6	3.5
UK	7.8	7.8	7.5	-10.1	-8.6	-7.6	-2.0	-1.7	-1.2
Emerging									
China	6.1	6.5	6.4	-2.2	-1.7	-1.6	6.1	4.3	3.9

Source: Forecasts from ING IM, historical data from IMF (GDP, inflation) and Economist Intelligence Unit (rest data)

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