Key points

- Europe heading into recession. US double-dip risks reduced
- Proximity endgame Europe justifies more neutral stance
- Equities, commodities and real estate neutral. Fixed income underweight.

HOUSEVIEW

ING Investment Management Asia Pacific December 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	2.0%	2.0%
Germany	2.0%	2.1%
Japan	1.0%	1.0%

Bond market contagion grows

The recovery of risk appetite in the wake of the Euro summit late October turned out to be temporary. Investors entered unruly waters again in November. Depending on economic and political news, investors continue to switch rapidly between higher or lower levels of risk.

Political events in the Euro area remain the prime source of uncertainty. New technocratic governments in Greece and Italy were market positive events, but focus turned on the ECB and its role as Lender of the Last Resort and on fixing the fiscal union. In the meantime, waning confidence among consumers and companies turned the economic outlook for the Eurozone bleaker. As the region probably headed into a (mild) recession this quarter, new ECB president Draghi cut interest rates by 25bps to 1.25%. In the US, macro data are painting a more optimistic picture than in Europe. US Q3 corporate earnings came in on the upside, while also macroeconomic data have been resilient (at a soft level). In China, some constructive moves on policy easing were observed.

Thanks to a strong end of month rally, induced by concerted Central Bank action to provide cheaper USD funding to banks, global equities printed a small positive number over the month. Emerging markets, the Eurozone and Japan all underperformed, whereas the US performed better. We remain cautious that the current uptick is another pre-Summit rally of the type witnessed in October.

All fixed income markets printed negative returns, as contagion grew. Policy disappointments resulted initially in significant spread widening of peripheral treasuries. Even fundamentally sound AAA countries such as Finland saw their risk premiums increase and an auction of German bonds was met by weak demand. The German 10y bond yield increased almost 50bps to a high of 2.37% (now 2.17%). Also credit markets lost ground. Emerging Market Debt Hard Currency declined somewhat less compared to investment grade and high yield corporate bonds.

View: risks are higher, but also more evenly balanced

Tail risks have arguably increased with the latest spreading of the Eurozone crises to 'core' sovereigns which threatens to drag the region into a deeper recession. But tentative signs that Eurozone politicians and the ECB are stepping up their actions and signs of policy support (easing in China, QE by the Bank of England and the Fed) and positive data surprises outside of Europe provide more counter balance than during the third quarter.

Economy

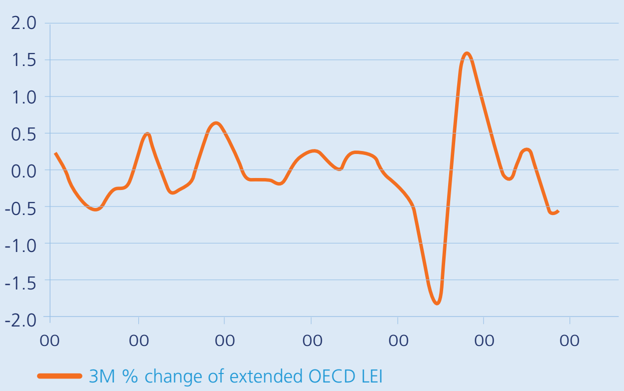
World economic growth slowing down

The main economic blocks are diverging while the global economy overall is slowing down. Recession risks have moved up above 50% for the Eurozone and the UK. We expect these economies to move into a mild recession with negative growth in the Q4'11-Q1'12 period. A "double-dip" in other developed market economies is not the base case yet, as we view that risks of a US recession are reduced to 30%. Overall the developed world remains in a growth recession: below potential output growth and slightly rising rates of unemployment. But there are some glimmers of hope too.

In Europe, economic data are clearly deteriorating in line with our recession expectation. Worse than the actual data has been the deepening of the Euro crisis. This has now reached countries previously thought to be immune: Finland, The Netherlands and even Germany. The fact that the disease is spreading to the core is a worrying development. This is the immediate consequence of the fact all sovereigns in EMU lack a lender of last resort (LOLR). This makes them vulnerable to self-fulfilling speculative attacks. Developments on the political front will be key, for financial markets and the outlook for the European economy. Our expectation is of a mild recession turning the corner at the end of Q1'12 for now, but this could easily deteriorate if politicians and authorities (such as the ECB) fail to come up with convincing solutions.

Our first glimmer of hope is the slight improved outlook for the US, where economic data have on the whole surprised on the upside. All in all, the US economy demonstrated growth around potential in Q3 at 2%. We remain cautiously optimistic on the underlying trend for final demand and have subsequently increased our GDP growth forecast for 2012 somewhat, to 1.6%. We do caution however that financial conditions are still tighter than at the start of the summer and confidence is decisively lower. The issue of further raising the debt ceiling will probably not come up until after the presidential election, but there is still a risk of a substantial fiscal drag next year. The recent failure of the congressional supercommittee is somewhat worrying as it is likely to delay any long term deficit-reduction agreement until after the presidential election. In our view, downside risks to the US economy have increased slightly in the wake of this failure.

OECD Leading Indicators - short term



Source: Thomson Reuters Datastream, ING IM

Another glimmer of hope may be found in the evolution of global leading economic indicators. Short term momentum in OECD leading indicators (extended with 6 non-members) appears to be bottoming as measured by the 3 months change of the normalized index (see graph). All this remains fragile, however, as Europe seems to be heading for a recession while the US will be confronted with a fiscal drag next year.

A last glimmer of hope stems from the easier global monetary policy stance. Central Banks in most parts of the world are in monetary expansion mode. In the US, the Fed has signalled to keep rates near zero until mid-2013 whilst also adopting an easing bias. We view that some form of QEIII is now a clear possibility. In the UK, we expect a further QE expansion to be announced early next year. In the Eurozone, the ECB cut its benchmark rate by 25bps in November. We expect that the rate will be reduced to 0.5% in the coming months.

In the wake of the spreading Eurozone sovereign crises, the ECB stepped up its purchases under the bond-buying program (the SMP). The ECB is clearly uneasy about these debt purchases and is hesitant to do it in size. The governing council has communicated the SMP program would be limited in time and size. However, purchases may be stepped up once a clear framework to counter sovereign moral hazard has been put in place. The greater involvement of the ECB may be part of the endgame in Eurozone, which we feel is near (see below).

Asian economies, while strong, cannot escape perils of world economic slowdown

In China, the central bank cut lenders' reserve requirement by 50bps in recent days. We believe that this is the first of more official easing steps in China. This latest move is in line with our base case of a soft landing scenario, part of which was an increased likelihood of early easing of the reserves requirement rate. The backdrop to this move has been deteriorating capital flows to China and the weakening Chinese growth picture itself. The latter was most recently confirmed in PMI manufacturing of 49 for November, the weakest index number since the recession eased in 2009. The authorities started their selective easing in October. We expect them to step up their efforts in the next few months, as growth headwinds are likely to intensify. We expect inflation to ease off, creating room for further easing.

The global economic slowdown is starting to impact (export) economies in Asia. China is one point in case, clearly suffering from falling export orders from its main European trade partners. Other, more open economies, such as Taiwan and Singapore, have seen their growth rates coming down quickly in recent months. India is another Asian economy clearly affected by global economic headwinds, although the slowdown there is primarily the result of tight monetary policy. Data releases in the recent week confirmed that the Indian economy grew 'only' 6.9% in Q3. This was lower than expected and the slowest rate in more than two years.

In Japan the economy will remain supported, however, by the rebuilding effort following the March earthquake. In this respect a supplementary budget of around 2% of GDP has recently been agreed upon. Nevertheless, business surveys have deteriorated somewhat over the month due to the combination of slower global demand growth and an appreciating Yen. This suggests there is a risk of a more marked slowdown after Q1´12. For now, however, both investment and consumer spending continue to hold up well.

The Eurozone crises has reached its endgame

The vicious spiral between sovereign and bank balance sheets in the Eurozone has accelerated over the past few weeks. This means that the endgame will in all likelihood be played out within a couple of months. From a bird's eye perspective this endgame is actually not that difficult to describe. The essence of the problem is too much monetary union in the face of too little fiscal union. The tension between these two will thus ultimately be resolved by either a (partial) EMU break up or more fiscal integration.

Because of the severe consequences of a break up of EMU, we still believe that a move towards more fiscal union will ultimately happen. Yet this is more easily said than done. The comprehensive solution which has been promised too many times by politicians is prevented by a set of political constraints that appear to be pretty binding. This makes the path towards the endgame fraught with high levels of uncertainty.

Asset Allocation

With the evolution of the Euro crisis remaining highly unpredictable, the outlook for financial markets has become very fluid. Still, over the weekend signals strengthened (comments Draghi, reform package Italy, meeting Merkel-Sarkozy) that more fundamental steps are being prepared in the run-up to yet another Euro summit. Since our base-case remains an end-game of a leap forward by European policy makers, we feel that the negative tilt in the risk balance is no longer large enough to anticipate a positive, risk adjusted (excess) return from an underweight equities position. With the closeness of the end-game and the increased uncertainty surrounding the binary outcome of it, we therefore decide to bring our equity stance back to neutral. For similar reasons we also moved our underweight spread position within fixed income back to neutral.

The consequence of our latest adjustments is that our top down asset allocation stance has become very neutral at this point in time with not only equities, but also real estate and commodities on a neutral stance (all compared to cash). The only exception is found in our fixed income preference. Our investment signals for treasuries have turned negative after the momentum signal weakened. Moreover, the ongoing sovereign run in the Euro treasury markets is introducing a significant risk factor into the German bund market pointing mainly in negative direction. Treasuries are therefore moved from neutral to a small underweight.

Equity

Against the backdrop of the diverging economic outlook for Europe and the US, we also note that the Eurozone is decoupling from the non-Eurozone which includes the UK. UK equities outperformed EMU equities by a wide margin year to date despite the low domestic growth environment. The international exposure of UK companies, quantitative easing by the BoE and a higher sensitivity to commodity prices are credit to this. For the FTSE100, developments in Asia are probably at least as important as domestic ones.

These trends are reflected in the evolution of corporate earnings. US companies have reported record high earnings over Q3, with 69% of companies beating the estimates compared to a mere 51% of European companies. In addition, the downward revisions are more important in Europe than elsewhere. This supports our 2012 earnings estimate for a 5 to 10% earnings decline in Europe, whereas US companies might be able to escape this. Even so, our view remains that bottom-up estimates at 9% for US earnings are still too high. Hence, earnings momentum will remain weak.

Top Down earnings estimates

	2011	2012
United States	14%	0% – -3%
Europe	5%	-5% – -10%
UK	14%	0% – 5%
Japan	10%	10% – -15%
Emerging Markets	12%	5% – 10%

Source: INGIM (23 November'11)

As we do not see a quick turnaround in the fortunes of the Eurozone, we cut our negative stance back further (from -1 to -2). We upgraded our exposure in Emerging Markets from neutral to a small positive (+1). Provided the world escapes a break-up of EMU, we think that the superior fundamentals of Emerging Markets translate into outperformance. Especially as these markets have a valuation discount. We also expect that the higher earnings growth of EM companies will help to outperform. Regionally, we prefer Asia to Latin America. Emerging Europe, with the exception of Russia is vulnerable to developments in the Eurozone and is our least preferred emerging region. In the rest of the world, we maintain our positive outlook on Japan.

Fixed income

The pressure in European treasury markets continues to build. Following an unsuccessful German Bund auction two weeks ago, Germany 10-year yields have risen above US Treasuries. We turned negative on Treasuries (duration) due to the risks posed by the Eurozone sovereign debt run on German Bunds. With tensions rising in the German bond markets also the Dutch and Finnish markets became affected. With these latest developments, it has become clear that the Euro endgame is near.

With the endgame near, the tails of the risk distribution have grown fatter. The uncertainty this creates explains our close to neutral position in our top down allocation preference. At the same time however, we feel that the outlook for Aaa treasuries (especially Germany) has deteriorated, while a Euro 'solution' might trigger a risk-on rally that causes a shift out of treasuries into risky assets. Treasuries are therefore moved from neutral to a small underweight.

Given the proximity of the endgame and the more or less binary outcome of this, we have scaled back our fixed income spread call too from negative to neutral. Intra-spread, our tilts in risk preference remain unchanged with Euro area exposed asset classes like European Peripheral Treasuries, Euro Investment Grade Credits and Aaa Euro ABS are kept at an underweight stance. Meanwhile, Emerging Markets credit in hard currency and "high yield" corporate credit exposure are kept in an overweight stance.

Foreign Exchange

With regard to the EURUSD, we remain bearish as we acknowledge a number of EMU idiosyncratic factors that remain EUR negative. More specifically, 1) further austerity measures are to be expected and will weigh on growth, 2) monetary policy remains too tight given the deterioration of the economic outlook for EMU and markets are not pricing enough easing, 3) ultimately we expect the ECB to step-in either by increasing the size of the SMP and transferring the credit risk to the currency, or by starting a broader QE program which would expand further its balance sheet.

With regard to the USDJPY, following the Bank of Japan intervention on October 31th, the currency managed to break below the 77.9 level which has been the lower bound of the range dollar/yen traded in the days following the intervention. According to us, the yen is not very overvalued. Also, the Japanese economy is not performing that poorly. Finally, compared to the fundamentals of USD and EUR, the JPY does not look that bad. Therefore, we continue to be bullish on the JPY, especially versus the euro.

With regard to EM currencies, we clearly have a strong regional preference as we favour Asian currencies to Latam or more European oriented currencies. The main arguments are 1) the major growth drivers for the global economy going forward are located in the region, 2) the currencies are usually managed which provided them with an attractive defensive characteristics in difficult times.

Dividend sustainability

	DY	PAY OUT	ND/EBITDA	RISK
Financials	3.6%	33%		High
Staples	3.1%	49%	1.8	Med
Discretion	2.7%	37%	1.8	Med
Telecom	5.3%	59%	2.1	High
Utilities	4.6%	61%	2.5	High
Materials	2.6%	28%	0.8	Low
Industrials	2.7%	31%	1.8	Med
Health Care	2.7%	43%	1.2	Low
IT	1.6%	21%	-0.4	Low
Energy	3.2%	30%	0.6	Low

Source: Datastream, INGIM (25 October '11)

Global Markets Performance

Equity: Selected Indices	1M	3M	YTD	1Y
MSCI AC World NR USD	-2.99	-2.74	-7.16	-0.36
MSCI AC Asia Ex Japan NR USD	-8.32	-10.84	-17.79	-13.24
DJ Industrial Average TR USD	1.18	4.46	6.70	12.39
S&P 500 Composite	-0.28	2.78	0.67	7.37
NASDAQ Composite PR USD	-2.39	1.58	-1.23	4.89
FTSE 100 TR GBP	-0.15	2.93	-3.39	3.19
FSE DAX TR EUR	-0.85	5.25	-11.94	-8.97
S&P/ASX All Ordinaries TR	-3.43	-3.00	-10.01	-6.59
Nikkei 500 PR JPY	-4.75	-4.71	-14.64	-10.91
Hang Seng HSI PR HKD	-9.44	-12.40	-21.91	-21.81
KSE KOSPI Korea PR KRW	-3.22	-1.73	-9.92	-3.00
TSEC 50	-7.94	-8.98	-21.31	-14.87
FTSE ST All Share PR SGD	-5.48	-7.22	-18.27	-16.68
Shanghai SE Composite PR CNY	-5.46	-9.11	-16.90	-17.26
Shenzhen SE Composite PR CNY	-4.51	-13.06	-23.00	-23.99
Bond: Selected Indices	**1M**	**3M**	**YTD**	**1Y**
BarCap Global Aggregate TR USD	-1.75	-2.74	4.94	6.31
JPM EMBI Global TR USD	-0.59	-0.47	7.20	6.84
HSBC Asian USD Bond TR	-0.50	-0.75	4.72	3.58

Source: Morningstar Direct as of 30 November 2011, measured in the base currencies

ING IM 2011 Market outlook

Bond yields (10y)				
quarter end (%)	Q4'11	Q1'12	Q2'12	Q3'12
Countries				
US	2.0%	1.8%	2.0%	2.5%
Eurozone	2.0%	1.5%	2.0%	2.3%
Japan	1.0%	0.8%	1.0%	1.2%
UK	2.3%	2.0%	2.3%	2.8%

Corporate bond (IG) yields				
quarter end (%)	Q4'11	Q1'12	Q2'12	Q3'12
Countries				
US	4.1%	4.1%	4.0%	4.1%
Eurozone	4.7%	4.7%	4.6%	4.5%
Japan	0.8%	0.8%	0.8%	0.8%
UK	5.6%	5.6%	5.5%	5.5%

Equity				
quarter end	Q4'11	Q1'12	Q2'12	Q3'12
Countries				
S&P 500	1100	1045	1100	1150
Euro stoxx 600	216	205	200	210
TOPIX	775	736	800	825
FTSE 100	5000	4750	5000	5250
MSCI EM Free	890	846	940	970

Foreign exchange rates				
quarter end	Q4'11	Q1'12	Q2'12	Q3'12
Currencies				
EUR/USD	1.30	1.25	1.20	1.30
USD/JPY	74	76	75	80
GBP/USD	1.50	1.45	1.40	1.50
EUR/JPY	96	95	90	104
EUR/GBP	0.87	0.86	0.86	0.87

Source: ING IM (12/10/2011)

ING IM Global Economic Outlook

	Real GDP			Inflation			Policy Rates (%, YE)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
World	5.0	3.5	3.1	3.0	4.0	3.0			
Developed	2.6	1.2	1.0	1.4	2.5	1.6	0.45	0.53	0.45
US	3.0	1.5	1.5	1.6	2.8	1.9	0.13	0.13	0.13
Euro	1.7	1.5	0.0	1.6	2.6	1.8	1.00	1.25	1.00
Japan	4.0	-0.4	1.8	-1.0	0.4	0.0	0.1	0.1	0.1
UK	1.8	0.7	0.5	3.3	4.4	2.3	0.5	0.5	0.5
Emerging	8.1	6.4	5.9	5.2	5.9	4.7			
China	10.4	9.2	8.2	3.0	5.5	3.8			

	Unemployment rate			Budget balance			Current account		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Developed	9.1	8.8	9.2	-8.1	-7.7	-6.0	-1.3	-1.4	-1.3
US	9.7	9.1	9.5	-9.1	-9.4	-7.4	-3.5	-3.8	-3.6
Euro	10.3	10.3	11.0	-6.4	-4.5	-3.5	0.0	0.3	0.1
Japan	5.1	4.8	4.5	-8.0	-9.3	-7.0	3.5	2.3	2.8
UK	7.9	7.9	8.4	-10.1	-8.8	-7.8	-2.2	-1.8	-1.3
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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