Key points

- 2012, a year of below potential growth in DM
- Positive cyclical trends justify a cautiously optimistic stance despite lingering Euro risks
- Equities and commodities turned to small overweight

HOUSEVIEW

ING Investment Management Asia Pacific — January 2012

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%	1.9%
Japan	1.0%	1.0%

New year, new optimism?

2011 was an extraordinary year for both the global economy and financial markets. The good old days of the Great Moderation, which were characterised by solid real growth, low and stable inflation and decent returns on risky assets are well behind us. They are not likely to return in 2012.

The seeds for our current predicament were sown in that very period. Behind the calm surface all kinds of imbalances in private and financial sector balance sheets were building up. At a global level these were reflected in ever increasing current account imbalances. While there was much focus on this, insufficient attention was paid to the deeper underlying problem. History is repeating itself: EU policymakers focus on mechanisms to safeguard sovereign solvency in the long run without recognising that the imbalances in the private and financial spheres of the economy are a large part of the problem.

And so it is that we have entered the new year with a global environment broadly characterised by four traits. Average DM (developed market) growth well below levels seen before 2008, the prospect of more volatile DM growth as the credit channel has become largely ineffective, subdued but potentially also more volatile (headline) inflation in DM and a state of policy paralysis particularly in the EU. Though Asian economies will outperform DM, they will unfortunately not be able to escape these perils.

But within this broad picture there are some bright spots too. Economic data in the US continues to surprise on the upside while the fiscal drag is less than previously thought. China has started to ease monetary policy and evidence so far is pointing in the direction of a soft landing. Strong EM (emerging market) fundamentals will entice investors as long as systemic risk does not raise its ugly head. The ECB, in an act to contain systemic risk, opened the liquidity tap to banks through a 3-year LTRO (longer-term refinancing operation) in December, which will be extended in February. Our base case is that EU policymakers, in the time they need to work on game changing solutions, will step in to prevent major accidents along the way through these types of actions.

View: cautiously optimistic

These bright spots give reason for cautious optimism. Stronger cyclical, momentum and sentiment indicators have turned our asset allocation investment signals positive in the early stages of 2012. While Euro zone tail risks have subsided somewhat, we feel that a small overweight position in equities and commodities is appropriate. We are neutral on fixed income (treasuries) and RE (real estate).

Economy

2012 will be a year of below potential growth

The past year has been an extraordinary ride for the global economy and financial markets. We characterise 2011 above all as a year of growing imbalances in private and financial sector balance sheets and a policy paralysis to deal with their repair. The result is a European economy that headed into recession by year-end and leaves the outlook for below potential growth in DM for 2012, combined with subdued inflation.

History has proven time and again that when a certain pain threshold is reached, an innovative solution is implemented to deal with problems that previously seemed insurmountable. Will that pain threshold be reached in Europe within our two year forecasting horizon? The answer is hard to give. Hence the best guess underlying our base case forecasts is that policymakers will muddle through towards a potential game changing solution and will avoid any major accidents along the way.

The themes otherwise underlying our forecasts are the following:

- The euro area succeeds in gradually reducing sovereign and banking system stress, which lays the groundwork for an end to the recession in H2'12.
- The current slowdown is cushioned by the more limited room for discretionary spending to fall than in 2008.
- Lower headline inflation boosts DM real disposable income and consumption.
- Stabilisation in financial markets and confidence prevents a significant (further) rise in household savings and prevents corporate hiring and capex plans from retrenching significantly.
- Strong EM fundamentals support domestic demand in that region and therefore also DM exports.
- Global monetary policy will turn easier next year, supporting financial conditions and confidence. DM policy rates are at the zero lower bound, but more unconventional policy will be implemented. The transmission mechanism in DM space remains heavily impaired though. Meanwhile, lower inflation affords some room in EM space to ease monetary policy.
- The US fiscal drag will be less than we anticipated as the payroll tax cut and emergency unemployment benefits are likely to be extended. China will see some additional fiscal measures.

This then produces a below potential growth outcome for 2012 and a slightly better around potential growth picture for 2013. But the risks are clearly to the downside. In both years we are below consensus, mainly because our view on Europe is more negative. Our outlook for G4 inflation in both years is also below consensus and the risks in our view are also tilted to the downside.

However, we are certainly not yet forecasting a Japan style deflation scenario. Mainly because outright falls in nominal wages are hardly ever seen and only occur after a much longer and deeper deviation of output from potential than we currently forecast. The same kind of downward stickiness applies to inflation expectations: As long as consumers still see a fair number of price increases in their consumption basket (energy!) they are unlikely to expect a fall in the general level of prices. Having said all that, a Japan scenario does represent a non-negligible downside risk beyond our forecast horizon.

ING IM Global Economic Outlook

	Real GDP			Inflation			Policy Rates (%, YE)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
World	3.5	3.0	3.8						
Developed	1.3	1.0	1.7	2.6	1.6	1.3	0.45	0.28	0.28
US	1.7	2.1	2.3	3.1	1.9	1.6	0.13	0.13	0.13
Euro	1.5	-0.5	0.9	2.6	1.8	1.4	1.00	0.50	0.50
Japan	-0.4	1.6	1.7	0.0	-0.2	0.0	0.10	0.10	0.10
UK	0.8	0.3	1.8	4.4	2.3	1.8	0.50	0.50	0.50
Emerging	6.4	5.5	6.5	5.9	5.0	5.0			
China	9.3	7.8	8.5	5.3	3.8	4			

	Unemployment rate			Budget balance			Current account		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Developed	8.7	8.9	8.8	-7.3	-6.3	-5.3	-1.4	-1.3	-1.3
US	9.0	8.8	8.5	-8.6	-7.4	-5.9	-3.1	-3.0	-3.0
Euro	10.3	11.0	11.3	-4.5	-3.5	-2.5	-0.5	-0.3	-0.2
Japan	4.5	4.5	4.2	-9.3	-9.0	-9.5	2.3	1.9	1.5
UK	8.1	8.4	8.2	-8.2	-7.5	-6.2	-1.8	-1.0	-0.8
Emerging									
China	6.5	6.4	6.4	-1.7	-1.6	-2	4.3	3.9	3.5

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

Asian economies, while strong, cannot escape perils of growth and waning risk tides

Prospects are better for emerging markets, though economies here are unlikely to escape the perils of slowing DM growth in 2012. Especially the export economies are vulnerable. 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.

Nevertheless, we think emerging markets may again perform in line with their superior fundamentals (low indebtedness, high growth, vast counter-cyclical ammunition), especially in equities where valuations also appear attractive. China's easing of monetary policy on top of the other countries that have already lowered interest rates may be the catalyst for renewed equity outperformance.

The monetary easing bias is not only visible in DM but also in many emerging markets, despite inflationary pressures. This will underpin EMD rates performance. We think that India is about to go on hold, while China has moved towards an easing bias of monetary policy. On November 30, the PBoC lowered its reserve requirement ratio by 50bp to 21% for big banks and 19% for smaller banks. We expect more of these easing measures. However, some emerging markets face important capital outflows and in these countries (Egypt, Hungary and Turkey) higher rates are likely.

While emerging markets, and Asia in particular, are our preferred regions for our equity and fixed income (spread) allocations, we are mindful that geopolitical risks are never far away. Libya, Egypt, Yemen, Iran, Syria, North Korea and Nigeria are all examples, where things might escalate. The performance of EM asset classes in 2011 was greatly influenced by the tides of risk appetite among investors and this will be the case again in 2012.

Asset Allocation

We went into 2011 year-end with a rather neutral top-down asset allocation stance. In the early stages of 2012, our asset allocation investment signals have strengthened significantly. For all asset classes the quant signals are tilted towards taking risk. Stronger cyclical, momentum and sentiment indicators are key drivers. Also, the likelihood of added short term stimulus and/or liquidity support has increased. We feel that this justifies a more optimistic stance. This optimism is with the necessary dose of caution though, because European downside risks are still present and the largest tail risk on the horizon. Our view is that these tail risks have subsided in the past three weeks and should as such not completely override our more positive asset allocation investment signals.

In light of the fundamental and market signals and our qualitative assessment of systemic risks, it is prudent to adjust our TAA (tactical asset allocation) stance to reflect a cautious optimism.

The positive tilt in the balance of signals and risk is sufficient to anticipate a positive risk adjusted (excess) return through a modest overweight position. We therefore upgraded our equity and commodities stance from neutral to a small overweight. For fixed income (treasuries), we adjust back to neutral from a slight underweight position. The market dynamics in recent weeks express a renewed investor willingness to buy (Aaa) Euro duration, but we are more cautious with respect to this asset class on the potential effect of Euro crisis risks.

Equity

Against the macro backdrop, we expect corporate earnings to decline, especially in Europe. The main reason is a decline in revenue growth; a direct consequence of lower global growth and diminishing profit margins. However, compared to previous recessions we only expect a moderate profit decline this time. In general, companies are in good shape, but we will observe big divergences between companies. Those heavily dependent on European sales and a high commodity input will suffer most; especially as emerging market growth will keep commodity prices at high levels. Internationally exposed companies will fare better.

The comforting news is that current valuations already reflect many uncertainties. From a historic point of view, the trailing PE for global equities is now more than one standard deviation below its 40-year average. In Europe, the valuations relative to the government bond markets are close to the levels reached in the aftermath of the Lehman crisis (see chart).

Bond yield minus Dividend Yield

Source: Datastream, ING IM (December'11)

We identify three themes for potential outperformance in 2012:

1. A regional tilt towards EM and Asia in particular. EM markets disappointed in 2011. Eastern European and Latin American funds lost more than 10% of their assets in 2011 whereas DM funds flows were stable. This was the first time since 2008 we saw such large outflows. Nevertheless, we think EM may again perform in line with their superior fundamentals. Chinese monetary policy loosening may be the catalyst.
2. A switch from defensive towards cyclical sectors. Although valuations of cyclicals relative to defensives are already close to previous recession levels, the timing of the switch depends on the turn in earnings momentum. We expect the upturn somewhere in Q1 of 2012, most likely starting in the US.
3. A continued emphasis on sustainable or growing dividends. In a moderate earnings downturn, dividends can remain stable. Companies do have the cash and the payout ratio is low.

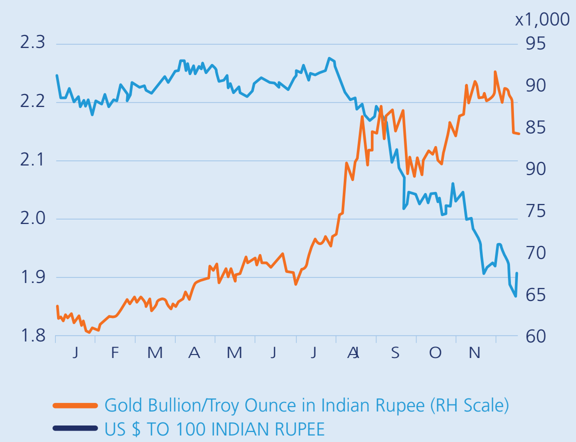
Commodities

Within commodities, we introduce an overweight on Copper within a neutral Industrial Metals sector allocation. This is largely on the basis of Chinese and Indian PMI Manufacturing which both moved higher recently as well as improving US macro data with pent-up demand in US Manufacturing, while LME (London Metal Exchange) copper inventories are falling again since October and copper mine supply remains constrained.

While we believe that crude oil trades at the upper end of the expected price range, geopolitical risks have risen recently. Increased tensions with Iran and their threat to block the Strait of Hormuz have increased tail risks. The departure of US troops from Iraq increases unrest and civil war risks in this country. This, together with improved US consumer confidence, makes us revert Energy from a small underweight to neutral.

We keep Precious metals at a small overweight position. Since September'11 the negative correlation between the USD and precious metals prices seems firmly back in place. USD not only appreciated versus EUR but increasingly so versus EM currencies undermining gold and silver demand in these markets. China and India in particular are the dominant jewellery demand players with a combined share over 55% in global demand. Jewellery demand as well as bar and coin demand proved to be increasingly price elastic in these countries recently. In this sense it is noteworthy that gold in Indian Rupee for example only recently fell below the previous peak (see chart), in contrast to gold in USD that peaked early September. Renewed demand out of India may therefore be triggered and be supportive to gold and silver.

Gold in Indian Rupee



Source: Thomson Reuters Datastream, ING IM

Fixed income

We think yields on government bonds may remain low for the time being owing to the very loose monetary policy in the US and Japan, and the fact that monetary policy in the Eurozone and parts of the emerging world is veering in the direction of further easing. But political turmoil could continue to trigger considerable swings in yields. Although European policy makers have taken steps in the right direction, the risk of a (temporary) loss of confidence among investors has not disappeared. But also for the US government bond market, the lack of effective collaboration between Republicans and the Democrats on bringing down the US federal budget deficit is a concern. Given the presidential elections in 2012, this situation seems unlikely to end soon.

Within fixed income, the disappointing outcome of the Euro summit caused us to move spreads back to underweight. Within spreads the allocation preference shifted further towards higher yielding assets (HY and SBL) they remain well supported by fundamental and market signals. Especially noteworthy was that relative return momentum within spread space became more supportive of high yield and senior bank loans. Next to that inflows remain supportive and bottom-up analyst expectations remain constructive for the next couple of months. Meanwhile, our EM overweight tilt was maintained, but reduced as especially the momentum in EMD HC softened in recent weeks. Still, with fading inflationary pressures and tentative signs of monetary policy easing, local bond markets in EM space remain attractive. Euro area exposed asset classes like European Peripheral Treasuries, Euro Investment Grade Credits and Aaa Euro ABS are still kept at an underweight preference.

Forex

For this year, the FX outlook remains highly dependent on Eurozone sovereign developments and the global cyclical outlook. Unfortunately, both are uncertain.

Regarding the Eurozone sovereign crisis, we will probably again see a year with many EU summits and erratic market behaviour. The ups and downs in risk appetite might again result in volatile price action of G10 commodity and EM currencies. In this uncertain environment, one of the stronger convictions we have is that the Eurozone economy will be weak and that the ECB will have to ease monetary policy further. This implies a lower euro versus the dollar.

It also suggests further weakness of currencies that are vulnerable to the Eurozone sovereign crisis. Apart from East European currencies, one can also think about the SEK (given Sweden's high export ratio to the Eurozone), and even the CHF (the Swiss economy is slowing down rapidly, the currency is still much overvalued, and the 1.20 floor seems very credible).

For USD/JPY we expect trading in a range, as both US and Japan 2-yr yields are expected to remain quite stable. In risk averse periods, USD/JPY might still trade lower.

The outlook for G10 commodity and Asian and Latam EM currencies is more uncertain. A further improvement in the global economic cycle might push these currencies higher, but the Eurozone sovereign crisis could cause sharp drops as well. On balance the outlook seems slightly positive, but cautious positioning is warranted. One of the better positions might be long CNY. As last year, we expect a further gradual appreciation versus the USD.

Global Markets Performance

Equity: Selected Indices	1M	3M	YTD	1Y
MSCI AC World NR USD	-0.20	7.18	-7.35	-7.35
MSCI AC Asia Ex Japan NR USD	0.59	3.29	-17.31	-17.31
DJ Industrial Average TR USD	1.58	12.78	8.38	8.38
S&P 500 Composite	0.99	11.67	1.67	1.67
NASDAQ Composite PR USD	-0.58	7.86	-1.80	-1.80
FTSE 100 TR GBP	1.25	9.40	-2.18	-2.18
FSE DAX TR EUR	-3.13	7.20	-14.69	-14.69
S&P/ASX All Ordinaries TR	-1.57	1.86	-11.43	-11.43
Nikkei 500 PR JPY	0.00	-4.09	-14.64	-14.64
Hang Seng HSI PR HKD	2.47	4.79	-19.97	-19.97
KSE KOSPI Korea PR KRW	-1.18	3.17	-10.98	-10.98
TSEC 50	3.09	-0.31	-18.88	-18.88
FTSE ST All Share PR SGD	-1.97	-1.32	-19.88	-19.88
Shanghai SE Composite PR CNY	-5.74	-6.77	-21.68	-21.68
Shenzhen SE Composite PR CNY	-12.81	-13.72	-32.86	-32.86

Bond: Selected Indices	1M	3M	YTD	1Y
BarCap Global Aggregate TR USD	0.67	0.23	5.64	5.64
JPM EMBI Global TR USD	1.18	5.12	8.46	8.46
HSBC Asian USD Bond TR	0.78	3.91	5.54	5.54

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

ING IM 2012 Market outlook

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

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

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

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

Source: ING IM (12/10/2011)

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