Market Outlook

Monthly Update – ING Investment Management

Key points

- 'Risk rally' highly resilient
- Higher growth forecasts for 2009
- More positive about equities
- Valuation of credits no longer extreme

Bonds	
10-year bond yield (3-month forecast)	
US	3.5%
Eurozone	3.3%
Japan	1.5%
Investment grade credits	+
High-yield credits	-
Emerging market debt	
Hard currency	=
Local currency	+
positive (+), neutral (=), negative (-)	

Equities	
Energy	+
Materials	=
Industrials	--
Durable consumer goods/services	-
Consumer staples	-
Health care	+
Financials	=
Technology	+
Telecommunications	+
Utilities	+
positive (+), neutral (=), negative (-)	

Region	
United States	=
Europe	+
Japan	-
Emerging markets	=
positive (+), neutral (=), negative (-)	

Markets enjoying momentum

Investors are refusing to budge. After a few hesitant weeks during June and July, their risk appetite returned. The main reason for the positive sentiment has been the corporate earnings reports over the second quarter. These have often been better than expected. In the US, about 75% of the figures were higher than expected, in Europe about 50%.

It should be noted, however, that these surprise positive earnings are being driven by substantial cost-cutting, not by higher revenues. On the one hand, this leads to higher than expected profit margins, on the other unemployment is rising due to cut-backs in the workforce. And this ultimately has a negative effect on income growth and consumer spending.

At the same time there are encouraging economic indicators which point to this economic cycle's low being behind us. Activity levels in global trade and the manufacturing sector continue to improve. Moreover, growth in global consumer spending is back in the black. There are also growing indications that the US and UK housing markets are stabilising.

Judging from the increasing optimism among investors about future earnings, the markets' current revival could continue for some time. However, the positive effect of company cost-cutting and inventory replenishment is expected to decline over the next six to nine months. After that the economic engine will have to be driven by a revival in consumer spending. This could be tricky, as households facing job losses, a lack of real wage growth and falling house prices will be more inclined to save their money.

View: growth predictions adjusted upwards

In view of the positive momentum on the financial markets, we believe there to be a fairly small risk of a substantial correction on the equity markets over the next few months. We are therefore more positive about equities and as from early August we adopt a neutral view compared to fixed income. Furthermore, we have adjusted our growth assessments for developed economies upwards for the second half of this year.

Economy: temporary factors behind powerful momentum

Economic contraction slows sharply

A decrease in the contraction rate of the global economy was in line with expectations arising from the various economic indicators published during the past few months. It has also been confirmed by recent growth figures over the second quarter. For instance, the US economy contracted by 1% in the second quarter compared to the first quarter of this year. The contraction of the Eurozone economy remained low at 0.1%. In the first quarter the Eurozone economy contracted by as much as 2.5%, while the figure for the US was nearly 6%.

Statistics on global trade and industrial production have ceased to fall and have even risen slightly recently. This is most visible in Asia, which is benefiting most from the large-scale stimulus package being implemented in China. Yet this trend can also be seen in the US and Europe. Activity is still substantially below the peak levels seen in 2007-2008, however. Consumer growth in the developed economies is also back in the black after an average contraction of 1.6% in the four quarters up to and including the first quarter of this year.

One highly encouraging sign is that there are increasingly strong indications that the US housing market is stabilising. House sales are picking up, while inventories have started to come down. This suggests that the rate of decline in prices will continue to slow. In view of the large inventory overhang, however, we expect prices to continue to fall this year.

These positive indicators have led to us raising our growth predictions for the developed economies by 0.5-1% in the second half of this year. Our assessments for 2010 remain intact: economic growth will generally remain below average, chiefly due to households, banks and (in some countries) companies continuing to reduce their levels of debt.

Three (temporary) growth stimuli

The improvement in growth in the second half of the year will chiefly be driven by three stimuli, the effects of which are expected to be temporary.

Firstly, there is the positive inventory pulse. Economic growth is affected by a decline (or rise) in company inventory levels, as any change to these can be seen as an investment. Inventory cycles are relatively short-term; their effect on growth vanishes as soon as companies have achieved the required inventory level. New orders to inventory ratios in the PMI indices continue to signal further improvement in production in the months to come.

The second stimulus comes from government fiscal policy, whereby any change to the budget deficit affects growth. As it can be assumed that governments will not allow another increase of the budget deficit like that seen over the past nine months, the effect of fiscal policy will gradually decline as we head into 2010. The fiscal stimulus could in fact become negative if governments become convinced this is a lasting economic recovery and they reverse their stimulus packages.

Finally, growth is boosted by developments in the financial system. The financial conditions in developed economies have improved dramatically over the past few months thanks to the rally on the equity and credit markets. We expect central banks to keep interest rate levels low over the next year (and possibly longer). A turnaround in unconventional monetary policy is not expected for the time being. This means that a radical reversal of the improvement on the financial markets is unlikely.

Access to credit for consumers and small and medium-sized businesses, however, depends much more on developments in the banking system. In this respect, the flow of new credit has been negative for a number of months. The question is whether this is caused by supply or demand. Various studies point to declining demand playing a major role, as the purchase of durable (consumer) goods and houses is delayed. Over the coming months, we could therefore see a revival in demand for credit, which would boost economic growth. However, over the past few quarters banks have severely tightened credit terms and conditions, which could cause supply constraints. This of course is a negative factor.

Equities: investors play "the great recovery game"

Optimistic investors drive equities

The positive sentiment on the equity markets has returned undiminished after a few weeks of consolidation during June and July. Global equities experienced a sound 7.3% rise during July.

The main reason for the positive sentiment was company earnings, which were significantly better than analysts had predicted. In the US, most companies have announced earnings for the second quarter and over 70% of them exceeded expectations, the highest percentage in history. In Europe, the reporting season is almost over and here, too, the figures are better than expected, although not as robust as in the US. About half the figures are better than expected. Both in the US and Europe, the surprise positive earnings are being driven by substantial cost-cutting by companies, not by higher revenues. In Europe, revenues even dropped further than expected. Cost-cutting is a phenomenon common to all industry sectors.

At the moment it looks as if company earnings will decline by over 20% this year, while it was earlier feared that this figure could fall by 25 to 30%. For 2010, analysts are already predicting that earnings will rise by about 20% from current levels. It remains to be seen whether this is feasible. The downside of the severe cost-cutting in industry is namely that US unemployment has risen more sharply over the past 12 months than at any time since the Second World War. In Europe, too, many jobs are expected to be cut. As higher consumer spending needs to be the major driver behind a further recovery in earnings next year, the question is whether embattled consumers will fulfil that hope.

In contrast to consumers, investors are pre-programmed to play "the great recovery game" as soon as the economy ceases to deteriorate and corporate earnings are close to rock bottom. This conditioned reflex is reinforced by the central banks confirming that interest rate levels will remain low.

Consumer behaviour, however, depends mainly on the state of the housing market and the availability of jobs. They see little reason for cheer, which is completely understandable in the wake of the sharpest decline in housing prices of the past eighty years and the enormous hike in unemployment (in the US).

Following the creation of the highest mountain of debt in history, companies (especially banks) and consumers need to reduce their levels of debt. Companies are tackling this energetically, partly by rapidly cutting back on their workforces. This is the main reason for the better than expected company figures. Households, too, are reducing their debts. Faced with job losses, a lack of real wage growth and falling housing prices, they have turned to saving their money, and this trend is not expected to be reversed in the near future.

More positive about equities, financials

In the short term, markets could revive further, driven by optimism about the recovery potential for economies and corporate earnings. Later this year, or possibly in early 2010, we may well see that investors have got ahead of themselves and a correction may occur. In the meantime, investors can still profit from attractive dividend yields, certainly compared to continuing low inflation.

In light of the strong momentum on the markets, we have adjusted our negative outlook for equities to neutral.

Moreover, we have become more positive about the financial sector and altered our negative view to a neutral one. Financials are profiting from higher interest rate margins (the short-term interest rates set by central banks remain low, while the 10-year yield has risen), the many credit and equity emissions by companies and the stabilising housing market in the US and the UK. This change is at the expense of the consumer staples sector, for which we have altered our neutral opinion to a negative one. The main reason for this is that we believe that this sector is the least attractively-valued defensive sector.

Bonds: credits no longer valued at extreme levels

Upward pressure on long-term yields

The yield on 10-year government bonds has risen again over the past few weeks. This is particularly true in the US; the increase in the Eurozone was small. This is due to the US government issuing new government bonds worth hundreds of billions of dollars in order to finance its enormous expenditure. This flood of new bonds has a downward effect on prices, which drives up the yield.

In addition, risk appetite among investors is on a rising trend, which leads to them exchanging government bonds for higher yielding investments such as equities and credits.

For the next few months there is still upward potential in yields on government bonds. In the medium term, we expect lower yields: the yield on German 10-year government bonds may fall to about 3% (currently about 3.3%). This is due to the continuing low interest rates set by the ECB, disinflation and the still fragile economic fundamentals.

Credit markets remain strong

Over the past few weeks the higher risk appetite has also greatly boosted the riskier parts of the fixed income markets, such as (high-yield) credits and emerging market debt.

We believe that the improvement in liquidity on the fixed income markets is sustainable. There will be no return to the extremely high risk premiums for the lack of liquidity in the period between September 2008 and March 2009. In combination with the improvement in the fundamental picture (low point of economic cycle behind us, end of economic contraction in sight, continuing stimuli), this has eliminated a substantial number of economic risks. In view of the importance to fixed income of protection against downside risks, this remains a strong boost to the credit markets.

Valuations no longer excessive

Valuations in almost all sections of the fixed income markets are no longer as extreme as they were after the rally from early March onwards. Following the continuing rally of investment grade credits over the past few weeks, this category is also no longer undervalued. The liquidity premium has as good as normalised. However, the cyclical trend, the improvement in the financial sector and the continued inflow of funds from private and institutional investors, remains a major boost for these credits.

We have decided to transfer part of our risk budget from this category to one of the few categories in which the liquidity premium is still abnormally high: asset backed securities (ABS). We expect the European ABS market increasingly to profit from the improvement in conditions on the British housing market in particular.

On the other hand, we are now more cautious about high-yield credits. This category is the most sensitive to the low economic growth environment which we forecast for the next few years and it may already have overstepped the mark in its anticipation of an economic recovery.

Real estate & cash

Real estate equities have risen sharply since their low on 9 March and are currently higher than the levels seen at the start of this year. Equities of highly leveraged companies have benefited most from the rally.

We maintain our preference for ‘sensibly’ financed companies. We believe that defensive companies are more flexible and better positioned to profit from opportunities in the market.

Over the next few months we expect the market to focus on the repair of company balance sheets (share issues, sale of assets). The continuing weak fundamentals for real estate companies mean that we retain our negative outlook for real estate equities compared to the general equity market and compared to cash.