

## Hitting Bottom: 2009 in Review



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*"And when he came back to, he was flat on his back on the beach in the freezing sand, and it was raining out of a low sky, and the tide was way out."*

In the final sentence of David Foster Wallace's 1996 post-modern magnum opus *Infinite Jest*, the narrator recounts the bottoming out of one of the book's central characters in the wake of a particularly harrowing narcotics binge. Certain elements of this character's story arc are reminiscent of the global economy and markets, particularly the collective hangover with which we've been stricken since 2007 after years of gorging on cheap money.

After the bleakness that pervaded the atmosphere this time last year, it's hard to find fault with how 2009 played out. Most major economies emerged from their recessionary slumber to return to growth, and risk markets of all stripes rallied sharply on the year, particularly after March. While major uncertainties persist, prospects for a sustained recovery are favorable. That said, a sense of existential dread seems to hover, with consumers reluctant to come around to the enthusiasm shown by the financial markets.

### A Renewed Appetite for Risk

After a January/February swoon left markets scraping against lows not seen for ten years, U.S. equities staged a furious rally beginning March 9 to more than make up for the disheartening start. The S&P 500 finished up nearly 24% for 2009, while the technology-heavy Nasdaq was even stronger, posting a gain of around 44%. What's more, these recoveries proceeded throughout the year without any significant correction; many markets closed 2009 at or near 52-week highs. Looking outside the U.S., robust returns could be found in pretty much every country and region except Japan, which was able to eek out an advance of only around 7%. Emerging markets were notably strong — the MSCI Emerging Markets Index surged more than 70%, and its Latin American and Eastern European components were even more frothy.

The renewed appetite for risk was also evident in the fixed income markets, as investment grade credit, high yield bonds, emerging market debt and the

entire suite of securitized assets rallied. Treasury securities continued to find an audience as well; despite concerns about the vast increase in issuance and a weaker U.S. dollar, foreigners continued to buy Treasury bills, notes and bonds, while financial institutions took advantage of the very steep yield curve and purchased Treasuries at auctions.

However, even this year's rally could not save the aughts from the ignominious distinction of being the worst decade ever in terms of equity performance in the United States; the S&P 500 Index was down more than 20% since New Year's Day 2000. So dismal was the ten-year period that even the *Wall Street Journal* noted, "Investors would have been better off...just stuffing money under a mattress." Rather than an indictment of U.S. equity investing, however, we think the previous decade — and the boom-and-bust cycles the characterized it — speaks to the importance of global diversification and the value that can be added through active management and thoughtful manager selection.

### Modest Economic Recovery Takes Hold in the U.S.

As reported in these pages on August 17, 2009, the proprietary ING Recession Index indicated that the recession in the U.S. ended in July. Third quarter GDP data released in October backed up our assertion, showing growth of 3.5% for the period and suggesting that the country had emerged from its longest recession since World War II. (Note that this number was ultimately revised down to 2.2%, suggesting a less robust start to the recovery.) The National Bureau of Economic Research, which is the ultimate arbiter on these matters, isn't expected to weigh in on the recession's end for several months.

Stimulative fiscal and monetary policy has been a major driver of this recovery. Fiscal stimulus — such as the "Cash for Clunkers" auto sales program and the home-buyer tax credit — served as a catalyst for private sector demand while also limiting job losses and supporting infrastructure development. Globally coordinated monetary policy by the Fed and other central banks helped to stabilize the financial system and inspire the recovery in the financial markets.

Taking a closer look at the housing market, home sales have ticked up for the past several months, aided by the government tax credit for first-time buyers and continued low mortgage rates. This has corrected excess supply situations in all but the most overbuilt or economically depressed regions. That said, the final S&P/Case-Shiller index release for the year (which reflects data from October) was uninspiring, coming in essentially flat from the previous month and showing price increases in only seven of the 20 regions measured. Still, we expect modest if uneven gains to continue throughout 2010 as home sales are bolstered by the recovering economy. With home prices currently at levels similar to 2003 — and almost 30% below the mid-2006 peak — concerns about the formation of a new housing bubble can be put on hold for the time being.

Despite the many positive economic signals, enthusiasm for the recovery remained fairly muted among consumers. And who can blame them after having lost around \$11 trillion in net worth over the past few years because of declines in housing and equity markets? Facing negative wealth effects, slowing income growth and excessive levels of debt, consumers are saving more and reducing debt, in stark contrast with multi-year trends. And a persistently high level of unemployment is doing nothing to encourage consumers to open up their wallets. In October, the U.S. unemployment rate topped 10% for the first time in 26 years, and it is expected that the country will finish the decade with fewer jobs than existed at its start. And while the monthly change in non-farm payrolls trended upward for much of 2009, we have not seen net new jobs added to the system since the end of 2007, though job growth should turn positive in early 2010. On the positive side, high unemployment contributes to the output gap — the difference between the current level of GDP and its “potential” — which should help contain core inflation in the near term.

However, there was some good news on the consumer front as the year drew to a close. Holiday retail spending was up 3.6% over year-ago numbers, and the Conference Board Consumer Confidence Index finished 2009 with two consecutive monthly increases. Every silver lining has a cloud, though; the shopping data was inflated by an additional day in

the 2009 measurement period, while the Confidence Index remains at levels well below what is considered appropriate for a healthy economy.

### **Have “Green Shoots” Given Way to a “New Normal”?**

With the end of the U.S. recession broadly accepted among economists, the debate has shifted to the strength, speed and durability of the recovery. The immensity of the government response to the financial crisis has created its own set of medium-term risks. The explosion of the federal budget deficit and national debt to historic levels — before accounting for the additional spending expected from the passage of any sort of healthcare reform — raises concerns of higher taxes, a weakened dollar and rising inflation. Further, all of the stimulus will need to be unwound at some point, creating additional uncertainty.

Many prominent analysts have cautioned investors to prepare for a “new normal” — an environment marked by high unemployment, cautious personal consumption and a structural slowdown in economic growth. We find ourselves in a more sanguine frame of mind, however, and our expectation for 2010 GDP growth continues to be toward the high end of the forecast range. We would add that as 2009 progressed and economic conditions brightened, the consensus moved closer to our view.

### **International Economies Are a Mixed Bag**

The third quarter of 2009 saw the euro zone post a positive quarterly GDP number for the first time in a year and a half, though growth was below expectations in part due to a surprisingly weak French economy. Meanwhile, the new year brings with it a new set of challenges for the currency bloc, as the European Commission has warned that public finances in eight of the 16 euro zone nations are at significant risk of becoming unsustainable. Rating agencies have taken notice of the looming debt crisis: Greece and Spain, for example, were recent victims of downgrades, while Ireland, Portugal and France appear to be at risk of similar treatment. Euro zone governments will spend the immediate future grappling with how to fix their debt situations without sabotaging the still-shaky economic recovery.

The U.K. remains mired in recession, posting its sixth consecutive period of economic contraction in the third quarter, even after accounting for subsequent revisions to the GDP number. There are strong signals that fourth quarter results will indicate the beginning of recovery for Britain, though there are still a number of challenges to face — record debt levels, continued tight credit markets, looming tax increases, the unwinding of stimulus programs. Japan, in contrast, has posted two quarters of economic growth but is now wrestling with deflation. With a strong yen making imported goods cheaper for Japanese consumers, the country has seen a sustained decline in price levels for the first time since 2006 and is at risk for a double-dip recession. Recent efforts by the Bank of Japan to remedy the situation were met with indifference from markets and economists alike.

Emerging markets were perhaps the biggest winners of 2009 and possibly of the decade. They were able to withstand the global recession better than developed markets — in sharp contrast to previous recessions in which emerging markets typically were among the hardest hit — due to better economic fundamentals and less dependence on the developed world. (Of course, one need only look to Dubai to understand that not all emerging markets are equally well positioned.) Equity market performance has been striking in 2009 (in the range of 70% in U.S. dollar terms) and nothing short of ridiculous for the decade (Ukraine, for example, posted a ten-year return well into the quadruple digits). And they were able to increase their influence on the international stage, as it was announced that the G-20 — which includes such nations as Brazil, China and India — would replace the G-8 as the main body for global economic policymaking.

China, in particular, continues to grow ever-more important to the global economy. China's economic transformation over the past few decades has been very impressive. GDP per capita has risen from less than \$500 in 1990 to about \$3,500 as of 2009 — a seven-fold increase within a span of two decades. Currently, the country is in the midst of robust rebound thanks to the quick response of Chinese authorities to the global financial crisis and economic slowdown, and its outlook for the coming year is favorable. But many policy challenges remain — from capital market structural reforms to better supervision of bank lending — to ensure China's steady progress and successful evolution into a medium-income country. (See the November 30, 2009, issue of *ING Investment Weekly* for more about China.)

#### **Burst and Bloom**

The oft-referenced "green shoots" of economic recovery matured into something more hardy as 2009 progressed. That news, however welcome, came as cold comfort to many: to the 10%-plus of the American workforce still unemployed, to the millions of homeowners faced with foreclosure, to investors nowhere near breakeven even after the sharp rally in markets since March, to businesses big and small that no longer exist. Maybe that explains the angst.

And so back to *Infinite Jest*: While Mr. Wallace (who took his own life in September 2008, just days before the collapse of Lehman Brothers) ended his book at a psychological nadir on the beach, chronologically the story concludes seven years later with the aforementioned addict presumably free from narcotics but facing an even more immediately precarious situation. Given the boom-and-bust tendencies of the financial markets in recent years, it's hard not to feel a certain cyclical kinship. ■

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