

Market Review Fourth Quarter 2009

Good Riddance

The oft-referenced “green shoots” of economic recovery matured into something more hardy as 2009 progressed. The fourth quarter saw a number of developed economies finally report GDP growth, while the equity bull market continued apace. That said, many investors are happy to bid good riddance to the aughts; in addition to two strong recessions — the most recent of which brought the global financial system to the brink of collapse — the decade proved to be the worst on record for U.S. equity performance.

Modest Economic Recovery Takes Hold in the U.S.; International Economies Are Mixed

Third quarter GDP data released in October indicated growth of 3.5% for the period and suggested that the U.S. 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 than previously perceived.) Stimulative fiscal and monetary policy since the onset of the crisis has been a major driver of the rebound.

Despite the many positive economic signals, however, enthusiasm for the recovery remained fairly muted among consumers — and a persistently high level of unemployment is doing nothing to encourage them 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. 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.

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, including higher taxes, a weakened dollar and rising inflation. Further, all of the stimulus will need to be unwound at some point, creating additional uncertainty.

Looking abroad, the euro zone also posted positive third quarter GDP numbers during the fourth quarter, 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.

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 it still faces a number of challenges — record debt levels, continued tight credit markets, looming tax increases, the unwinding of stimulus programs. In contrast, Japan posted two consecutive quarters of economic growth but is now wrestling with deflation, putting it 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.

A strong secular growth story has been playing out in many emerging nations. The rebound in Emerging Asia thus far is suggestive of a classic V-shaped recovery; China and India have been dominating, and Korea and Taiwan should also contribute. The economic recovery is well underway in Latin America as well — notably in Brazil and to a lesser extent in Mexico — and regional growth should be strong during 2010.

A Strong End to a Strong Year for Equities

A negative return in October broke a streak of seven consecutive months of positive equity performance and led investors to once again consider whether the market had come too far, too fast. October proved to be a temporary blip, however, as the bulls resumed their run in November and December. For the quarter, the S&P 500 advanced nearly 5.5%, while the tech-heavy Nasdaq Composite was up around 7%. Looking at the S&P 500 sectors, information technology, consumer discretionary and health care stocks were the biggest gainers on the period, while financials was the worst performer and the only sector to decline on the quarter. Growth outperformed value over the last three months, while mid- and large-cap stocks were favored over their small-cap brethren.

Most developed markets were able to deliver positive returns on the quarter, though not many kept the same pace as the U.S. Greece, notably, plummeted more than 20% on continued concern about its soaring deficit and the impact of downgrades on its sovereign debt. Emerging markets were quite frothy in the fourth quarter, surging more than 8% on the back of Latin America and Eastern Europe.

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Despite the strong quarter and year, the 2000s are saddled with 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." For emerging markets, on the other hand, 2009 was the icing on the cake of a strong decade. While equity performance was striking in 2009 (in the range of 70% in U.S. dollar terms), it was nothing short of ridiculous for the decade (Ukraine, for example, posted a ten-year return well into the quadruple digits). Not only were the emerging nations able to withstand the global recession better than developed markets, 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.

Looking ahead, we expect the first half of 2010 to be marked by a persistent appetite for risk assets amid continuing accommodative policy measures and low interest rates; cyclical sectors — such as technology, energy, materials and industrials — should benefit. Fed policy, the unemployment picture and fading stimulus should come to the forefront of investor concerns as the year progresses, however, which would favor more defensive sectors, such as consumer staples and telecommunication services.

Rising Rates Hamper Fixed Income on a Total Return Basis

Although November witnessed a mini flight to quality — at one point the yield on three-month bills briefly fell into negative territory as investor demand spiked — the fourth quarter was generally good for risk-based fixed income assets, as most sectors were able to outperform comparable duration U.S. Treasuries. Yields on Treasuries rose across the board, while issues maturing in seven, ten and 30 years fared the worst. The Barclay's Aggregate Index was able to eke out a slight positive return for the quarter despite poor performance in the rising-rate environment of December; for the year, the index was up nearly 6%. Corporate bonds posted excess returns relative to Treasuries in the period — led by financials, leading industrials and utilities — but it was not enough to offset the December increase

in rates and left the sector with its first monthly negative total return since March. Securitized assets also performed well on a relative basis during the fourth quarter, as commercial mortgage-backed securities (CMBS), asset-backed securities (ABS) and fixed-rate agency residential mortgage-backed securities (RMBS) each posted excess returns. Non-investment-grade sectors continued to surge, with global high yield and emerging market debt both outperforming Treasuries.

While some macroeconomic data have improved and prospects for a sustained recovery are favorable, major uncertainties — from high unemployment to significant economic slack — persist. As such, we expect the Federal Reserve to continue to be accommodative, maintaining the fed funds target rate at its current level until at least mid-2010 and potentially for the duration of the year. And although concerns about inflation may resurface intermittently, we don't expect it to be a problem in the near term. This environment should be supportive of fixed income investments in general, even after the asset class's strong 2009 performance. ■

The Barclays Capital U.S. Aggregate Bond Index is an unmanaged widely recognized, unmanaged index of publicly issued investment grade U.S. Government, mortgage-backed, asset-backed and corporate debt securities.

The Nasdaq is a computerized system that facilitates trading and provides price quotations on more than 5,000 of the more actively traded over the counter stock

The Standard & Poor's 500 Index is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The indices do not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot invest directly in an index.



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C10-0107-007 (1/10)