

World Equity Markets: Is There Still Value After the Recent Run?

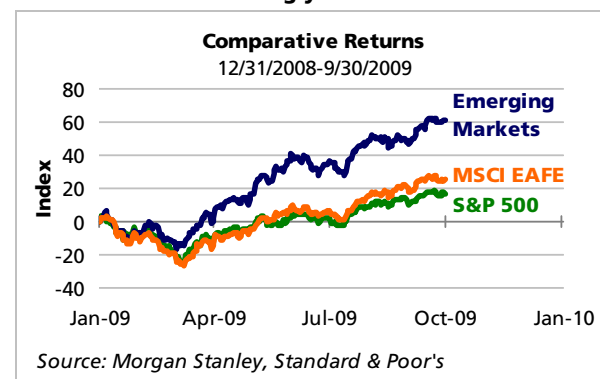


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For the global equity markets, 2009 continues to be a year of superlatives. After being in freefall until early March, markets recovered strongly through June. The much-anticipated third quarter pause never materialized; in fact, the S&P 500 Index posted a third quarter return of 15.6%, one of its best quarters ever but slothful compared to the MSCI EAFE Index return of almost 20% and the MSCI Emerging Markets Index's 21% gain. The graph to the right depicts year-to-date performance as of September 30: the S&P 500 Index has returned 19.3%, the developed international markets are up 29%, and the emerging markets are up a spectacular 64%.

The sudden shift from Dante's inferno to a somewhat rosier outlook in just a few months has left many investors perplexed. Despite the strong recent advances, however, ten-year returns for the S&P 500 and MSCI EAFE indexes at the end of the third quarter were still hovering around zero — one of the lowest ten-year runs on record for developed markets. Emerging markets, with a ten-year annualized return of almost 9%, have done markedly better after the lost years of the 1980s and 1990s. Secularly, the developed economies (arguably

Market Recovered Strongly from March Lows



experienced their deepest troughs early this year. The previously crisis-prone and mismanaged emerging nations have improved their economic stewardship remarkably since being flooded in the 1990s. As a group, they have weathered the recent economic turbulence better than their developed peers; China, India and Brazil, in particular, have either continued to grow or have experienced only a shallow recession, as shown in the table below.

China, India, Brazil have Weathered the Storm Comparatively Well

| Countries | GDP | | | | Trade (% of GDP) | | Demographics | |
|-------------------------------|----------------|------------|-------------|-------------|------------------|-----------------|-----------------------|---------|
| | USD (Billions) | Per Capita | 1-Yr Change | 5-Yr Change | Exports | Deficit/Surplus | Population (Millions) | Unempl. |
| Developed Markets (G7) | | | | | | | | |
| US | 14,143 | 45.4 | (3.9%) | 1.1% | 10.6 % | (2.4%) | 312 | 9.4 |
| Canada | 1,296 | 39.0 | (3.2%) | 1.2% | 27.7 % | (1.8%) | 33 | 8.7 |
| UK | 2,289 | 37.4 | (3.0%) | 1.4% | 28.7 % | (2.4%) | 61 | 7.8 |
| Eurozone | 12,786 | 38.9 | (4.7%) | 0.8% | 14.9% | (0.2%) | 329 | 9.6 |
| Japan | 4,943 | 38.8 | (6.5%) | 0.0% | 12.0% | 0.4% | 127 | 5.7 |
| Emerging Markets | | | | | | | | |
| Brazil | 1,510 | 7.9 | 1.2% | 3.2% | 14.4 % | 0.2% | 192 | 8.0 |
| Russia | 1,531 | 10.8 | (10.9%) | 2.2% | 30.0 % | 8.0% | 141 | 8.3 |
| India | 1,083 | 0.9 | 6.1% | 8.5% | 24.5 % | (6.5%) | 1,181 | 7.2 |
| China | 4,477 | 3.4 | 7.9% | 10.4% | 27.3% | 6.0% | 1,321 | 4.3 |
| Mexico | 849 | 7.8 | (10.3%) | 0.8% | 6.4 % | 0.1% | 109 | 6.1 |

Source: CIA World Fact Book, Bureau of Economic Analysis, U.S. Department of Labor, Statistics Canada, Statistisches Bundesamt Deutschland, National Institute of Statistics and Economic Studies (France), UK National Statistics, Italian National Institute of Statistics, Japanese Cabinet Office, Statistics Bureau (Japan), FactSet. Data as of 8/31/09

Emerging Markets Offer Best Growth Prospects

With the trauma of 2008 and early 2009 barely behind us, it is natural that investors are somewhat uneasy about the 60% climb in global markets over the past seven months. With the global financial system now stable (though by no means eligible for a clean bill of health) and leading economic indicators implying that the global economy is bottoming, the first phase of the equity recovery was largely a reversal of the excessive pessimism embedded in stock prices in March. Resumed (if anemic) growth combined with aggressive corporate cost cutting is setting the stage for strong earnings recovery in 2010. That said, assuming consumers and financial players in the developed world continue to unwind leverage, earnings growth sourced domestically beyond 2010 would likely fall in the mid- to high-single digit range at best. As the figure below shows, the trailing and current year price/earnings ratios are similar for U.S., international developed and emerging markets. Analyzing the expectations and the current valuations in a little more depth could, however, lead to some interesting conclusions.

Looking first at the United States, S&P 500 companies appear the most profitable in terms of return on equity. Expected earnings (from 2010 to 2011) yield a price/earnings ratio of 13.4. A weaker U.S. dollar — which results in higher foreign earnings when translated to the home base — and a modest domestic recovery allow for 15% earnings growth. Despite the mauling it received during the recession, the long-term debt-to-capital ratio indicates a corporate sector that is adequately capitalized. Against a backdrop of low interest rates, we believe valuations remain attractive in the United States.

Like the United States, the international developed markets should see a resumption of growth. However, given the headwind of strong currencies — both the yen and the euro have appreciated markedly against the dollar this year — recovery in

earnings growth is likely to be lower than that of the United States. Return on equity remains relatively low for the index, weighed down by Japan's marginal contribution to profitability. Companies in international developed markets are also emerging from the crisis in relatively strong financial shape. While these markets are a little cheaper than the United States on a trailing basis, the forward price/earnings ratio is expected to be similar. Growth could surprise on the upside if the euro weakens and/or the newly elected government in Japan proves itself capable of jump-starting its marginally profitable domestic sector, though it is premature to consider either of these outcomes likely.

For the emerging markets, strengthening commodity prices and sustained internal consumption growth imply earnings growth in excess of 20% in fiscal 2011. If this proves realistic, the emerging markets continue to offer the best long-term growth potential, at valuations currently equivalent to those of the developed markets. Emerging market companies employ lower levels of debt than their developed peers but generate a return on equity that is only slightly lower than the United States. Given their relative valuation, growth potential and conservative capital structures, emerging markets remain attractive.

Superior Growth Expected to Spur Emerging Market Outperformance

In sum, markets in the United States and other developed nations remain relatively attractive based on an assumption of near-term earnings recovery. Taking a slightly longer view, we believe emerging markets remain the most attractive equity category given a superior earnings growth outlook combined with attractive relative valuations. However, much will depend on the paths of both global growth and interest rates over the course of 2010 and 2011. So while the easy pickings may be behind us, we believe markets have further upside in the coming quarters as the global economy gains some traction. ■

Valuations Attractive, Corporate Profitability Intact

| Valuation | S&P 500 | MSCI EAFE | MSCI Emerging Markets |
|---|---------|-----------|-----------------------|
| P/E (last fiscal year reported earnings) | 15.90 | 14.65 | 13.53 |
| P/E next fiscal year estimated earnings) | 15.48 | 14.87 | 14.41 |
| P/E (next to next fiscal year estimated earnings) | 13.39 | 13.25 | 11.76 |
| Price to Book ratio | 2.08 | 1.57 | 1.90 |
| Price to Cash Flow ratio | 6.30 | 5.53 | 6.26 |
| Price to Sales ratio | 0.99 | 0.72 | 1.09 |
| Long-Term Debt to Capital ratio | 34.40 | 37.45 | 24.94 |
| Profitability | | | |
| Return on Equity (ROE) | 19.42 | 12.24 | 18.19 |

Source: FactSet. Data as of 8/31/09

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