December 2007

Focus

Outlook for 2008

This publication contains ING Investment Management's outlook for 2008. We deal in turn with our predictions for the economy, fixed income, equities and real estate.

The economy

Walking the tightrope between growth and inflation

Let's start with the question on everyone's lips, one which will continue to dominate in 2008: will the United States enter a recession? We do not think it will, even though there are clear downside risks to contend with. The most notable are: a much greater than expected deterioration in the US housing market and labour market and a deepening of the credit crisis.

The situation was clear in November: the market is afraid that the weak US housing market will cause a recession in the US via the financial markets, and as a result lead to a significantly lower level of growth in the rest of the world. Financial institutions are writing off billions of dollars on mortgage-related investments and no-one knows exactly how much damage has been done and when it will all stop. This is causing huge uncertainty on the financial markets.

We estimate the risk of the US entering a recession during 2008 to be about 35%. We expect a slowdown in growth (up to 1 to 1.5%) in the fourth quarter of this year and the first half-year of 2008. However, we do predict a recovery in the second half of next year. Across 2008 as a whole, our forecast for US economic growth is 1.8%. The most important reasons for this are the continuing low unemployment rate and the strong growth in exports. The latter is profiting from the weak dollar, the healthy economic growth in Europe and the robust growth in emerging markets.

Emerging markets sustaining growth

The continuing strong growth in emerging Asian and Latin American countries will provide sufficient counterweight for the slowdown in growth in the US. These emerging markets are playing an increasingly important role in the global economy.

Economic growth in emerging markets is expected to remain high. This is increasingly due to domestic consumption as a result of rising prosperity. The high levels of growth (led by China and India) are also contributing to large-scale investment in infrastructure for example. This in turn results in a continuing high demand for energy and raw materials. Exporters of raw materials, including emerging markets such as Brazil and Russia, are benefiting from this.

Developed economies no longer follow suit

Another interesting development is the decoupling of the US economy from those of other developed countries. Until a few years ago, there was a strong correlation between the US economy and other large economies such as Germany and Japan. This was because their exports depended greatly on the US. Since 2006, however, we have seen a decline in that correlation. The graph (on the next page) shows that the correlation between US (ISM index) and German (Ifo index) business confidence is now in fact negative. A large proportion of exports is still destined for the US, but over the last few years emerging markets have become ever more important to developed countries' sales. This has led to a further decoupling of the various economies. If the economy slows down in the US, this does not necessarily result in a slowdown in the other economies.

The Eurozone economy, for example, is underpinned by strong domestic demand. Incomes are rising steadily, which bolsters consumer spending. Furthermore, economic confidence is high among both manufacturers and consumers.

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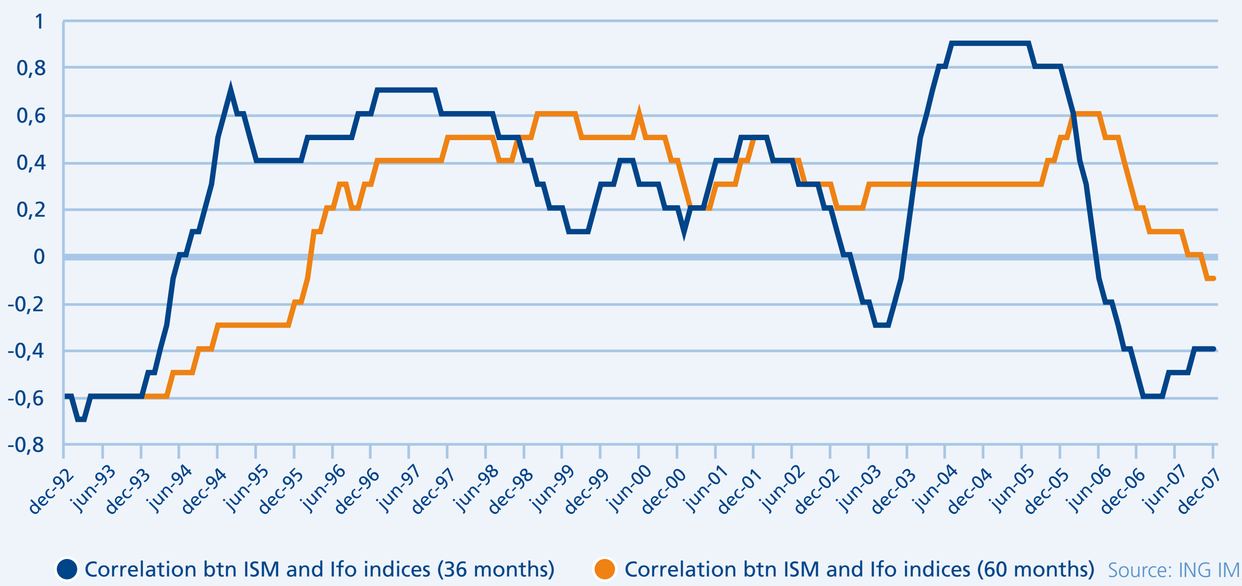
Decoupling of US and German economies



Source: ING IM, Datastream

Central banks facing a huge challenge

2008 will be a tough year for the central banks. They will increasingly have to walk the tightrope between downside growth risks and upside inflation risks.

US consumption under pressure

The Fed is having to deal with severe downside growth risks caused by the US housing market. Falling house prices could have serious consequences for consumer spending. Across 2008, house prices are expected to decline by an average of 10%. House price deflation could continue for 12 to 18 months. The US has a large number of unsold houses. It could take a year for this number to be reduced to an acceptable level.

Americans have been spending more and more, chiefly as a result of the rise in house prices, but also due in part to equity and bond prices. Now that house prices are falling again, a significant boost to spending is being placed under great pressure. Consumer spending accounts for about 70% of the US Gross Domestic Product (GDP) and is therefore vital.

The number of new jobs remains at a reasonable level, but growth is slowing. The weakening of the economy over the next few quarters means that this will not improve for the time being. This will in turn place pressure on income growth and thus also on consumer spending. Banks applying stricter credit conditions, as a direct result of the credit crisis, may also affect consumer spending. Finally, high energy prices also negatively affect consumer spending power.

On the other hand inflation risk is also rising, in the short term mainly due to the high energy prices. The weak dollar has contributed to the rise in the oil price, as this is listed in dollars. The slowdown in growth means, however, that inflation should not be too much of a problem next year.

Fed confronted with rising inflation expectations

A much greater risk for the long term, however, is the forecast of a rise in inflation. This can chiefly be attributed to the declining deflationary trend from Asia (mainly China). Low prices in Asia have long exerted downward pressure on inflation in the West. However, export products from Asia such as clothing, toys and consumer electronics are becoming more expensive. In China, inflation has risen considerably this year thanks to the strong liquidity growth, higher food and energy prices and lower labour force growth. Moreover, the US productivity rate is declining. Since the mid-1990s, the rising productivity rate has boosted growth and exerted downward pressure on inflation.

The Fed will therefore have to tread a careful line between growth and inflation; no easy task. In the short term, it will have to cut interest rates (we predict by up to 4% early 2008) in order to stimulate growth (which means that the dollar may come under further pressure), while in the long term it may be confronted by rising inflation expectations. Just how tricky this can be is illustrated by what happened when the Fed cut interest rates by 50 base points on 18 September this year. The market forecast of higher inflation led to the long-term interest rates rising instead of declining. The effect of the interest rate cut was therefore limited. This underlines how important it is to the Fed's monetary policy to keep inflation expectations under control.

Eurozone growth on target, inflation rising

The ECB also has to find the right balance between growth and inflation, although things are looking rosier in the Eurozone for 2008. Whereas the US and Japan are expected to remain below their long-term growth levels in 2008, we expect a potential growth of about 2% for the Eurozone. A major difference from the US and Japan is that domestic demand will remain strong in the Eurozone as a result of continuing job creation.

The ECB's task is made more difficult by its explicit objectives of monitoring price stability and keeping inflation under control (the Fed's tasks, for instance, include stimulating employment). By doing so, the ECB focuses on headline inflation, i.e. inflation including food and energy prices (the Fed focuses on core inflation). Rising food and energy prices have led to Eurozone inflation rising to 3% in November, while the ECB target is to keep inflation at no more than 2%. In the event that inflation remains above 2% for a long period (we forecast inflation of 2.2% in the Eurozone in 2008), the ECB will come under pressure to raise interest rates. We therefore cannot rule out a rise in interest rates of 25 base points up to 4.25% during the first half of 2008.

We must emphasise that the balancing acts which the central banks will have to perform mean a rising chance of policy mistakes.

US dollar expected to recover

The weakening of the dollar against the euro since 2006 can chiefly be attributed to the difference in interest rate levels in the US and the Eurozone. These levels have now moved much closer to each other. The decline in the dollar has had a favourable effect on the global economy this year. In fact, the weak dollar is keeping the US out of a recession as it shores up the US export position. This is also one of the reasons why job creation remains at a reasonable level.

We predict that the dollar will recover against the euro. There is however room for further weakening against Asian emerging market currencies. The dollar has undergone a record correction and is now undervalued by approximately 20% against the euro. It does seem as if the worst is over however. The trade deficit is also declining for the first time in years. If the US economy does recover, and this is forecast to happen during the second half of 2008, then the dollar may also recover.

The (partial) turnaround of the undervaluation and the expected recovery of the economy could result in the euro/dollar rate moving towards fair value during 2008. This fair value is between 1.15 and 1.20. We do not expect such a dramatic recovery, but a euro/dollar rate of 1.30 as of the end of 2008 is certainly feasible. Two essential preconditions for the recovery of the dollar are the US avoiding a recession (and recovering during the second half of 2008) and avoiding a further escalation of the credit crisis.

Forecast for 2008

	2007	2008	
US			*Consensus*
GDP	2,1%	1,8%	2,1%
Inflation	2,8%	2,4%	2,3%
Central Bank	4,25%	4,00%	3,4%
10-year yield	4,00%	4,25%	
Eurozone			
GDP	2,7%	2,0%	2,0%
Inflation	2,1%	2,2%	2,0%
Central Bank	4,00%	4,25%	3,9%
10-year yield	4,00%	4,25%	
Japan			
GDP	1,7%	1,5%	1,9%
Inflation	- 0,1%	0,3%	0,4%
Central Bank	0,50%	0,75%	0,75%
10-year yield	1,40%	1,70%	

Currency	Current	2008
EUR/USD	1,47	1,30
EUR/JPY	163	130
USD/JPY	111	100

Fixed Income	
Bonds	=
IG Credits	+
HY Credits	+
EMD	+

Source: ING IM

Fixed income

The uncertain economic climate means that financial markets are also facing huge risks. Our outlook for these are given below in brief.

Government bonds

Our position on government bonds is neutral. For 2008, we expect stable to slightly higher 10-year bond yields in the US, the Eurozone and Japan. The outlook for government bonds is therefore not particularly favourable.

Investment Grade Credits

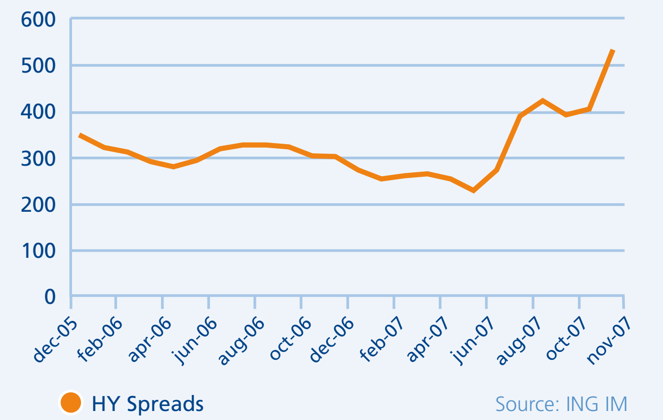
We are positive on Investment Grade Credits as the fundamentals are good. This also applies to values, and particularly to the financial values. We believe that the spread widening of the past few months is highly exaggerated when set off against the fundamental risks.

High Yield

We remain positive about high yield bonds. The macro-economic prospects are good, although the downside risks have clearly increased. We are cautious with respect to the cyclical sectors and are focusing mainly on defensive sectors. The financial sector, which is currently under fire, is as good as absent from the market for high yield corporate bonds. We continue to believe that the default rate (the risk of a company defaulting on payments due to e.g. bankruptcy) will remain low in 2008.

Market prices have already absorbed the fact that 5 to 6% of companies cannot fulfil their obligations, e.g. as a result of bankruptcy. This risk has been allowed for in the (higher) spreads. Our quantitative risk model shows, however, that the market strongly overestimates the risks. Our model puts the risk at 1-2%, a percentage which corresponds to our fundamental analysis.

High yield bond spreads (base points)



Source: ING IM

Emerging Markets Debt (EMD)

For EMD, we are positive on both Hard Currency (HC) and Local Currency (LC). The fundamentals for EMD are also positive. Furthermore, EMD LC is benefiting from attractive differences in interest rates and the expected appreciation of local currencies. Our outlook is positive for fundamentally strong currencies such as the Brazilian real and the Malaysian ringgit.

Equities

The glass is half full

2008 will be a challenging year for equities. Our outlook is moderately positive, but we must emphasise that a great deal depends on the US economy as explained above. This is because the decoupling of economies does not apply to the evolution of the equity markets. US equities continue to account for approximately half of the market capitalisation of equities worldwide.

Expected dollar recovery good news for European investors

This year's declining dollar was not beneficial to European investors. A rise in equities listed in dollars does not translate into much in euros. This also applies to the AEX index. The index is sensitive to dollars as it contains many companies which obtain a large portion of their turnover in dollars. The forecast recovery of the dollar during 2008 will have a positive effect on returns.

Which risks do the equity markets run?

The greatest risk is a US recession, or growth below 1%. If this occurs, 2008 will almost certainly be a loss-making year for equities. We assume, however, that this will not be the case. It would be the first time in history that we had experienced a bear market without a recession. As there is a 65% chance of higher markets, we are moderately positive. The usual suspects for a bear market - overvaluation, over-optimism, weak balance sheets, recession - are simply not in place.

Company balance sheets (too) strong

One reason for remaining positive about equities is the strong balance sheets companies are currently enjoying. Company earnings growth is clearly declining, but profits are at historically high levels. Even if these do turn into losses, companies are in a position to weather the storm for a while.

The most favourable scenario for the equities markets involves companies continuing to re-leverage: reducing a company's capital on the balance sheet and increasing its debts. In the years following the bursting of the internet bubble, companies set to work cleaning up their balance sheets. They now hold relatively large amounts of cash and have few debts. As earnings growth is falling, companies have to find new methods for increasing the return on equity. This can be achieved by reducing the amount of company capital. We are seeing more and more that companies are using their cash to buy back their own shares. Mergers and acquisitions are also sharply on the rise. We predict that these two trends, both favourable to equities, will continue in 2008.

Bush & Bernanke

Another positive aspect for the markets is the situation in which two leading US policymakers find themselves: Bush and Bernanke. They will both give a great deal to avoid a recession. US presidential elections are due in November 2008, and in order to keep alive some hope of electing a new Republican president, the US must not be allowed to enter a recession. Bush's legacy in the history books will also depend on averting a recession. One option, which he just taken up, is to pass financial measures to help the victims of the sub-prime lending crisis. Incidentally, it is noticeable that the S&P 500 index performs best during the third and fourth years of the (four-year) presidential term of office.

Fed Chairman Bernanke has already demonstrated that he is not afraid to act, witness the interest rate cuts in September and October. He is also only at the start of his term of office and is eager to prove himself. A recession would simply not be convenient. If we look at the statistics, equity markets benefit from interest rate cuts. Over the last 30 years, there have been 14 periods in which the Fed has cut interest rates. In 12 of those 14 periods, the S&P 500 index rose in the 12 months following the first interest rate cut and by an average of over 18%. The exceptions were 1981 and 2001, when there was extremely high inflation (1981) and extremely high valuations (2001). Neither of these applies now.

Where the opportunities lie: style, sectors and regions

In times of declining earnings growth, investors shift their focus to equities with an above-average earnings growth, i.e. growth stocks. We prefer companies with above-average earnings growth and a strong balance sheet. These are generally found among large caps.

Diversification across sectors and regions is also important. For 2008 we prefer the Technology, Telecom, Utilities and Energy sectors. In the Technology sector, we find familiar themes such as the internet and biotech. And, once the credit crisis has passed, Financials will again be attractive. These have greatly decreased in value over the past few months. British banks, for example, have dropped in value by about 40%, which takes them down to 2002 levels. Many financial values are now enjoying an attractive dividend return of an average of 5 to 6%.

At regional level, emerging markets offer the best opportunities. In an environment in which above-average earnings growth is becoming scarcer, emerging markets still have room for further outperformance. Valuations are not low, but there is certainly no bubble. The Chinese equities market, incidentally, is experiencing a bubble in the making. We are still seeing huge liquidity flows towards the emerging markets. Moreover, it must be remembered that the current global economic growth enjoys broad support from many areas. Healthy growth in Europe and strong growth in Asia are compensating for the slowdown in growth in the US. This is also beneficial to emerging markets.

We are also positive about Japan. We predict that Japanese companies will achieve the highest earnings growth (8%) among developed countries in 2008. Japanese equities are also attractively valued. Furthermore, we forecast a rise in value for the Japanese yen against the euro.

No recession = higher equities

In conclusion, we can say that if the US does enter a recession (35% chance), it will be difficult for equities to rise. We do not expect a crash, however, if this is the case. Our basic scenario assumes a limited slowdown in the US. This scenario envisages an average earnings growth of 3 to 5% in 2008. In line with this, we predict a total return for global equities of about 5% for 2008. If companies re-leverage fully, there is room for higher valuations and returns could reach 10%. The evolution of the dollar will of course continue to play a major role in achieving returns in euros. The expected recovery of the US dollar could in this case be beneficial to European investors.

Possible scenarios for 2008

	Scenario	US economic growth	Global earnings growth	Inflation/Fed policy	Return	Probability
1	Upside (with corporate re-leveraging)	1-2,5%	2-6%	Comfort zone (with some Fed easing)	> 10% (earnings growth + P/E expansion)	25%
2	Central (with financial de-leveraging)	1-2,5%	2-6%	Comfort zone (with some Fed easing)	3-7% (earnings growth without P/E expansion)	40%
3	Recession	< 1%	slightly negative	Comfort zone (with clear Fed easing)	-5% or worse (earnings declines)	35%

Real Estate

Stable fundamentals, even in volatile markets

2007 has been a turbulent year for real estate equities. Following years of excellent returns in almost all parts of the world, this year has displayed considerable regional differences. European real estate investors have experienced a disappointing year, while sound returns have been earned in Asia. A good example of why it is prudent to spread investments across various regions.

Limited effect of sub-prime crisis

The situation in the US has led to investors being less willing to take risks. We also saw the flow of funds to real estate from hedge funds largely dry up. The latter invest using mainly borrowed money and they could no longer obtain the required loans. Banks were only prepared to offer 70% financing instead of 90%, so the hedge funds had to put up more of their own money. The interest costs also rose. Real estate equities had already allowed for a price cut, which would then later be adopted by the direct market. This is, however, a positive development for the ‘proper’ real estate companies. Until the credit crisis, they found themselves ousted by hedge funds prepared to pay large amounts (too much) for real estate. Now that the hedge funds have largely disappeared from the market, we are seeing the situation return to normal.

What is the outlook for 2008?

In economic terms, the prospects for real estate investments are still good. The interest rate climate, for instance, remains positive. In the US, the Fed is expected to cut interest rates further, while the European central bank is likely to operate a wait-and-see policy for the time being. As long as the cost of financing remains the same or falls, this is positive for real estate projects.

Furthermore, inflation is expected to rise. Although this could lead to higher interest rates, this is not necessarily negative for real estate companies as rental contracts are indexed. If inflation does rise, rents will also rise by the same percentage. Real estate investments have a defensive nature. In the event of weakening economic growth, real estate will usually outperform the market. Real estate equities also have stable and relatively high dividend payments.

The current valuation of real estate equities is also not at extreme levels. Direct real estate was priced at a premium, but that was chiefly in Europe. Declining equity prices in Europe have cancelled out the premium. The valuations for 2008 could even be described as a discount. Finally, demand for real estate as an asset class remains high; after all, a truly diversified portfolio ought to contain real estate alongside equities and bonds.

Has Europe already seen the worst?

We expect the low to be reached during 2008. The United Kingdom is the biggest villain at the moment. This is chiefly due to the Bank of England's attempt to calm the housing market, among other things, by raising interest rates. British real estate equities have experienced a fall of 35% this year and the worst does appear to be over.

The European market is also expected to profit from the new REIT structure. REIT stands for Real Estate Investment Trust. One major benefit is that a REIT is not subject to company tax. This enables a relatively high dividend to be issued. The REIT structure has only just been introduced in a number of European countries, including the United Kingdom, Germany and Italy. The effect of these dividend increases still has to reach its full growth.

The prospects for Asia continue to be favourable. We expect China to continue its solid performance, certainly in the first half of next year. Incidentally, we invest in companies out of Hong Kong with exposure to China. The growth percentages are huge and as yet there is no end in sight. The upward pressure exerted on the Chinese currency, the renminbi, is also a boost. High valuations are in line with the high levels of growth. Within Asia we are also positive about Singapore.

This publication has been produced by Investment Services.
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