GLOBAL PERSPECTIVES

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September Surprise, Tax and Spend Choices, and Mid-term Elections

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Markets should not be confused with the economy. While markets ultimately are tied to the fundamentals and direction of the economy, the market's assessment of the economic environment can be excessively pessimistic and flat-out wrong in the short term. This year, investor psychology has been markedly bearish, interpreting any weak economic data point as a sign of a looming "double dip" and leading investors into a classic bear trap. After a relentless onslaught of bad news in August, September was the polar opposite — positive economic surprises resulted in a quick market reassessment and the best September for equities since 1939. Impending tax and spending policies continue to be sources of uncertainty; should these issues be resolved favorably, however, September may have represented the opening of the door to the express elevator at a time when most investors are still taking the stairs.

September was a very strong month for global equity returns

Index	YTD	Sep-10	2009	2008	2007	2006	2005	2004	2003	1 year	3 years	5 years	10 years
United States													
DJIA	5.6	8.0	22.6	(31.8)	8.8	19.0	1.7	5.6	28.3	14.1	(5.4)	3.1	2.5
S&P 500	3.9	9.0	26.5	(37.0)	5.5	15.8	4.9	10.9	28.7	10.2	(7.2)	0.6	(0.4)
S&P Mid Cap 400	10.4	11.2	35.0	(37.3)	6.7	9.0	11.3	15.2	34.0	16.1	(3.2)	2.3	4.1
S&P Small Cap 600	7.8	11.3	23.8	(32.0)	(1.2)	14.1	6.7	21.6	37.5	13.0	(5.4)	0.5	5.1
Europe													
EAFE	1.5	9.3	32.5	(43.1)	11.6	26.9	14.0	20.7	39.2	3.7	(9.1)	2.4	3.0
Germany	(0.2)	13.7	26.6	(45.5)	35.9	36.8	10.5	16.7	64.8	2.0	(10.2)	6.0	3.7
FTSE100	0.0	8.6	37.1	(50.4)	5.6	26.2	4.4	15.3	26.3	6.5	(12.8)	(2.0)	(0.6)
Emerging Markets													
Brazil	3.2	12.5	128.6	(56.1)	80.0	45.8	57.0	36.5	115.0	16.6	5.5	22.5	21.0
Russia	2.5	5.8	104.9	(73.8)	24.8	55.9	73.8	5.7	75.9	13.2	(13.6)	2.3	15.5
India	18.3	15.6	102.8	(64.6)	73.1	51.0	37.6	19.1	78.4	27.4	1.5	19.1	18.6
China	4.1	8.3	62.6	(50.8)	66.2	82.9	19.8	1.9	87.6	14.1	(7.1)	20.3	12.1
BRIC	5.7	10.5	93.5	(59.3)	59.1	56.6	44.5	17.1	91.7	16.9	(3.1)	16.4	16.2

Governments worldwide stepped into the worst recession since World War II with courage and confidence, boldly led by Fed Chair Ben Bernanke, a student of the Great Depression. Policymakers around the world — including Europe, with its European Stabilization Mechanism — got it right once in a row. Although world leaders were able to encourage recovery, they are less certain about how to promote growth and jobs. While there is significant disagreement about how best to pursue these dual goals, there is no disagreement that they are of the absolute highest priority.

Though jobs continue to be added in the private sector, overall employment growth remains sluggish

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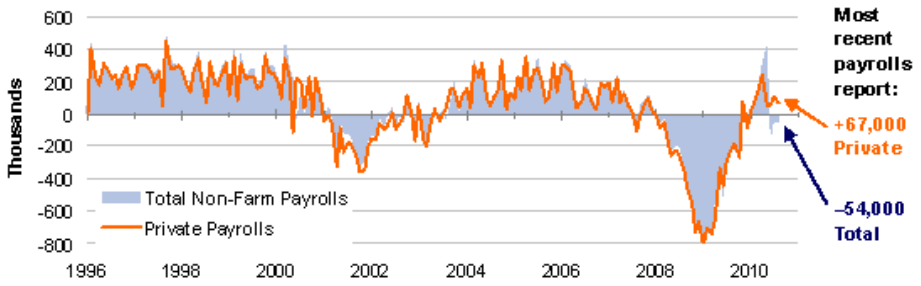
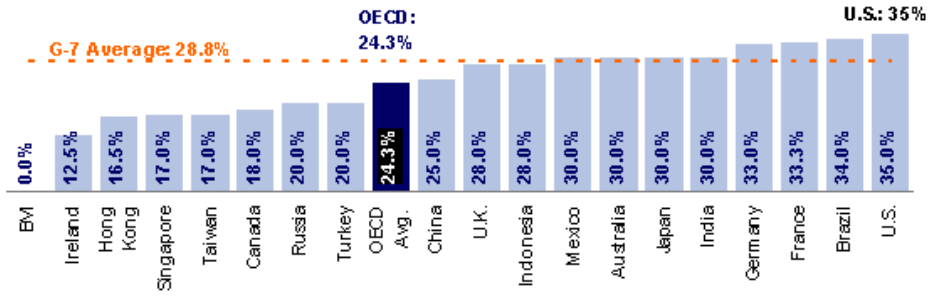


Source: Bureau of Labor Statistics, U.S. Census Bureau, FactSet

In his seminal book on economics The Road to Serfdom (1944), Friedrich von Hayek, Nobel laureate in economics and recipient of the Presidential Medal of Freedom, pointed out the inherent dangers of government economic planning and decision-making (i.e., socialism) on entrepreneurial activity, capital formation and employment. The failure of socialism, ostensibly writ in stone with the fall of the Berlin Wall, has been revisited with the apparent failure of capitalism and the rising economic power of China and its "state capitalism".

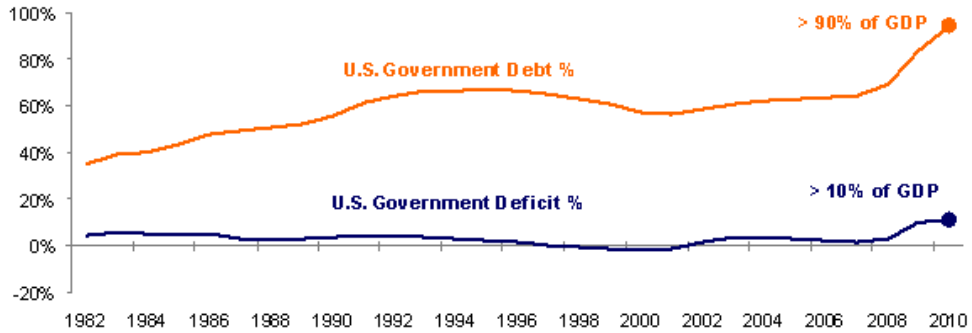
A more pragmatic and less philosophical approach considers the "tax vs. spend" decision. Professor Alberto Alesina of Harvard University has done extensive research into this issue. In his paper "Large Changes in Fiscal Policy: Taxes versus Spending", Alesina and co-author Silvia Ardagna looked at 107 notable fiscal changes that took place in 21 Organisation for Economic Co-operation and Development (OECD) countries between 1970 and 2007, concluding that "tax cuts are more likely to increase growth than those based upon spending increases." Alesina and Ardagna noted that the current fiscal situation in the U.S. — notably the deficit at 12% of GDP — "is partially the result of the stimulus package that was passed to lift the economy out of recession and constituted by increases in government spending". They opined that present fiscal policy "seems too much based on spending" and said that "primary spending needs to be kept under tight control otherwise increasing taxes running after ever increasing spending will not work." Alesina added in a Wall Street Journal op-ed that "Europe seems to have learned the lessons of the past decades: In fact, all the countries currently adjusting their fiscal policy are focusing on spending cuts, not tax hikes. Yet fiscal policy in the U.S. will sooner or later imply higher taxes if spending is not soon reduced."

Corporate tax rates in the U.S. are high relative to other major economies



Source: Organisation for Economic Co-Operation and Development

Both government debt and the deficit are up sharply in the wake of the recession

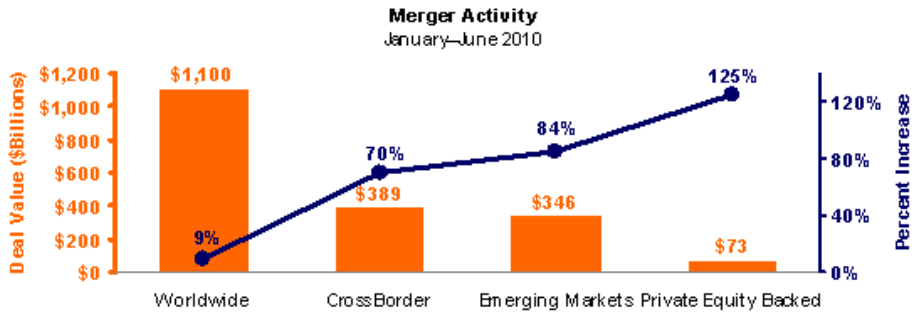


Source: Bloomberg, U.S. Treasury

The U.K. has adopted this compelling approach, which is known generally as "fiscal austerity" but may be better termed "fiscal responsibility". In an attempt to tackle the U.K.'s ballooning budget deficit, Deputy Prime Minister Nick Clegg has instituted significant spending cuts combined with smaller tax increases. The plan received some validation on September 20, when Moody's Investors Services in the U.K. said the country's triple-A sovereign debt rating should hold if cost-cutting plans remain on track.

Returning to Alesina, as a guest speaker at a recent meeting of the ING Investment Management Asset Allocation committee he was keen to point out that while spending cuts reduce deficits, tax cuts are the most effective path to growth since they have a positive impact on both the "demand side" and the "supply side" — that is to say, consumers have more money to spend and businesses have more money to produce.

M&A activity is surging worldwide, especially in cross border and emerging markets



Source: Nasdaq, Bloomberg, ING Investment Management

With mid-term elections looming, tax cutting is suddenly a bipartisan crusade. President Obama and the Democrats proposed business and middle-class tax cuts, while Republicans favor extending all the 2004 Bush tax cuts. Interestingly, Ezra Klein's Washington Post blog reported that Andy Stern, President Emeritus of Service Employees International Union — which represents close to 2 million workers in the U.S., Canada and Puerto Rico — called for a temporary tax break from 35% to 5.25% on foreign earnings of U.S. companies. This is similar to a provision contained in the American Jobs Creation Act of 2004 passed during the Bush administration. We are in an increasingly borderless economy, with multinational operations and enormous cross-border merger and acquisitions activity; clearly, limiting corporate choice through excessive taxation promotes neither growth nor jobs.

Stanford economist Paul Romer perhaps put it best: "A crisis is a terrible thing to waste". The Great Recession should be used as an opportunity both to rein in deficits and to promote growth and jobs. Politicians are well advised to take a global perspective when making their choices on tax versus spend — the voters will remember come November. n

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