Outlook 2015

Equities should remain attractive in 2015 as investors step up their search for yield and central banks maintain favourable monetary conditions.

- Sustainable growth recovery in Developed Markets may be at its strongest since the crisis
- Risky assets remain attractive; equities, real estate expected to be strongest asset classes
- Equity markets likely to be less US-centric as earnings growth picks up in Europe, Japan
- China's economic slowdown remains biggest concern in Emerging Markets

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Outlook 2015
Search for yield intensifies

Summary

As private and public sectors scale back debt-reduction operations and as labour markets show broad-based improvements, economic growth is poised to accelerate further next year to its strongest level since the 2008 financial crisis. Even as fears related to China's slowdown and deflation in Europe continue to weigh on growth and investor sentiment, central bank policies should help maintain easy overall liquidity conditions. Economic growth in the US and Japan is positioned to exceed potential.

The Bank of Japan's continued quantitative easing should boost Japanese equities. Eurozone equities could also benefit from easy monetary policy. Company earnings growth may accelerate in the two regions while slowing in the US, signalling a shift in earnings growth leadership. Emerging Markets (EM) growth will continue to slow amid persistent global and domestic obstacles. Foremost among concerns for EM investors will be China, where uncertainties regarding the housing market and banking sector remain unresolved.

Strongest asset classes in 2015 are likely to be equities and real estate. Interest rates may rise in the US as the Fed prepares to hike rates. Bond yields in Germany and Japan may also show limited increases.

Signs point to a risk-on environment into 2015

While the US Federal Reserve (Fed) and the Bank of England (BoE) prepare for rate hikes next year, the Bank of Japan (BoJ) and the European Central Bank (ECB) continue to move in a dovish direction. The overall mix of monetary policies should result in easier global liquidity conditions, which is good news for risky assets.

Shadows of the 2008 financial crisis still linger in the form of persistent imbalances relating to debt, competiveness, profitability and unemployment. Yet the data suggest that growth momentum is intact. Global growth is projected to be moderately above potential.

Worldwide retail sales have already gained steam in the past few months and should receive an extra boost from falling prices for commodities, especially crude oil, which will have a positive impact on disposable incomes. Employment growth remains in positive territory in most regions and will further underpin consumer spending. All these factors would serve to repudiate the belief that risky assets are widely overvalued.

Economy: central banks' role remains key

- US growth has benefited from policy decisions
- Eurozone recovery dependent on policy action; weaker euro may provide support
- Headwinds prevail in emerging world
- Japan likely to benefit from government and central bank action

Growth forecasts (%, real GDP)

	2014	2015	2016
World Economy	**2.9**	**3.0**	**3.1**
Developed Markets	**1.5**	**2.2**	**2.3**
United States	2.3	3.3	3.0
Eurozone	0.7	0.9	1.6
Japan	0.4	1.5	1.7
United Kingdom	3.1	2.5	2.3
Emerging Markets	**4.7**	**4.1**	**4.2**
China	7.3	6.4	5.3

Source: ING IM, IMF (December 2014)

Central banks' parting of ways sets tone for 2015

Central banks will play a key role again next year. One of the major themes for equity and bond markets in 2015 is the widening divergence in policy paths being taken by the major central banks -- the Fed and BoE on the one hand, and the ECB and the BoJ on the other.

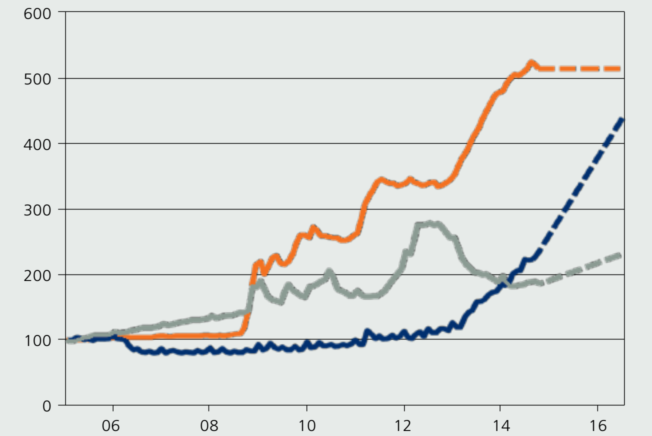
As was predicted, the Fed terminated its purchases of government bonds after more than five years. The Fed's quantitative easing (QE) policy, long a subject of hot debate, appears to have been a success, with the US economy emerging from the crisis significantly stronger than its main counterparts.

In Japan, the central bank surprised analysts by substantially expanding its QE programme in an attempt to boost private sector confidence and convince the market of its determination to get inflation and growth onto a structurally higher path. The purchases are also no longer detailed in specific amounts for a given calendar year but rather as an annual pace, suggesting that the programme has become open-ended with its duration dependent on the attainment of well-anchored inflation expectations.

That leaves the ECB as the only major central bank that hasn't resorted to buying government bonds. ECB President Mario Draghi has attempted to convince markets that the bank will do everything in its power to get growth and inflation on a structurally higher path, and while resistance from central bankers and politicians in the core Eurozone countries remains, sovereign QE seems to be inevitable for the ECB.

The People's Bank of China (PBOC) has also moved toward monetary easing with cuts in its lending and deposit rates after fiscal and liquidity measures failed to stabilise economic growth. The PBOC's decision may also have been driven by the BoJ's aggressive policy and the weaker yen, which has led to currency depreciation throughout Asia. History shows that policy measures in China come in waves, so more such actions may follow.

Central banks' different balance sheet approaches



Fed Balance sheet size (1 jan '05 = 100)
BoJ Balance sheet size (1 jan '05 = 100)
ECB Balance sheet size (1 jan '05 = 100)
(Dotted lines are ING IM forecasts)

Source: Thomson Reuters Datastream, ING IM (Jan 2005 - Nov 2014)

Global economy

The outlook for global growth is characterised by tension between lift in developed markets and drag in emerging markets. In the developed world, uncertainty has decreased and the overall policy response has become more supportive of growth, while emerging markets are still processing some of the imbalances that have built up since 2008. All in all, global growth is likely to remain above potential on average.

Momentum in worldwide retail sales has picked up and will receive a further boost from falling commodity prices. Employment growth is in positive territory in most of the world's regions, which will provide further support for consumer confidence and spending.

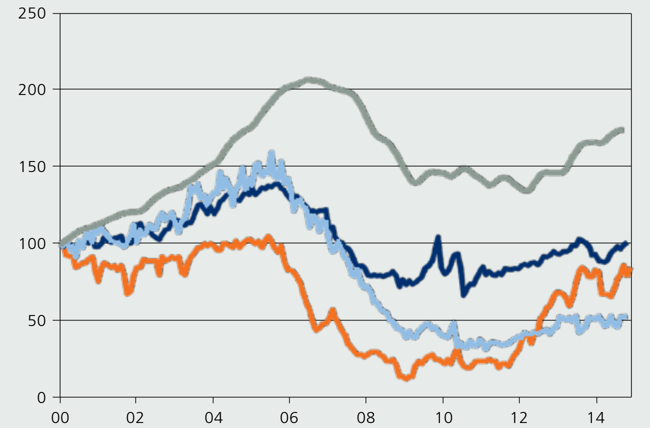
Further evidence of growth momentum can be seen in companies' willingness to spend, as reflected by various capital-expenditure indicators as well as trends in capital goods production and durable goods sales orders and shipments.

US economy

The US is benefitting from a policy response that consists of an absence of fiscal tightening and sustained monetary policy accommodation. The impact on growth of the rise in the dollar and the decline in oil prices should roughly cancel each other out. The momentum in employment growth and other labour market indicators remains robust while consumer balance sheets continue to improve as financial asset and house prices advance.

Other sectors in the economy that until recently showed only subdued growth are showing signs of acceleration as well. While the clearest example is capital spending, many housing market indicators suggest a recovery in that part of the economy as well. The NAHB home builder confidence index is still at a level that suggests a further pickup in home sales and construction spending.

US housing market is on a firmer footing



NAHB Home Builders Index
Existing Home Sales
New Home Sales
S&P/Case-Shiller 20-city Home Price Index

Source: Thomson Reuters Datastream, ING IM (Jan 2000 - Nov 2014)

Japanese economy

Japan's recovery since the April consumption tax increase has fallen short of expectations. In response, the Bank of Japan has expanded its monetary easing efforts and Prime Minister Abe has postponed the second stage of the tax hike.

A plus point in the GDP (gross domestic product) report of the third quarter, which showed an unexpected contraction in the Japanese economy, was that it confirmed the robust growth in aggregate nominal wages of the previous quarter. Real wage income growth should remain positive going forward amid robust employment growth and a relatively tight labour market.

Macroeconomic data for Japan show considerable strength in real activity, which is already showing up in exports, but surveys indicate that current conditions and outlook components remain in a moderate downward trend. Policy announcements and lower oil prices may help reverse that trend in coming months.

Japanese labour market data are strong

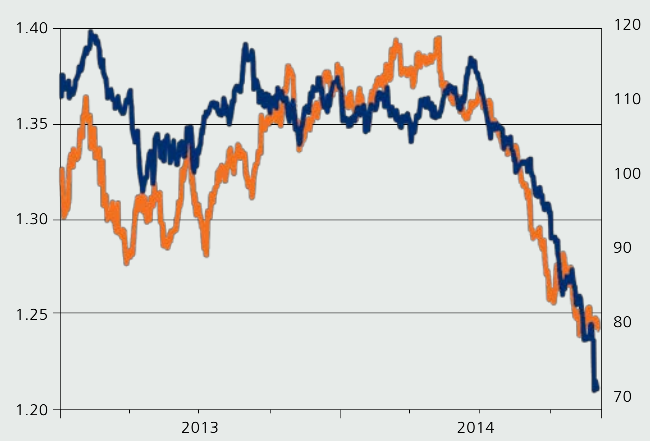
Job to applicants ratio ■ Unemployment rate (RHS)

Source: Thomson Reuters Datastream, ING IM (Jan 1996 - Oct 2014)

Eurozone economy

Europe's GDP is still not back to its pre-crisis level. Underlying inflation is at a record low level and inflation expectations are under downward pressure. Sentiment indicators are still at acceptable levels but a continued slide could be worrisome. Potential positive points are a weaker euro and lower oil prices, which could bolster consumer sentiment as well as business confidence. Unemployment remains stable but hiring intentions have weakened. We expect a moderate but clear improvement in new credit flows, which may help provide support for domestic demand.

Weaker euro and lower oil price should benefit the Eurozone



■ EUR/USD ■ Oil price (Brent, in US$, RHS)

Source: Thomson Reuters Datastream, ING IM (01/01/2013 - 02/12/2014)

Other elements that could help underpin sentiment are a reduction in geopolitical risks and an increase in global risk appetite. A forceful and coordinated policy response could also turn sentiment around but, given the region's current political constraints, may not be forthcoming in the near future.

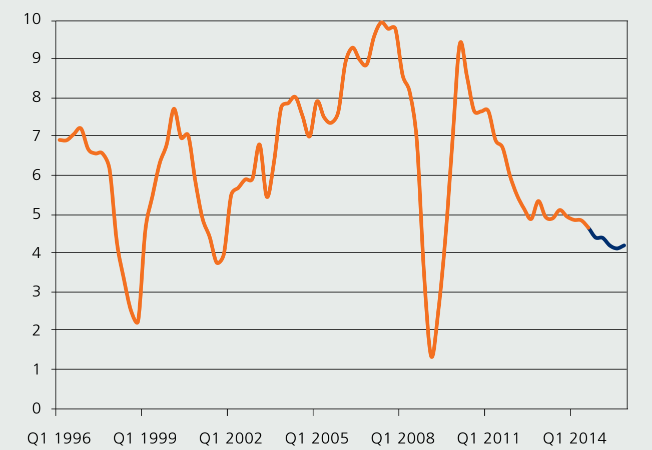
Emerging Market Economy

The EM growth momentum remains weak. GDP growth is likely to slow further to 4% in 2015. Policy makers still fail to decisively reduce macroeconomic imbalances and to create the conditions for future growth. This has kept the dependence on credit and foreign capital high. Without clear improvements in the investment climate and competitiveness, we see limited room for a growth pick-up.

Additional pressure comes from the deterioration in China's growth, as reflected in a deceleration in EM export growth, particularly in the commodity-exporting countries. Anticipation of Fed rate hikes is putting pressure on the global search for yield and therefore on capital flows to EM.

As Chinese demand continues to cool, and with global trade growth likely to remain in low single digits, exports probably won't offer any traction for momentum. What can help is fiscal reforms, liberalisation measures to improve the investment climate and decisive steps to facilitate infrastructure investments. These kinds of policy decisions could create new domestic growth engines to offset the negatives coming from China, the Fed and the high levels of domestic debt.

Emerging market slowdown expected to continue



■ y-o-y GDP change, %, weighted average of 15 main markets ■ ING IM forecast

Source: Thomson Reuters Datastream, ING IM (Jan 1996 - Oct 2014)

Equities: corporate outlook is solid

- Equities remain our favourite asset class
- US earnings growth likely to continue at slower tempo than in Europe, Japan
- Eurozone, Japan to benefit from easier monetary policy, exchange rates
- Balance sheets indicate shift from corporate deleveraging to investment
- Dividends likely to increase in line with earnings
- Japan offers attractive valuation-growth trade-off

Risk premiums, dividend yields are attractive

Equities remain our favourite asset class. The corporate outlook is solid, risk premiums over fixed income look attractive and flows indicate optimism among institutional investors.

Given the investment alternatives, equities and other riskier asset classes have substantial appeal going into 2015. European dividend yields are almost 150 basis points (bps) higher than corporate bond yields, a multi-year high. Risk premiums on equities in all markets are 100-200 bps higher than the long-term average, indicating a sizeable buffer against an increase in government bond yields. Risk premiums will probably normalize in the next one or two years as bond yields rise and economic risks abate.

2014/2015 Earnings estimates

	I/B/E/S 2014	I/B/E/S 2015	ING IM 2014	ING IM 2015
United States	8.0%	10.0%	8.0%	6.0%
Europe	5.0%	12.0%	4.0%	9.0%
UK	1.8%	4.7%	1.0%	8.0%
Japan	19.0%	12.0%	12.0%	11.0%
Emerging Markets	4.8%	11.1%	-	-
World	8.2%	11.4%	-	-

Source: ING IM, I/B/E/S, December 2014

Equity valuations

- Price/earnings ratios in the US and Europe are above historic averages
- Uptrend in earnings growth, easier monetary policies justifies higher valuations in Europe, Japan
- Risk premiums in all markets are above long-term average
- Dividend yield in the Eurozone is higher than corporate bond yield

Earnings growth to shift away from US

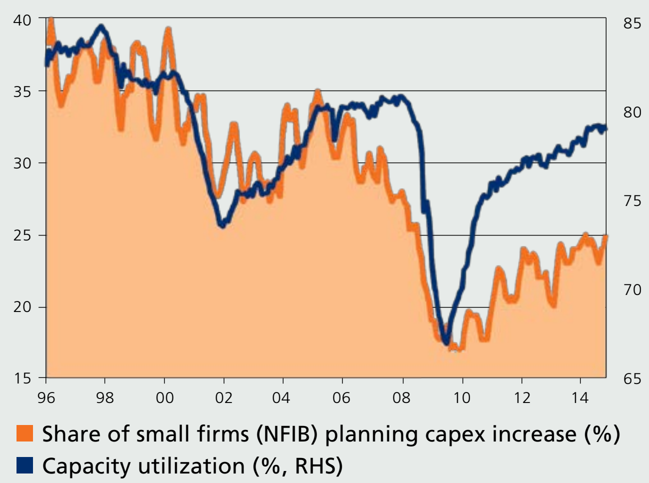
Earnings growth in Japan and in the Eurozone will probably be in double digits, driven by a more competitive currency environment, improved margins and a strong US domestic economy. Valuations in the US and Europe may appear high, based on trailing price/earnings ratios that are 10-15% above their historic averages.

In Europe, as well as in Japan, though, the current point in the monetary and earnings cycles justifies higher multiples. Earnings growth is at the beginning of an uptrend and the ECB and BoJ are both expected to maintain or step up their easing bias. In the US, the picture is less clear. With the Fed likely to move toward a tighter monetary environment, the dollar may strengthen marginally, contributing to slower earnings growth.

Balance sheets appear healthy

Companies are in sound financial shape. Deleveraging is largely over; indeed, US companies have already resumed increasing their debt levels. The net debt-to-equity ratio has bottomed out and companies may actually start to add more leverage, as is already happening in the US. The positive earnings outlook, easy credit conditions and healthy balance sheets form a favourable setting for dividend increases, equity buybacks and equity-financed mergers and acquisitions. The time may also be right for investment in new facilities and equipment, which could give an extra stimulus to economic growth.

US firms expected to step up capital investment



Source: Thomson Reuters Datastream, ING IM (Jan 1996 - Oct 2014)

Japan still our favourite region

Japan remains our preferred region. High earnings growth, favourable valuations and aggressive policy measures – as evidenced by the supplementary fiscal stimulus plan to bolster consumer spending, the central bank's quantitative easing programme and the postponement of the next sales-tax increase -- make the country attractive. A stronger dollar could also help corporate earnings.

Fed action, currency effects will be widely felt

The US faces headwinds in 2015 from a stronger dollar, slower earnings growth and a relatively hawkish central bank. In Europe, the monetary and earnings cycles may offer support for equities. A slightly weaker euro against the dollar may improve companies' competitive positions. The most attractive investment theme in emerging markets is reforms. In a weak EM growth environment, it should pay off to select countries where reforms will improve the prospects for growth. Reforms are a relevant theme in e.g. Mexico, India and Indonesia.

EM equities have become somewhat more attractive since the surprise rate cut in China.

Sector Preferences

Among sectors, we prefer Financials, Technology and Consumer Discretionary. Financials are likely to benefit from credit growth in the US and Europe, an improved outlook for the US housing market and ECB rules aimed at limiting systemic risks in the Eurozone. The sector also offers an attractive dividend yield and the potential for dividend growth.

The Technology sector stands to gain from strong balance sheets and, if corporate confidence returns, improved business investments in IT. Consumer Discretionary may profit from positive wealth effects in the US, lower energy prices and fading austerity in developed markets in general.

Bonds: monetary policies fuel search for yield

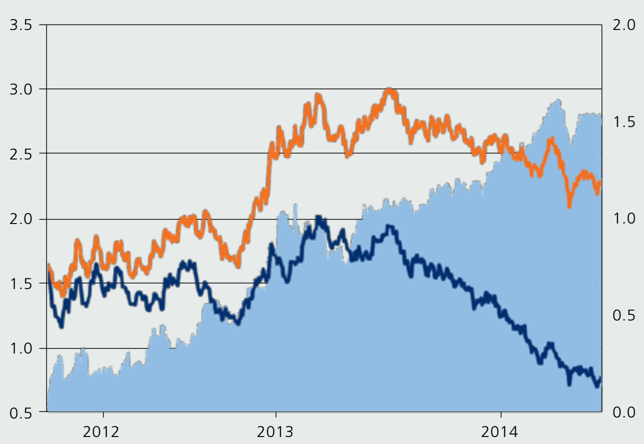
- Treasury yields near historic lows
- Search for yield could support spread products as government bond yields remain low
- We prefer high yield credits vs investment grade
- EUR paper more attractive than US in HY, IG

Fed action may strengthen dollar

With the Fed widely expected to raise rates sometime in 2015, US 10-year treasury yields are likely to show a modest increase next year and the dollar is poised to strengthen against most currencies.

In an overall environment of easy monetary policy, low inflation and slow growth, however, benchmark interest rates in the Europe will most likely stay near their historically low levels. As the major central banks' policies continue to show a willingness to maintain accommodative financial conditions, a renewed search for yield could be supportive for spread products.

US-German bond yield gap expected to widen further



Source: Thomson Reuters Datastream, ING IM (30/06/2012 - 05/12/2014)

The search has already intensified amid anticipation of further easing action by the BoJ and ECB. Among fixed-income assets, spread products are likely to receive most support from this trend.

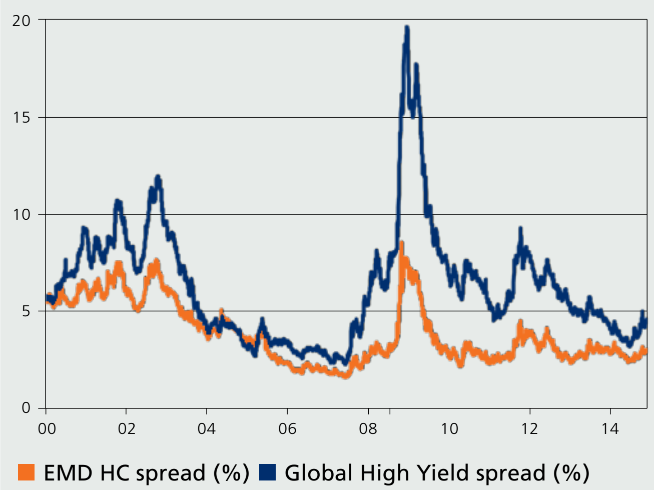
Improved Valuations for High-Yield Paper

Within spread products, the relative valuation of high-yield (HY) paper has improved substantially since the summer up until mid-October, especially versus investment grade. The search for yield appears to be supporting liquidity flows to HY.

Regionally, we prefer euro-denominated paper over US debt. US HY is vulnerable to the near-term risk of a further decline in crude oil prices, which may hurt US HY shale oil producers. The relative weakness in Eurozone macroeconomic data versus the US and the regions' divergent monetary policies makes euro paper more attractive than US paper in investment grade.

Emerging market debt (EMD) also scores increasingly favourably in terms of relative valuation and may benefit from a renewed search for yield. The region's economic surprises have also improved lately. We are most positive on local-rate EMD, given the improving trends in EM monetary policy and inflation surprises. Nevertheless, unresolved balances argue for further weakness in EM currencies, in particular versus the dollar. Again, the Fed's expected tightening next year will probably be negative for flows to the region. The slide in oil prices is also hurting hard-currency EMD for sovereign oil exporters.

Spreads are tight, but not at record lows yet



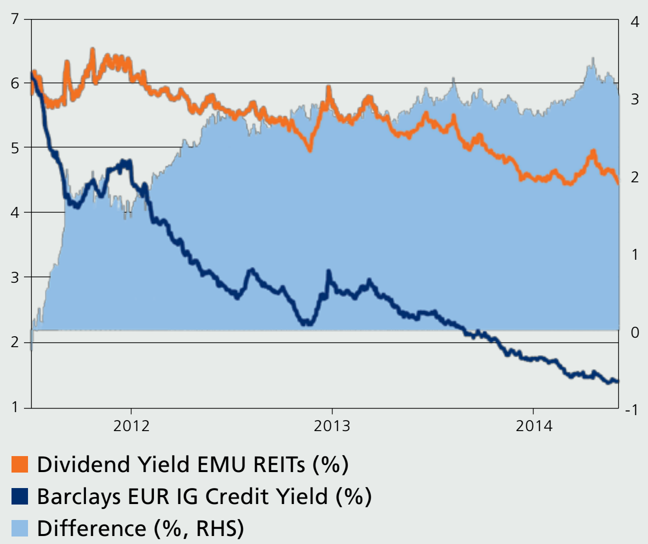
Source: Thomson Reuters Datastream, ING IM (01/01/2000 - 02/12/2014)

Momentum toward Eurozone Peripherals may continue to be supportive as the ECB moves toward sovereign QE. The biggest risk for the category, however, is the increasing risk of deflation and the vicious debt-deflation dynamics that result from it. We also expect divergence within Peripherals to increase in favour of Spain versus Italy and Greece.

Real estate: support from strong US economy

The fundamentals remain positive for real estate. The residential market stands to benefit from a strong US economy and improving labour market. Mortgage delinquency rates meanwhile continue to decline and are almost back at pre-crisis levels.

Attractive dividend yield in Eurozone Real Estate



Source: Thomson Reuters Datastream, ING IM (01/01/2012 - 02/12/2014)

In the non-residential segment, retail sales is an important driver for shopping centres. Increased purchasing power as a result of the drop in oil prices is a positive factor. And while the increasing share of internet sales may reduce the need for brick-and-mortar shops, it could increase the need for logistical real estate like warehouses and distribution centres. Demand for office space and industrial real estate may increase with corporate spending.

As an asset class, real estate offers investors relatively high income that's partially protected from inflation. Current nominal dividend yields for real estate investment trusts in the major developed markets far exceed yields on long-term government bonds, so the search for yield is dominating investment flows into real estate.

The most important risk for the asset class would be a rise in US bond yields, which could deliver a short-term hit before fundamentals take over. During last year's tapering of the Fed's asset-purchase programme, which caused bond yields to soar, US real estate lost 16% in a matter of weeks. We do not expect a sharp rise in US bond yields, however.

Commodities: China remains key

The outlook for commodities is closely tied to China. Deterioration in Chinese macroeconomic data and uncertainty in the outlook for stability of China's financial system are among the chief headwinds facing the asset class. Nearly all segments have been under selling pressure since the summer.

Oil prices have fallen sharply since June as supplies increased with the return of Libyan production and the ongoing shale-oil boom in the US while global growth concerns weighed on demand.

A somewhat oversupplied oil market fuelled some anticipation of signals from OPEC, specifically Saudi Arabia, that the producer group might move to rebalance the market. Those expectations have gone unfulfilled, at least in the near term. At its November 27 meeting, OPEC chose not to cut production, leaving its production quota unchanged at 30 million barrels a day. The cartel appeared to show a fair degree of complacency over price levels at the press conference that followed the decision.

It appears that OPEC is content to let financial markets decide at what price oil should trade. That's a sharp contrast with the group's historic pattern of taking steps to rebalance the market and prices, with a view to meeting their own budgetary break-even requirements. OPEC has for now refused to put a floor under oil prices. We see further downside risks in the near term, as the market is likely to test US shale producers breaking point.

Agricultural commodities meanwhile have continued the outperformance that begun in October, following severe underperformance. Corn may outperform on lower expected acreage and higher feed demand based on attractive relative prices. Meanwhile attention shifts to South American planting where delays have been seen.

Conclusions

In view of global monetary and macroeconomic developments, we maintain a modest risk-on stance going into 2015. The world's major central banks appear willing to maintain accommodative conditions, while companies' financial positions have become stronger.

With interest rates near their historic lows and yields on cash virtually at zero, investors' search for yield will keep funds flowing into riskier assets.

Equities remain our favourite asset class. Conditions are right for companies to increase capital spending -- capacity utilisation is rising, the capital stock is aging, financing conditions are loose, corporate balance sheets and cash flows are strong. Whether firms take the step and resume investment remains to be seen.

We are also positive on fixed-income spread products, with a preference for high-yield over investment grade and for euro- over dollar-denominated paper.

Real estate remains attractive as an asset class. Short-term sensitivity to interest rates remains a dominant characteristic of real estate, despite a strengthening in underlying fundamentals, which remain firm throughout developed markets.

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