AIG Investments

Global Market Watch

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OVERVIEW

- It looks like it is time to declare that the worst of great 2008/ 2009 recession is behind us. Extremely loose monetary conditions and massive fiscal stimulus around the world have stabilized demand and are likely to trigger a fairly strong rebound in economic growth by the end of the year and into early 2010. Some regions will emerge somewhat faster than others, but the globalized nature of the downturn suggests that a synchronized global recovery will follow.
- The big question now is how durable will the recovery be. We believe there is a significant risk of a renewed slowdown in 2010, caused by the reversal of the massive monetary and fiscal accommodation of the past two years.
- Financial markets have been quick to price in a more optimistic economic scenario and stock markets around the world enjoyed strong price appreciation since bottoming on March 9. However, equity investors have taken their foot off the gas so far in June, with most major markets posting negative returns.
- In U.S.-dollar terms, emerging market equities slightly underperformed their developed brethren. Japan was the only market registering positive growth so far this month, and Asia posted smaller declines than Latin America and Eastern Europe.
- Not surprisingly, the U.S. dollar enjoyed a better June to date, rising more than 1% against the currencies of its major trading partners. The biggest losers were the Canadian dollar and the Swedish krona. The British pound followed a sharp 9.5% surge in May, with another 1% gain through the middle of June.

NORTH AMERICA

- One of our major convictions in the past six months was the belief that the U.S. would lead the rest of the world in the coming global economic rebound. However, dramatic policy easing in almost every corner of the world has closed the gap, and the rebound is likely to be more coordinated now.
- In the U.S., the most obvious “green shoots” include the strong rebound in real disposable household income, which should give consumers the ability to rebuild their savings and expand consumption at a moderate pace. Housing is also showing promising improvements on the back of record-high home affordability, as well as government subsidies for first-time home buyers.
- The crucial element behind a rebound, however, will be a slowdown in the pace of job destruction; a necessary condition to lift consumer confidence. The most encouraging evidence here is the sharp slowdown in the number of people continuing to file for unemployment benefits.
- We still expect a more vigorous rebound in the second half of 2009. But, the crucial questions going forward center around the pace and timing of the Federal Reserve’s exit strategy.
- We expect that central banks around the world will begin to remove the current extreme policy accommodation at the start of next year, which will likely trigger a renewed slowdown in the global economy in late 2010 or early 2011.

EUROPE

- Looking purely at the GDP numbers, second-quarter GDP reports are likely to show a slower pace of contraction, similar to the trend in the United States. However, the impetus is coming more from abroad than from an improving domestic backdrop.
- In fact, despite much a larger decline in overall GDP growth, (-4.8% from a year ago in the Eurozone, compared to -2.5% in the U.S.), the domestic recession in the Eurozone was less severe. This was evidenced by Real Domestic Demand, which declined 2.6% from a year ago, compared to 3.1% in the U.S. The difference, of course, is net exports, which added 1.4% to annual first-quarter GDP growth in the U.S., whereas net exports subtracted 2.1% in the Eurozone.
- As a result, U.S. consumers should feel the rebound more directly, especially if we also see job growth picking up. Meanwhile, in the Eurozone, unemployment is likely to drift higher, despite an expected rebound in manufacturing. And the latest data supports exactly those trends with business surveys, such as the German Ifo-Index, showing a faster-than-expected improvement in strongly export-driven manufacturing, while the pace of domestic job losses is still accelerating.
- Similar to the U.S., the UK economy experienced the worst decline in real GDP at the end of 2008, driven by a sharp decline in consumer spending and inventories. The rebound here is clearly helped by declining mortgage rates, which, due to the prevalence of floating-rate mortgages, augment household purchasing power.
- Meanwhile, the outlook for Sweden’s economy has darkened again, as a result of the local banking sector’s exposure to the rapidly deteriorating crisis in the Baltic economies. Latvia has been the hardest hit of the three, posted a stunning 18% decline in real GDP growth during the first quarter.

ASIA

- Japan’s overall GDP data looks even worse than the dramatic decline in the Eurozone. The economy has contracted more than 9% from a year ago. Net exports played a strong role here, as well, shaving 4.8% off the annual growth rate. However, that still leaves a 5% drop in domestic demand, considerably worse than to the United States. The good news is that Japan is likely to benefit more than most developed economies from the rebound in global manufacturing.

- Surveys like the Purchasing Managers Index or the Bank of Japan's widely watched TANKAN manufacturing outlook already exhibit a sharp "V" shape as the decline in activity is starting to turn around.
- Finally, Australia is another economy that stands to benefit from a rebound in global manufacturing in general and commodity demand in particular. Employment growth has turned only mildly negative in just the past three months, which helps explain why the economy posted positive real GDP growth again in the first quarter after just one quarterly decline.

INVESTMENT OUTLOOK

- It seems that the initial equity-market rally that started in March has run out of steam, as investors wait for reality to catch up with the more optimistic macro backdrop that investors are pricing in right now.
- We had been looking for a correction to add to our current moderate equity overweight. The main thrust of the equity rally so far has been in Emerging Markets, which stand to benefit the most from a normalization in trading activity. Hence, we are looking to increase our exposure to the faster-growing regions within our international equity strategies.
- We are heading in the same direction in our fixed income strategies. Here we have increased our exposure to Emerging Market bonds in recent months, while we dial down our allocations to asset-backed securities, which had benefited in the past from asset purchases by the Federal Reserve and the U.S. Treasury Department. We remain overweight in High Yield bonds, which have seen excellent performance in recent months and still look attractive, despite the recent run-up in underlying Treasury yields.
- We expect the path of the global recovery will remain volatile, and investors will have to steer around many additional obstacles in the next 12 months. Therefore, our main emphasis remains on short-term trading flexibility to take advantage of ongoing market dislocations. However, we are positioning our portfolio strategy around a medium-term increase in risk appetite, and one of our strongest convictions is the positive outlook for both Emerging Market bonds and equities.

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Markus Schomer, Global Economic Strategist for AIG Investments, is responsible for providing macro-economic forecasts, analysis and commentary for all AIG Investments groups, with a focus on global economic trends and their impact on financial markets. He holds degrees in Economics from the University of Bonn in Germany and the University of East Anglia, in the UK. He also studied at the London School of Economics and is a Chartered Financial Analyst.