AIG Global Investment Group®

Global Market Watch

March 2007

Markus Schomer, CFA – Global Economic Strategist

REVIEW

- Global economic conditions remain fairly constructive for equity markets. There are growing signs that the U.S. economy is on a weaker-than-expected growth path, but the economies in Europe and Japan show continued strength. Inflation trends are generally within or close to central bank targets, suggesting that monetary policy won't require too much tightening and the very bullish liquidity backdrop can support the 'Goldilocks' backdrop for a while longer.

UNITED STATES

- The tone of the U.S. economic news flow turned more bearish again in February. Only a few weeks ago, economists were cheering a report showing that the U.S. gross domestic product (GDP) increased 3.5 percent in the fourth quarter of 2006. Yet, weaker inventory data and stronger import growth indicate that the Bureau of Economic Analysis, which publishes official GDP data, will have to significantly revise its first estimate.
- News from the U.S. housing market remains mixed. Anecdotal evidence suggests increasing problems in the sub-prime market segment, which is, thus far, more a micro problem that shouldn't affect the whole economy. The 14-percent drop in January's new housing starts restored the sharp downtrend in housing supply from the middle of last year. Yet, the number of unsold homes on the market should start to diminish at a faster pace as housing completions slow more significantly in the coming months.
- Federal Reserve Chairman Bernanke presented a fairly positive outlook on growth and inflation at his latest semi-annual Congressional testimony. However, the chairman made it pretty clear that the risks to the Federal Reserve's inflation forecast were mainly to the upside. If growth rebounds back above three percent in the second half of the year as we suspect, then rising wages could quickly threaten the current positive inflation trend and trigger further interest-rate hikes before year end.

EUROPE

- In contrast to the United States, the European growth backdrop remains strong. The latest data for 2006's fourth quarter GDP growth showed the 12-member Eurozone economy growing at the fastest pace since early 2000. The current main driver is a very buoyant German economy, which is registering faster growth than the United States for the first time since the U.S. recession in 2001.
- The European Central Bank (ECB) is widely expected to continue its policy of gradually tightening monetary policy at its next meeting by raising interest rates to 3.75 percent. The stronger growth figures at the end of 2006 should encourage those ECB board members who are advocating higher interest rates, despite the fact that inflation has remained fairly well contained.

ASIA

- Last month also brought good news for Japan's economy. Its GDP growth accelerated to 4.8 percent in the fourth quarter of 2006 – the best result in almost three years. The strength was broad-based with everything from consumer spending and investment, to trade and government spending all contributing to growth during the quarter. While Japan's growth numbers are notoriously volatile and often subject to significant revisions, the report supports the view that the country's economic rebound is gaining a firmer foothold.
- The strong growth numbers for the fourth quarter of last year also helped the Bank of Japan justify its recent decision to raise interest rates by a quarter point to 0.50 percent, the second interest-rate hike since ending its zero-percent interest-rate policy last July. This decision repaired some of the damage to the bank's credibility after the bank surprised investors in January by leaving policy rates unchanged despite strong indications of an impending rate hike.
- Despite the rate increase and stronger growth, it is likely that "carry trades," borrowing money at very low interest rates in Japan and investing it at much higher rates in markets such as Australia or the United Kingdom, will continue. Even though surveys of investor positioning indicate record levels of capital invested in such trades, it is unlikely that investors will reverse those positions unless interest rates in Japan start rising at a faster pace.

INVESTMENT OUTLOOK

- The outlook for global equity markets remains positive, but we highlight once again the more volatile fundamental backdrop. Our short-term outlook for the U.S. dollar and the greater macro risks in the United States continue to favor international equities. U.S. Treasuries are likely to trend sideways until we see more evidence that the U.S. economy is gathering steam again, while foreign bond yields, with the exception of Japan, are likely to continue their upward trajectory.
- Given the lack of consensus about the U.S. growth outlook, we expect that the U.S. dollar will remain range-bound against most currencies in the coming months. The current bout of weaker economic data in the United States and continued strength in Europe indicate some short-term upside for the Euro, while the Japanese Yen is likely to remain weak until the Bank of Japan adopts a more aggressive tightening strategy.

Markus Schomer, Global Economic Strategist

Markus Schomer, Global Economic Strategist for AIG Global Investment Group (AIGGIG), is responsible for providing macro-economic forecasts, analysis and commentary for all AIGGIG 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.

1001366 02/07