



Market Watch

Markus Schomer, CFA - Global Economic Strategist

U.S. OVERVIEW

- We have witnessed a dramatic increase in market volatility in the past few weeks. Even though the economy appeared in fairly good health going into the summer, a crisis of confidence in the credit quality of mortgage-backed securities triggered a broad-based liquidity crisis in the global financial system. Central banks around the world were forced to provide significant amounts of additional funds to ensure the stability of their banking systems.
- As a result, the deteriorating credit quality of assets linked to the U.S. subprime mortgage market, caused by rising mortgage delinquency rates and questionable business practices among mortgage originators, did not prove to be a surprise. Threatening the stability of U.S. and global financial markets was the realization that the U.S. banking system appeared overwhelmed by a combination of losses from subprime mortgage-backed investments; a large overhang of loans from the recent private equity buyout wave; and the call-up of liquidity back-up lines extended to asset-backed commercial paper issuers.
- The subsequent sharp increase in risk aversion triggered a substantial decline in Treasury yields, as investors scrambled to buy safe, government-owned securities. 10-year Treasury yields fell almost 50 basis points from the middle of July, a reflection of renewed concerns about the overall economic outlook. Even more dramatic, however, was the drop in 3-month Treasury Bill yields, which experienced the biggest weekly decline since "Black Monday" in October of 1987.
- Fixed income credit spreads widened sharply, as many over-the-counter markets saw liquidity dry up and pricing vanish. Equity markets corrected sharply, yet stock indices in the U.S., Europe and most emerging markets are still up for the year. Currency markets were affected by the unwinding of "carry" trades, where investors borrow money in currencies with low interest rates, such as the Japanese yen, and invest the funds in higher-yielding currencies, such as the Australian dollar. This caused a sharp appreciation of the Japanese Yen, while the scramble for liquidity among U.S. investors triggered a pull-back of capital from foreign markets and a broad-based strengthening of the U.S. dollar.
- If the current liquidity crisis abates in the coming weeks, the economic fall-out should remain relatively small. We expect some deterioration in sentiment surveys, and possibly some postponement of spending and investment decisions, but economic growth should remain in the 2.5% - 3% range in the coming six months. The principal reason we remain optimistic for the U.S. economy is the good health of the corporate sector. Here, default rates are still near record lows, cash levels remain high, and profit growth continues to surprise on the upside.
- The Federal Reserve has so far done an excellent job dealing with the extreme financial market volatility. The problem is not a shortfall in demand (other than in the housing market) that can be addressed with interest rate cuts. A liquidity crisis is often a crisis of confidence, which a central bank can only help resolve gradually, by encouraging risk-taking and shoring up the stability of the banking system. The Federal Reserve did exactly that in the past few weeks by providing emergency liquidity and lowering the Discount rate.
- The big question is whether the Federal Reserve will also cut the Funds rate at – or even before – the next scheduled FOMC meeting on September 18. Clearly, if the situation deteriorates further, cutting the Funds rate is the next logical step. However, the Federal Reserve has to balance the need to ensure stability in the banking sector against the stated desire not to be seen as bailing out investors, hedge funds or the housing market. So the monetary policy outlook depends on the evolution of market trends and economic data in the coming weeks.

U.S. INVESTMENT OUTLOOK

- The current liquidity crisis is making it quite difficult to maintain a longer -term investment strategy. However, we believe equity market fundamentals remain positive, helped by strong global growth and robust profitability. Moreover, valuations have improved in recent weeks. We continue to favor stocks over bonds, given the extreme bearishness priced into bond markets right now. Among the major markets, we continue to prefer the U.S. market, at the expense of both Europe and Japan.
- Within our fixed income strategies, we already dialed back some risk in the past few months and continued to do so by reducing our emerging market exposure in August. However, we still believe fundamentals remain supportive for credit market and valuations, which were clearly stretched before the recent sell-off, and these have improved in the past few weeks. Finally, the U.S. dollar is likely to hold onto its gains, as long as markets remain in risk-averse mode.

THE ECONOMY

- Economic news in the past few weeks has remained mixed. Data related to the housing market continues to disappoint, and does not reflect any evidence that demand for homes is stabilizing, or that inventories of unsold homes are being reduced. This combination of factors would be a necessary condition for ending the recession in the construction sector. Manufacturing has lost some momentum at the start of the third quarter, but it is consumers – and their spending – that remain key to the outlook for the rest of the year.

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.

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