



## OVERVIEW

- After the dramatic events of September, which triggered an unprecedented broad-based collapse in counterparty confidence, financial markets responded with some of the worst declines in decades. The S&P 500 lost almost 17% in October, the second worst month since 1940; just behind another infamous October – in 1987.
- Even more dramatic was the explosion of interest rate spreads in the fixed income credit markets. The Lehman High Yield index lost 15.9% last month alone, and spreads over Treasuries widened to a full 15 percentage points.
- Hardest hit were Emerging Market bonds, which posted a 20.6% index decline, with an almost doubling in spreads to 906 basis points over Treasuries.
- Short and intermediate Treasury bonds were the big winners last month with 2-year and 5-year bond yields declining 30 and 34 basis points, respectively. Longer-dated bonds did not participate in the rally, and yields on the benchmark 10-year Treasury bond actually increased 13 basis points, reflecting concern about future inflation and rising bond issuance to finance rapidly increasing public budget deficits.
- The U.S. dollar also continued to benefit from the market turmoil. The broad trade-weighted dollar index gained 7%, and, against the smaller basket of major currencies – which has a longer history – U.S. currency appreciated 8.5%. This was the dollar's best month since currencies started floating in 1973.

## ECONOMY

- The “Great September Crash” wasn't the only reason for dismal market performance last month. Evidence of the economic damage resulting from the shutdown of short-term funding markets pointed to a much more serious contraction in GDP growth in the second half of the year than we had previously forecasted.
- The third-quarter GDP report showed “only” a 0.3% decline, but expectations for the current three-month period are much more pessimistic; we are looking for a 2.9% decline.
- The virtual collapse in manufacturing activity is especially striking and is not just confined to the U.S., but is evident around the world. This supports the argument that the credit crisis is to blame.
- Consumers are still shell-shocked from surging oil and gasoline prices earlier in the year, declining housing and financial market wealth over the past 12 months, and now, surging unemployment. The result is a deeper decline in real consumer spending than in each of the past three recessions.
- The grimmest picture right now is auto sales, which suffer from tighter credit conditions, rising fuel costs, reductions in actual miles driven and darkening expectations about personal finances and job availability. It's no wonder that the Big Three auto companies are calling for Government help.

- The latest employment report also added to the gloom, showing another jump in the unemployment rate to a 14-year high of 6.5%, exceeding the peak of the last recession. Looking ahead, we think we are only at the halfway point in terms of job losses in this recession and expect approximately 1.1 million more people to join the unemployment ranks.
- As for the recession, when the dust settles, we expect the National Bureau of Economic Research (NBER), which officially dates business cycles, will declare the recession to have started in the fourth quarter of 2007 and last until the first quarter of 2009, which would equal the longest post war recessions from 1973 to 1975 and from 1981 to 1982.

## POLICY

- We know the current situation appears bleak, but what is more troubling is the realization that the free market is unable to provide a solution. In fact, everybody is looking to the Federal Reserve and the Department of Treasury to stabilize financial markets and fix the economy.
- Indeed, the Federal Reserve has aggressively expanded its balance sheet in the past 10 months, taking on about \$2 trillion worth of questionable assets from banks, brokers and insurance companies. Of course, that doesn't eliminate the risk, but puts it into the hands of someone with enough patience to hold the assets to maturity and deal with the actual losses, rather than suffer the mark-to-market declines that brought down banking systems around the world.
- In addition, the Fed is increasingly taking over credit intermediation in the short-term funding markets from banks unwilling or unable to do so. Meanwhile, the Treasury is more aggressively using its \$700 billion cache to directly infuse new capital into the banking system. So far about \$165 billion have gone to shore up equity at a variety of banks and insurance companies, and it won't be surprising, if the Big Three auto companies are next on the list.
- We also have to consider the transition of power from the outgoing Bush administration to the incoming Obama government, a period that plunges us into a 2½-month-long lame duck session right at the time when decisive governmental leadership is paramount. So far, Fed and Treasury have done what they can to prevent greater damage to the broader economy; a strategy that, at best, has produced mixed results.
- The next step is a boost to aggregate demand at a time when consumption, investment and exports are all suffering from the fallout of the crisis, and neither monetary policy nor the exchange rate seems to be able to provide the necessary stimulus. The only help right now is coming from rapidly falling oil and gasoline prices, as well as resilient corporate productivity growth, which should shore up earnings and lead to wage and salary growth.
- The trigger for a stabilization in the first half of next year, however, will be another sizable economic stimulus package, which will buy more time to allow the easing of monetary policy to trickle down to consumers and corporate funding costs and engineer a stronger rebound in the second half of 2009.

## INVESTMENT OUTLOOK

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- We maintain a cautious risk profile in most of our portfolios. We have not changed our balanced bond/equity position believing equities will remain very volatile during the current bottom-building phase. There are still a lot of downside risks and concerns about further downgrades to earnings expectations and more forced selling from hedge funds suffering massive asset withdrawals.
- However, stock market valuation is starting to look attractive with price/earnings ratios and earnings revisions running close to levels seen during the 1990-1991 recession. Within our international equity portfolios we maintain our long-standing U.S. overweight and still expect the U.S. economy to lead the rest of the world in the current business cycle, due to its stronger, more decisive policy response.
- Within our fixed income credit portfolios, we increased our underweight in Emerging Markets where funding concerns and a stronger dollar are hurting fundamentals. In addition, massive portfolio capital outflows have hurt performance in the past few months, a trend that is likely to continue in the near term.
- Offsetting the EM underweight, we maintain an overweight position in pass-through mortgage-backed securities, which have held up much better than other fixed income credit asset classes compared to Treasuries thus far this year.
- The Lehman MBS index is posting a 2.5% absolute return through the end of October, compared to 4.5% for the Treasury index. Before we start looking at increasingly attractive valuation propositions in many of the typically riskier asset classes in our portfolios, we need to see more evidence of a return of counterparty confidence and an easing of financial market conditions coupled with more government action as a prelude for an improving fundamental outlook.



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