AIG Investments℠

Global Market Watch

February 2008

Markus Schomer, CFA – Global Economic Strategist

GLOBAL OVERVIEW

- Over the past few weeks, investor fears of a U.S. recession and a spillover to other parts of the world intensified, affecting global stock and bond markets. Last month in the U.S., stocks fell a little over 6%. However, domestic markets still outperformed Japan, which lost 11%, and Europe and Emerging Markets, which were down 13%.
- Global government bond markets saw the biggest rally in U.S. Treasuries, which increased 2.6%. Other markets followed the same direction, but spread widening vis-à-vis the U.S. meant that all major government bond markets underperformed in January. In the currency market, the U.S. dollar lost further ground during that period, with the Yen and Swiss Franc the main beneficiaries.

NORTH AMERICA

- The past few weeks brought more evidence of a more serious slowdown in the U.S. in January. Job growth appeared to slow more than expected, consumer confidence is deteriorating sharply and a survey that tracks activity among U.S. service sector businesses registered the biggest decline since its inception in 1998.
- We still want to see confirmation of a deterioration in consumer spending, for example in the next Retail Sales report, but we have to acknowledge that the economy is starting the year in worse shape that we had expected; a more serious slowdown in the first quarter cannot be ruled out.
- However, we still believe the aggressive fiscal and monetary policy response from the Federal Reserve will engineer a strong rebound in the second half of the year.
- In our opinion, the picture in other parts of the world varies more widely than the headlines suggest. Instead of simply reacting to a slowdown in the U.S., there are separate drivers at work in each of the major economies.
- In Canada, for example, the growth backdrop is deteriorating due to the strong connection between the manufacturing sectors in the U.S. and Canada; the clearest evidence here is the sharp drop in Canadian motor vehicle exports last quarter. Consumer spending in Canada has remained quite healthy due to robust job and real income growth. The latter is the result of country's low inflation, which is the key difference between the two neighboring economies.

EUROPE

- We have been highlighting the loss of momentum in Eurozone growth, which last year was mainly driven by slowing manufacturing activity, seemingly the result of a stronger currency and eroding international competitiveness. However, at the turn of the year, manufacturing stabilized, and the most recent data evidence points to a strong rebound in export orders, despite a strong currency. Meanwhile, service sector activity slowed abruptly at the end of last year, driven by a notable decline in real household income; the result of higher Eurozone inflation.
- The European Central Bank decided to leave its interest rate unchanged. While domestic demand in France is still holding at very robust levels, most recent Purchasing Managers' Indices for the Service sector showed Germany has slowed notably, and Italy significantly – close to the lowest level since the index inception in 1998.
- Services activity in Spain outright collapsed in January according to the most recent survey. Undoubtedly, this was caused by falling house prices, but also rising inflation, which created a notable slowdown in real consumer spending. President Trichet has toned down his previously hawkish rhetoric, yet it seems the ECB will only yield to calls for lower rates if inflation starts to recede from the current 14-year high level of 3.2%, back towards the bank's 1% - 2% comfort zone.

ASIA

- We have also highlighted the deteriorating growth momentum in Japan in the past few months. While we are still waiting for confirmation from the fourth quarter 2007 GDP report, there are already tentative signs that the slowdown will be short-lived and that Japan is not heading for a recession.
- Surveys show confidence among smaller, more domestically focused companies deteriorated sharply at the turn of the year, yet larger, more global firms reported little change in sentiment. The Bank of Japan has toned down its own rhetoric in recent months and postponed the thought of raising interest rates for now.
- Australia is another unique story. Here, the local central bank just raised interest rates by a quarter point to 7%. The trigger was a pickup in core inflation to a 16-year high of 3.6% last

quarter. Home prices are still growing at a double-digit pace and show little sign of slowing, retail sales are running at an 8% annual pace, and unemployment remains close to record lows.

- Export growth has slowed significantly in the past 18 months as a result of the appreciation in the Australian dollar. Yet, the strong exposure to Asia has insulated the country from the additional headwind of weaker U.S. demand.

GLOBAL OUTLOOK

- Clearly, current market volatility is generating considerable tactical investment opportunities. Valuations in both global equity and many fixed income credit markets start to look quite attractive. However, fundamentals still remain somewhat uncertain, and earnings expectations are still on a downward trend. We have not changed our asset allocation and maintain our moderate equity underweight.

- In the U.S. we are starting to look beyond the current weakness towards the impact of aggressive policy stimulus; in the rest of the world we are still monitoring the slowdown. Market technicals, which are difficult to forecast, are keeping us from increasing risk in our asset allocation. These include further extensive asset write-downs by global banks, the lack of securitization of mortgage or other types of bank loans, and the lack of liquidity in secondary fixed income markets.

- There are signs that a few long-term investors are starting to return to the market, but most investors remain on the sidelines, waiting for the uncertainty in financial markets to improve before committing new funds to equity or credit markets.

Markus Schomer, Global Economic Strategist

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.

1003070 2/08