

GLOBAL OVERVIEW

- The global financial markets are currently revolving around developments in the U.S. housing and banking sectors. At the end of October, fears of a systemic crisis in the U.S. financial sector resurfaced; this time with a vengeance. Housing data in the U.S. continues to deteriorate, with sales continuing to fall and delinquencies accelerating. Oil prices are close to \$100, which two years ago most economists thought would be unimaginable. Additionally, major banks and brokers are reporting massive asset-value write-downs as a result of actual losses in their mortgage portfolios and mark-to-market losses for assets where the secondary markets have dried up.
- Right now, investors appear to be focusing their risk management on speculating about extreme scenarios, irrespective of the low probability of such outcomes. How else can we explain that genuinely robust economic trends are being brushed aside with the argument that if U.S. and global growth hasn't slowed yet, it surely will in the future? In such an environment, it's no surprise to see market volatility spiking once again.
- Equity markets around the world have sold off sharply in the past few weeks. Hardest hit were North American markets, Japan and Emerging Asia, while Europe and Latin America fared better. The latter markets continue to benefit from strong Asian export demand and rising commodity prices.
- Government bond markets around the world rallied, led by U.S. Treasuries. This move was driven by concerns about economic growth; expectations of further interest-rate cuts by the Federal Reserve; and "flight-to safety" flows, as a result of the renewed intensification of the global liquidity crisis. Finally, the U.S. dollar continues to lose ground against most other major currencies on the back of increasing economic uncertainty, deteriorating interest-rate support, and concerns that holders of large foreign currency reserves will diversify away from U.S. dollars to other currencies, such as Euros and Japanese Yen.

UNITED STATES

- While market trends are dominated by fears that the U.S. housing and financial market crisis will lead to a recession – or at least a sharp slowdown – investors continue to ignore the evidence that outside of housing, economic

activity remains fairly robust. Recent reports on trade and inventories suggest that the U.S. economy grew close to 5% in Q3, an amazing result for an economy that is considered "on the brink of a recession"

- Of course, growth will slow in the current quarter from the 4% average we've experienced over the past two quarters; we are forecasting 1.9% growth in Q4. However, if you believe this is the start of the recession, rather than payback for the excessive returns of Q3, you would also have to believe the summer's strong performance truly reflected the underlying strength of the economy, which we don't believe.
- The Federal Reserve is putting on a brave face amid the ongoing turmoil. Following the larger-than-expected September rate cut, which was supposed to "forestall some of the adverse effects on the broader economy [...] from the disruptions in financial markets" (FOMC, 9/18), the Fed followed up with another rate cut on October 31, despite a much-stronger-than-expected Q3 GDP report published the same day.
- In addition, the Fed moved to a more balanced assessment of inflation and growth risks, indicating that further rate cuts will not be automatic. However, given the fear gripping the financial markets and the systemic risks in the banking sector, the Fed has very little choice but to support sentiment through rate cuts. This will prevent a further downward spiral in stock prices, which – if it continues – would add to the headwinds buffeting the overall economy.

EUROPE

- Monetary policy is also becoming more of a factor in the European landscape. So far, the ECB is sticking to its story of emphasizing inflation risks. However, the most recent Purchasing Managers Surveys gave additional credence to the fact that the Eurozone economies are losing momentum. The strong Euro, higher interest rates, and the overall impact of tighter credit conditions are weighing on the region's business spending.
- To date, negative consequences from slowing house prices are not reflected by Eurozone-wide data. The outlook for the UK has probably deteriorated the most, given its dependence on housing and the large financial sector. Consequently, we are looking for the Bank of England to lower interest rates early next year.

ASIA

- The main story in Asia in the past few weeks has been the strength of economic activity in Australia. Despite a weaker housing market, appreciating currency and rising interest rates growth remains buoyant, which last week spurred the central bank to again raise interest rates to 6.75%. These developments are occurring in the middle of an election campaign, where the opposition is leading in the polls. Election issues are adding fuel to the fire by attacking higher fiscal spending and promising tax cuts in the next fiscal year.



Markus Schomer, Global Economic Strategist

GLOBAL OUTLOOK

- As part of our global asset allocation, we maintain our neutral stance between bonds and equities in volatile markets, still believing global economic growth will remain strong, and financial markets will calm down once the current wave of fear subsides.
- Bond markets are already pricing based on the sizable probability of recession in the U.S. and they are ignoring existing inflation risks. Within our equity allocation, we still prefer the U.S, despite the current difficulties, based on interest-rate support and greater transparency. However, it's important to remember that U.S. markets have not been rewarded for its equity strategy yet.
- Among the major fixed income asset classes, we increased our exposure to Emerging Market bonds and non-dollar bond markets, given our bearish near-term outlook for the dollar. Given the volatile market backdrop, we remain vigilant regarding the probability of more extreme economic outcomes, such as a faster rebound or a more severe slowdown, and we are monitoring our asset allocation strategies more closely, so we are always ready to take advantage of changing market trends.

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.

AIG Investments is a group of international companies that provide investment advice and market asset management products and services to clients around the world. AIG Investments is a service mark of American International Group, Inc. (AIG). Services and products are provided by one or more affiliates of AIG.

Certain information may be based on information received from sources AIG Investments considers reliable; AIG Investments does not represent that such information is accurate or complete. Certain statements contained herein may constitute projections, forecasts and other forward-looking statements that do not reflect actual results and are based primarily upon applying retroactively a hypothetical set of assumptions to certain historical financial information. Any opinions, projections, forecasts and forward-looking statements presented herein are valid only as of the date of this document and are subject to change. AIG Investments is not soliciting or recommending any action based on any information in this document. AIG Investments Europe Limited is authorised and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by AIG Investments Europe Limited.

Certain statements provided herein are based solely on the opinions of AIG Investments and are being provided for general information purposes only. Any opinions provided on economic trends should not be relied upon for investment decisions and are solely the opinion of AIG Investments