AIG Global Investment Group®

Market Watch

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Markus Schomer, CFA - Global Economic Strategist

OVERVIEW

- Although the volatility that shook financial markets in late February declined again in March, investors are still nervous about the U.S. economic outlook. The sharp divergence of opinions among major Wall Street forecasters regarding the economy's immediate future is evident in the lacking trend in recent economic reports. Attention is focused on the sub-prime mortgage market problems, as exemplified by the headline-grabbing solvency crisis of New Century, the nation's second largest sub-prime lender.

- Stock markets recovered most of the losses incurred in February. In fact, in late March, the S&P 500 enjoyed its largest weekly gain in four years. Most other stock markets around the world followed suit, posting positive year-to-date returns at the end of March. Bond markets, on the other hand, have not given back much of their gains from the late February rally. Bond investors are clearly more concerned about the economy than their equity colleagues.

ECONOMY

- The key concern for most investors is a spill-over of the sub-prime mortgage market's credit problems to the wider economy. So far, the evidence is patchy at best. Delinquency rates among sub-prime borrowers are quickly increasing, and a number of lenders in the sector have gone out of business. However, for this to turn from a sector event to a macro issue, the credit crunch needs to spill over to borrowers with better credit scores and to non-housing related sectors. So far, there is no evidence that suggests this scenario will occur.

- It remains quite difficult to assess the true state of housing market. Extreme weather in the past six months has significantly distorted reports of indicators such as housing starts and home sales. New construction is still declining rapidly in response to the high level of unsold homes on the market. However, we continue to believe that the inventory overhang will adjust in the coming months as stable housing demand meets sharply falling housing completions, the result of falling housing starts in the past six to eight months.

- Another issue clouding the U.S growth outlook is the inventory correction in the manufacturing sector. Part of this issue is the auto industry's adjustments of output and inventories to match structurally lower sales. Judging from General Motors' much improved results from the fourth quarter of 2006, at least the nation's #1 auto producer is making money again under the prevailing supply and demand conditions. For the rest of the sector, a sharp increase in unfilled orders suggests that production is likely to rebound in the coming months to meet demand.

POLICY

- In March, the Federal Reserve changed a key part of the statement that usually accompanies every Federal Open Market Committee (FOMC) rate decision. In the past, the FOMC had explicitly referred to the need for higher rates should inflation not continue to moderate. In its latest version, the committee talks more generally about future policy changes. Some commentators interpreted this as a move toward an eventual interest-rate cut. However, the Federal Reserve maintained its explicit focus on inflation, indicating that the risks to growth are not significant enough to switch the bank's sights away from potential inflation risks.

- Clearly, the recent increase in core consumer price inflation is a concern given the Federal Reserve's repeated warning that it will not tolerate inflation rates stabilizing above two percent. It will be interesting to see whether a renewed slowdown in core inflation in the coming months will be enough to trigger a change of view in the FOMC. However, this is not likely because deflating the current liquidity bubble is exactly what the U.S. economy needs to continue the current expansion.

INVESTMENT OUTLOOK

- For the next few weeks, we see more risk coming from the U.S. economic data calendar. I am a little concerned that the first few manufacturing and housing surveys for March have not indicated an increase in activity. If the argument that extreme weather caused the recent volatility is correct, we should see stronger economic reports in April and May, which, in turn, should move the consensus back toward our general growth forecast for the remainder of the year.

- In such an environment, riskier asset classes should fare well. Consequently, we have a positive view on equities, and believe U.S. Treasury bonds are overvalued. However, acknowledging the current volatile market backdrop, we would not add to our equity overweight right now. Given the recent dollar weakness and the consensus that the biggest macro risk is in the United States, international equities should continue to perform better than U.S. stock markets.

- We believe the most obvious mispricing can be found in the U.S. Treasury market, which is pricing between three and four interest-rate cuts in the next year or so, despite the fact that the Federal Reserve has not indicated it will move in that direction. We don't need to see actual interest-rate increases, but merely a shift in the market consensus that interest rates will remain unchanged for the near future and that treasury yields will likely rise back toward five percent.

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.

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