AIG Investments®

Global Market Watch

July 22, 2009 | Markus Schomer, CFA – Global Economic Strategist

OVERVIEW

- In early July, the International Monetary Fund (IMF) added its seal of approval to the emerging consensus that we have reached an inflection point in the global business cycle and indicated that the global recession is likely to end this summer. The organization opened its latest World Economic Update with the upbeat pronouncement that "the global economy is pulling out of [...] recession." However, the Fund is not particularly exuberant, indicating "stabilization is uneven, and the recovery is expected to be slow."
- The IMF, which has been one of the more bearish institutes in the past, is evidently adjusting its forecasts back towards the median. Remember, in April the Fund was still predicting that the total amount of write-offs in the global financial system could reach a whopping US $4 trillion. But Bloomberg reports that, thus far, financial institutions have only taken just over $1.5 trillion in losses, and the pace of write-offs slowed significantly from a peak in the fourth quarter of 2008.
- Since early June, investors have taken their "foot off the gas," as we described it in last month's *Global Market Watch*. Yet the last few days have pushed many markets back to new highs for the year, pointing to a rebound in risk appetite. Global equities are up 3% since mid-June (in USD terms), with Emerging Markets once again outperforming developed world indices to the tune of an almost 5% jump. Asia was the best-performing region in equities, while Japan posted a nearly 4% decline.
- Treasury yields are still about 20 basis points below their mid-June levels, outperforming most other developed world government bond markets during that time. Finally, the US dollar index (DXY) lost about 3% from mid-June, particularly versus the Japanese Yen and Euro, which are both up between 3% and 4%.

NORTH AMERICA

- We are still waiting for an unambiguous sign that the recovery is here. Manufacturing activity has stabilized, and exports and housing have started to recover. Yet, domestic consumer spending remains weak, as households still worry about job security.
- This isn't surprising at a time when the U.S. Unemployment Rate is approaching a generational high of 10%. Funds from the massive fiscal stimulus package passed by Congress earlier in the year are still only trickling, (rather than gushing) into the economy, and are not generating the stimulus effect initially envisioned.
- Although the U.S. remains stuck in the current transition phase, we still expect a stronger initial recovery in the second half – driven by housing – rebounding industrial production and a more gradual recovery in consumer spending. Looking further into next year, we believe managing the yield curve will become a major challenge for the Federal Reserve.
- Leaving policy rates too low for too long threatens a more pronounced sell-off in longer term Treasuries, which, in turn, could jeopardize the housing rebound. However, raising rates too quickly could stall the equity market recovery, and, with it, consumer confidence and spending, which is not an enviable position.
- North of the border, the Bank of Canada just raised its outlook for the Canadian economy, expecting a healthy 3% growth rebound next year. Improving financial conditions support the bank's more optimistic outlook for next year, although current economic activity remains subdued, as a result of a weak consumer backdrop.
- The Canadian unemployment rate has risen to an 11-year high, but remains almost a full percentage point below the current U.S. rate. Manufacturing activity is improving, evidenced by a jump in the Purchasing Managers Indices (PMI) index back above 50 in June and the rebound in Housing Starts in recent months. Canada's economy is likely to emerge from the recession together with the U.S., yet fiscally in much better shape. The OECD predicts Canada's Debt/GDP ratio will peak in 2010 and start declining again thereafter.

EUROPE

- With second-quarter GDP reporting season around the corner, the Eurozone is likely to remain very much at the back of the developed world's growth-momentum rankings. Following a dramatic 9.5% annualized decline in the first three months, second-quarter GDP growth will probably be stuck in a deeper recession. PMIs are recovering much more slowly than equivalent surveys in other developed regions, and fiscal stimulus packages have had little impact on European nations so far.
- The main threat to an eventual recovery later in the year is a continued increase in job losses. The unemployment rate has increased just 2 percentage points so far, compared to a full 5 points in the U.S. Yet the lack of a more vigorous rebound suggests no immediate end to payroll reduction in the Eurozone.
- Tentative "Green Shoots" of recovery are emerging in the UK. PMIs for the manufacturing and service sector have moved back to the expansion/contraction threshold of 50, signaling that the underlying momentum in the economy is stabilizing. Not surprisingly, the Bank of England left its asset-purchase program unchanged, opting to move to a "wait-and-see" stance similar to that of the Federal Reserve.
- The increase in UK unemployment has been less pronounced compared to the U.S. or the Eurozone, and underlying domestic demand is likely to remain fairly weak. This suggests the UK economy won't emerge from recession until later in the year. The main challenge for the UK, as well as most other economies, is the dramatic deterioration in fiscal balances. The OECD has the UK's debt/GDP ratio surging to 88% by 2014, twice the level from two years ago, before the start of the crisis.

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ASIA

- The outlook for Japan's economy remains mixed. On one hand, industrial production is rebounding powerfully after the dramatic collapse earlier in the year, driven by improving global manufacturing conditions, in general, and stronger demand from China, in particular. Additionally, exports to China grew by more than one third in the three months through May.

- On the other hand, domestic demand in China remains weak. Service-sector activity has not picked up notably, and growth in household spending remains anemic. Adding to the uncertainty is Prime Minister Taro Aso's decision to call for a "snap" general election at the end of next month, which is likely to result in a defeat of the long-ruling LDP party.

- China recorded a strong rebound in the second quarter, posting an almost 15% annualized growth rate. The surge in economic activity was mainly driven by domestic demand, evidence that China's economic stimulus through fiscal spending and accelerated bank lending is working.

- The challenge over the coming quarters is an orderly reduction in government stimulus, as exports and private demand pick up. At stake is a potential increase in non-performing loans, which could threaten the recovery down the road. China's stronger recovery should also benefit its regional trading partners, including Japan.

- Australia has so far experienced a much shallower recession than most other developed economies, already registering a rebound in growth during the first quarter. Not surprisingly, the Reserve Bank halted its rate easing cycle at 3% in June, though clearly keeping an eye on further economic downside risk.

- Australian unemployment has increased two full percentage points in the current cycle, yet at 5.8% stands well below equivalent measures in the U.S., or even Canada. We expect Australia to remain at the forefront of the current recovery and benefit from its commodity exposure and growing trade linkages with China

INVESTMENT OUTLOOK

- The recent consolidation in global equity indices has brought financial market trends back closer in line with the underlying fundamentals. The unfolding earnings season will be one of the key drivers of stock market performance in the near-term, yet we still expect equities to maintain an upward trend in the medium-term.

- We are also still tilting our equity strategies further towards an overweight position in Emerging Markets, where we see better growth prospects and less damage from the current global recession.

- The thesis of U.S. leadership in the developing recovery remains on track with respect to the Eurozone and Japan, yet other developed world economies such a Canada and Australia are likely to emerge with the U.S. from the current recession.

- The lack of convincing evidence of a global economic rebound does not mean the recovery is in question again. Rather a broader consensus is emerging that economic conditions are improving, yet less vigorously than was expected a few months ago.

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