

GLOBAL OVERVIEW

- Two major macro themes emerged in November to impact economies and financial markets globally. The first was the intensification of the financial market crisis in the U.S., which is again threatening a sharp reduction in credit availability and the securitization of loans. These concerns are based on deterioration in bank balance sheets that resulted from a decline in asset values and rising liabilities from the consolidation of off-balance-sheet structured investment vehicles (SIVs). The second theme was an overall potential slowdown that may well impact the rest of the world.
- Global equity markets fell sharply during the first three weeks of November. Recession concerns increased dramatically, and nervous investors once again sought refuge in safe-haven government bonds. Yet most indices staged a modest rebound towards the end of the month, based on rising prospects for further interest rate cuts in the U.S. and elsewhere. Nevertheless, for the full month, global stocks lost 8.7%, while government bonds staged a dramatic rally. During this period, the yield on 2-year notes dropped 94 basis points – the biggest one-month decline in 20 years. Bond yields around the world followed the U.S. directionally, but overseas bond markets underperformed the U.S. significantly.

NORTH AMERICA

- The U.S. remains at the center of the current crisis, and the renewed deterioration in banking sector liquidity has again raised recession fears. Indeed, the broader economy has clearly slowed from an unsustainable 4.3% average pace over the two summer quarters. However, we still believe the underlying growth trend can remain above 2% in the first half of next year.
- What has changed, however, is the Federal Reserve's risk assessment, which now acknowledges the risk of a broader credit crunch. Consequently, we expect at least two further rate cuts in December and January, which should spur economic growth at the start of next year.
- Investors are expecting further rate cuts by the Federal Reserve in the coming months, which could take the Funds rate to 4% or below, if the financial market conditions don't ease in the new year. North of the border, the Bank of Canada has become the second major central bank reacting to the increased risk to economic growth.

The quarter-point Canadian rate cut at the start of December took markets by surprise, although the move was supported by Canada's stable inflation backdrop and sharp Canadian dollar appreciation, which is threatening export growth.

EUROPE

- The macro outlook in the Eurozone is also looking more ambiguous. Activity surveys point to slowing growth momentum, and the strong Euro is threatening the export engine that has fueled Eurozone GDP growth in the past few years. However, structural improvements in labor markets in Germany and France are continue to support domestic demand and should help cushion Eurozone economies against a broader fall-out from tighter credit conditions around the world.
- The European Central Bank (ECB), which evidently has a lower inflation tolerance than most other central banks, has so far given little indication it might lower interest rates in support of growth. While the strong Euro has clearly tightened financial conditions, stubbornly high inflation still dominates monetary policy deliberations. The UK has a macro risk profile is comparable to the U.S. in terms of exposure to both housing and financial services. Here, as in Canada, the central bank has stepped in and started to lower interest rates to support the general economy.

ASIA

- In China, authorities are considering a faster pace of currency appreciation to accomplish three goals: take pressure of the overheating economy, slow down accumulation of foreign currency reserves, and help reduce inflation. While one implication could be slower export growth in China, we believe this could actually reduce the macro risk by eliminating the need for further rate increases.
- In Australia, economic growth rebounded strongly in Q3 highlighting the country's favorable macro backdrop. Still reacting to the global financial market crisis, the Australian central bank has dropped its hawkish stance, suggesting the country's monetary policy could remain on hold for the time being.

GLOBAL OUTLOOK

- It is still very difficult to plan a longer-term asset allocation against the current, extremely uncertain macro backdrop, and risk management remains the single overriding portfolio concern. Despite – or perhaps because of – the sharp increase in volatility, we remain neutral on the decision between bonds and equities. Bond markets are extremely overvalued, if the current financial markets crisis doesn't cause a recession, and equity markets look relatively cheap.
- Although we acknowledge the increase in potential downside risk for equity markets, more supportive global policy should support equity market valuations around the world. With a potentially highly volatile year-end still ahead, it's too early to increase portfolio risk. However, if fixed income credit markets start to look quite attractive, this could well be next year's story.



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.

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