

# Global Market Watch

January 2008

Markus Schomer, CFA – Global Economic Strategist

## GLOBAL OVERVIEW

- We finish the year still nervous about global liquidity conditions, but slightly less concerned about a sharp slowdown or contraction in economic growth in the fourth quarter. The main story in December was the concerted effort by a number of major central banks to address banking liquidity. The troubles in the U.S. economy have triggered a response from policy makers and investors that is now counter-acting some of the headwinds to economic growth. We are not out of the woods yet, but we do feel more comfortable with our belief that financial markets conditions may be to ease early next year.
- Global equity markets continued to lose ground in December and have given back most of this year's gains. Emerging markets have underperformed the rest of the world in the past two months, but are still benefiting from very strong first half performance. Government bond yields have staged a tentative rebound in recent weeks, following the massive rally in November. Fixed income credit markets appear to have stabilized following the worst month in the history of the Lehman Credit Index. Finally, the U.S. dollar continued to trend stronger against most other major currencies.

weakening further. In fact, we are looking for a rebound in manufacturing next year on the back of strong exports and very lean inventories, which are already driving up prices in the producer sector and are likely to stimulate faster output growth in the next few quarters.

## EUROPE

- Disappointing economic news from Europe continued in December. Activity indices are highlighting further downside risk. At the same time, inflation is creeping higher, which should worry the European Central Bank (ECB) and further reduce the already slim chance of a policy rate cut in the coming months. In fact, the ECB is banking more on money market operation and just a few weeks ago pumped an incredible \$500 billion into the Eurozone inter-bank market to address liquidity concerns in the system. In the U.K., expectations of further interest rate cuts are rising again. The Bank of England sounds more concerned about the growth risks and further evidence of a slowing housing market could swing the Monetary Policy Committee vote towards another rate cut.

## NORTH AMERICA

- The specter of a credit crunch is still hanging over the U.S. economy as more investment banks report massive asset write-offs. However, the damage limitation process is also in full swing. The Federal Reserve cut interest rates again in December and organized coordinated money market operations with a number of major central banks around the world, designed to ease liquidity concerns. While the Fed is trying to support the economy and the inter-bank markets, further significant capital injections from Asian Sovereign Wealth Funds directly support bank and broker balance sheets and help restore their lending capacity.
- Meanwhile, the U.S. economy continued to surprise on the upside. Following a 4.9% growth rate in Q3, most recent data on consumer spending suggests growth in the fourth quarter held up better than expected. Looking forward, consumer spending will remain under pressure from mortgage resets and higher energy prices, but steady job and income growth should prevent consumption and with it the economy from

## ASIA

- The outlook for Japan's economy has probably deteriorated the most. Economic activity appears to be decelerating notably, despite continued strength in exports. Consumer spending is under pressure from rising energy and food prices and the government appears to have greatly underestimated the negative impact new construction laws would have on residential investment. The latter is falling at a faster rate than what we're seeing in the United States. So even without the additional headwind of slower U.S. growth, Japan is likely to start the new year with a more downbeat outlook.

## GLOBAL OUTLOOK

- The evolution of asset allocation in 2008 greatly depends on developments in the global banking sector in the next few months. We will start the year in a cautious mode and remain more confident in the visibility of earnings in

the U.S., where most of the bad news is already priced in, while Europe and Japan are now showing signs of a deteriorating fundamentals. We maintain our overweight in emerging markets, where we still see strong growth potential next year, if the U.S. avoids a recession. Global bond yield should trend higher in the new year, with U.S. Treasuries probably underperforming the rest of the world, as markets reverse some of the excessive gains from November. Finally the U.S. dollar is most likely trading sideways, but with a fair degree of volatility in reaction to further shocks and negative headlines.



---

**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