

# Global Market Watch

Markus Schomer, CFA – Global Economic Strategist

## OVERVIEW

- The global recession intensified in November and early December, but so did the policy response by governments around the world.
- On hopes of an even more aggressive policy stimulus in the new year, global equity markets posted a tentative rebound, after hitting a new cycle-low in late November.
- Bond markets posted a dramatic rally led by U.S. Treasuries, which drove 10-year bond yields to their lowest level since the early 1950s. Not only are bond investors reacting to the deepening recession, but also to the growing prospect of at least temporary deflation in many developed world economies next year.
- Treasuries have outperformed most other developed bond markets in the past four weeks. However, the spreading recession and increasingly similar policies adopted to halt the slide in economic activity, suggest other bond markets will catch up to the U.S. in the weeks to come.
- Currency markets do not necessarily reflect the difference in policy response, but rather the difference in timing. The U.S. Federal Reserve's move toward more aggressive quantitative easing has halted the bullish dollar trend that had taken hold in the past six months.

## NORTH AMERICA

- Recessionary forces are still in full swing in the U.S. economy. Massive job losses will continue for awhile, and consumer spending over the holiday period is likely to disappoint.
- However, the first few December manufacturing surveys showed a tentative improvement, suggesting the sharp downturn in the economy might be coming to a close.
- Meanwhile, the U.S. Federal Reserve cut policy rates to a range of 0.25% - 0% and strongly hinted at more aggressive quantitative easing at their last meeting in early December.
- The risk of a collapse of the Big Three U.S. car manufacturers is triggering more fiscal aid for the auto industry in Canada. The government had promised to match 20% of any U.S. bailout and followed through when the Bush administration decided to extend a bridge loan to the U.S. auto giants.
- Meanwhile, employment had started to decline, which will dampen retail sales going forward and most likely trigger further rate cuts by the Bank of Canada.

## EUROPE

- There is no silver lining in the deepening recession in the Eurozone. The dramatic decline in manufacturing activity is reversing the increase in Eurozone employment seen over the past few years that had also contributed to steady economic growth.
- Forecasters are still downgrading Continental Europe growth predictions, indicating that 2009 could be the worst year since World War II for the economies.
- The European Central Bank (ECB) has picked up the pace of its rate cuts, but has more work to do as inflation rates around the world are racing towards zero. ECB President Trichet has alluded to the possibility of quantitative easing, but has not provided any indication that the governing council is actually getting closer to implementing such a strategy.
- Meanwhile, across the Channel in the UK, evidence of an even more rapid collapse in economic activity is mounting. Discounting among the main retail chains has been so intense that a number of high profile bankruptcies are expected in the new year.
- Consumers are still increasing credit-card fueled spending, which is likely to weaken sharply in the new year, when UK consumers face the reality of falling house prices and rapidly rising unemployment.
- The Bank of England had recognized the problem early, but even the bank's dramatic rate cut in recent week's won't prevent a deep recession in the coming quarters.

## ASIA

- Japan has not escaped the dramatic deterioration of the global economy and growth is expected to contract significantly in the coming quarters. The 62% collapse in Machine Tool Orders in November underscores the sharp contraction in business activity.
- The Bank of Japan cut rates again to 0.1%, and the government has announced a fiscal stimulus package. However, with Japanese rates already well below those in similar economies, a government budget deficit, and a poor total debt ratio, the government has much less flexibility to stimulate the economy.
- Another worrisome sign that things are still deteriorating is the current slowdown in China. Exports are declining, and construction activity has collapsed. Unemployment, as well as social tensions are rising.
- The Chinese government announced a massive stimulus package about a month ago, but is already under pressure to do more. The People's Bank of China is cutting rates, but similar to the U.S., we will have to wait for the stimulus implementation to take place sometime next year.

## INVESTMENT OUTLOOK

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- Our asset allocation reflects the current tug-of-war between the very negative current economic backdrop and the increasingly market positive outlook for a historic policy stimulus.
- Over time, we expect equity markets will react positively to the more forward-looking stimulus and increasingly discard the current backdrop if the economy can find a bottom.
- Consequently, we moved our balanced strategies to a small equity overweight a few weeks ago.
- Within our equity allocation, we remain overweight in the U.S. market and maintain a small underweight in Japan and in Emerging Markets in anticipation of continued U.S. leadership in the current business cycle.
- Later on in the year, we envision a rotation out of early-cycle developed markets towards the better, longer-term fundamental growth story of Emerging Markets.



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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.

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