

Global Market Watch

April 2008

Markus Schomer, CFA – Global Economic Strategist

OVERVIEW

- The financial market crisis and the potential U.S. recession still dominate the global macro backdrop. Despite another round of joint swap agreements between the Federal Reserve and a number of global central banks that gave foreign banks access to dollar liquidity, the global policy reaction to the current banking crisis remains disappointingly uncoordinated.
- As a result, the U.S. is shouldering most of the burden to offset the crisis, which has led to a sharp depreciation in the dollar in recent months. Inflation remains a key global theme, impacting real income growth in Europe and leading to growing social pressures on governments and central banks in emerging economies.
- Global equity markets experienced another disappointing month in March, falling 2.7%. The U.S. fared better than most other markets, almost holding its value, while Europe and Japan ended the month significantly lower. Emerging markets were the worst performers again, continuing their underperformance compared to equity markets in developed countries. Within EM, Latin America fared best due to strong commodity prices, while Asia proved to be the poorest-performing region.
- U.S. government bond markets also experienced more divergence, as 10-year Treasury yields fell four basis points. Canadian and Australian markets recorded even bigger yield declines, while Eurozone yields trended notably higher. Finally, in the currency markets, the U.S. dollar continued to lose ground against the Euro and Japanese Yen, which both surged 4%. The exceptions were the British Pound (unchanged) and the Canadian dollar (-3.8%).

NORTH AMERICA

- The latest labor market data in the U.S. reflected a disappointing loss of 80,000 jobs in March; the biggest decline in four years. Not all the labor-market indicators have been that bearish, however. For example, payroll processing company ADP registered a small gain in private-sector jobs last month. So the truth about employment figures probably lies somewhere in between these two numbers.
- Be that as it may, accelerating job losses would greatly increase the recession risk in coming months. Other data had been less downbeat, with both the manufacturing and services sector indices released by the Institute of Supply Management inching up from February. This points to a domestic economy in suspension at about zero growth,

yet provides no evidence that the domestic backdrop is deteriorating further. We still believe the economy will post a small positive growth result this quarter, on the back of strong export growth.

EUROPE

- The divergence of economic prospects in Europe continued last month. Despite the strong Euro, German manufacturing businesses registered stronger confidence for the third consecutive month in March, and unemployment in Europe's biggest economy continues to fall. Consumer spending remains lackluster, however, as a result of falling real incomes. Unions have stepped up their pressure on companies to raise nominal wages to keep up with rising inflation.
- On the other side of the spectrum, Italy and Spain face an increasingly difficult macro backdrop. In Italy both the manufacturing and service sector Purchasing Managers Indices have fallen below 50, the index threshold between growth and contraction, suggesting the economy is slipping into recession. At the same time, the sharp downturn in Spain's housing market is potentially pushing that country's entire economy into a recession.
- Against the backdrop of such divergent economic prospects, the European Central Bank (ECB) is trying to balance the needs of weaker economies against persistent inflation pressures. Inflation increased again in March, with the CPI index reaching 3.5% — the fastest pace since 1992.
- Statements from key ECB members have been more on the hawkish side, with one going so far as not to rule out rate increases, if inflation continues to accelerate. However, we believe such a move is highly improbable. In fact, we are looking for a rate cut in the summer as headline inflation recedes on the back of weaker commodity prices. Such a belated rate move would also trigger a shift in sentiment in favor of the undervalued U.S. dollar and against the Euro.

ASIA

- The Chinese economy shows little sign of slowing. In fact, the central bank is still firmly in tightening mode, trying to slow money supply growth. This scenario has resulted from China's rapid accumulation of foreign exchange reserves. The Bank of China has raised the Reserve Requirement Ratio — the amount of reserves commercial banks have to hold with the central bank — to 17%. This is the fifteenth such increase in the past two years.

- Across the Taiwan strait, the recent Presidential election was won by the opposition candidate Ma Ying-jeou. He won on a platform of closer economic relations with Mainland China, which could provide a strong boost to the Taiwanese economy in the coming years.
- The latest TANKAN business survey of manufacturing companies in Japan showed a deterioration in the sector, pointing to slower growth in the first half of the year. However, the index was not as downbeat as some economists had feared. Most companies are still reporting shortages of workers and capacity, which is inconsistent with an economy on a sharp downtrend.
- Meanwhile, in Australia, the central bank's rate hikes in the past few months and higher oil prices are starting to weigh on both business and consumer confidence. With inflation running well above the Australian Reserve Bank's target, a slowdown in economic growth would be desirable and should not be taken as evidence that the U.S. recession is spreading around the world. In fact, Australia will have ample room to stimulate demand, should the economy slow more than necessary to cool inflation.
- We are cautiously optimistic that the recent aggressive Fed measures will impact liquidity conditions. As a result, we tactically reduced the equity underweight within our balanced strategies. In the medium term, however, we believe that global stocks are still in a bear market. We need to see a rebound — or at least a bottom in the current economic cycle — before adopting a more bullish tone in our asset allocation.

INVESTMENT OUTLOOK

- As we indicated in our latest U.S. monthly, the improvement in financial market conditions will initially impact fixed income credit markets, where valuations have been most dramatically affected by the liquidity crisis. In fixed income credit markets, we are starting to dip our toes back into riskier asset classes, such as high yield corporate bonds and highly rated commercial-backed securities.
- The recent substantial asset write-downs by a number of German regional banks are a good example of the lack of transparency in the banking system in Europe and strengthens our argument to overweight stocks in the U.S., where banks are more likely to communicate any negative news.



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.