



U.S. Market Watch

March 2, 2009

Markus Schomer, CFA - Global Economic Strategist

OVERVIEW

- The U.S. economy is taking another turn for the worse in February as the financial market crisis intensifies the pressure on major U.S. banks and auto companies. Both industries are again knocking at the government's door for more funding to prevent an even more dramatic loss of jobs and output.
- At the same time, the bulk of the government's policy response to the crisis is still stuck in the implementation phase. Yes, Congress has passed a massive fiscal stimulus package, and the Obama administration has presented plans to stabilize both the financial system and the housing market. Yet, the lack of details, the number of unanswered questions of how to value toxic assets, and the lack of a united front in Washington has left both financial markets and economists unimpressed.
- The lack of investor confidence is clearly evident in the stock market. Despite progress on the stimulus package, U.S. equity indices fell to a new cycle low in the second half of February, erasing all the stock market gains from the past 12 years. The yield on 10-year Treasuries continued to drift higher, but so far they have not broken through the 3% level. This is because investors continue to assess the threat of increased issuance against the prospect of continued deflation this year.
- The bullish spread tightening in the U.S. credit markets was interrupted in February, most likely due to renewed concerns about near-term U.S. economic prospects. Finally, the U.S. dollar continued its upward trend against most major currencies around the world. The Japanese yen and the Swedish krona lost the most ground, the euro was little changed, and the Australian dollar managed a small gain vis-à-vis the greenback.
- However, it did include a quintupling of the funding for the so-called Term Asset-Backed Securities Loan Facility, or TALF. This program is designed to offset the decline in securitization, therefore spurring lending to consumers and small businesses by allowing the Federal Reserve to fund up to 90% of the purchase of newly issued Asset-Backed Securities (ABS). So far, the TALF is the most promising plan to restart the flow of credit to the private sector, but, like so many programs, it has yet to get out of the starting gate.
- Although none of the \$787 billion fiscal stimulus has been utilized yet, President Obama is forging ahead and presenting even more government spending in his Fiscal Year 2010 budget proposal. Total spending is expected to increase by a full \$1 trillion, or 32% compared to the previous period. Even when we exclude Troubled Assets Relief Program (TARP) funds allocated to this year's budget and a \$250 billion placeholder for "potential additional financial stabilization efforts," the growth rate from a year ago still exceeds 15%, the fastest rate of spending since 1980.
- The biggest increase comes in mandatory programs, which mostly represents funding designed to offset the recession impact on state and local revenues. But discretionary spending, other than military, is also slated to grow at a double-digit pace. What matters now is to see the impact of all the promised policy support. The tax cuts are expected to hit households by April, and items such as unemployment-benefit extension and health care funding will help prevent further spending cuts right away. As a result, we are still looking for stabilization in business and consumer spending by the summer.

POLICY

- The Obama administration remains in full crisis mode, rolling out program after program designed to deal with the growing economic crisis, all while still choosing Cabinet members. The problem is that "quantity" is no replacement for "quality," as Treasury Secretary Tim Geithner learned a few weeks ago. At that time Secretary Geithner presented a Financial Stability Plan that lacked critical details on how to relieve banks of toxic assets.

ECONOMY

- As we progress deeper into the first quarter, the economic news flow in the U.S. has turned more bearish again, dousing our cautious optimism from last month in a dose of depressing realism. Whereas we were looking for businesses to slow the pace of production and job cuts, the data shows the U.S. corporate sector remains in a deep retrenching mode.

U.S. Market Watch

March 2, 2009

- Jobless Claims have risen to within a whisker of the record high from December 1982, Consumer Confidence collapsed to a new all-time low in February, and business orders for durable goods remain in freefall, pointing to another sharp reduction in business investment in the current quarter. There is nothing new occurring on the housing front either. Home sales are still dominated by foreclosure properties that crowd out sales of new homes and depress transaction prices for all houses on the market.
- Looking forward, there is not much we can hang a more constructive story on, other than to keep pointing at the massive stimulus in the pipeline. The government is the only active game in town right now. While we have underestimated the implementation lag, and probably overestimated the anticipation effect, the fact remains that a wave of initiatives are about to hit the economy. Granted, much of that will simply fill the crater the financial crisis has left behind. Yet, even a return to 0% growth could start to generate a more positive momentum and a multi-year fiscal package could eventually lead to sustained recovery.
- The underlying problems of an overleveraged financial system, widespread destruction of household wealth and dramatically underused resources will not be resolved overnight, or even within a year or two. Hence, we expect the growth path in the next two years to remain extremely volatile. We still believe a strong rebound in the second half of the year is possible, but the U.S. economy won't recoup its underlying growth potential for awhile.
- In addition, we have yet to see the effect of the plethora of government measures. We still prefer domestic exposure versus international markets, while U.S. policy action is still comparatively more aggressive. Our fixed income asset allocation maintains a small overweight in high yield, which offers attractive valuations and benefits from the gradual improvement in market liquidity, balanced with an underweight in emerging markets and international fixed income.

INVESTMENT OUTLOOK

- In the current volatile and uncertain environment, asset allocation has to be more tactical by necessity, adapting to changing developments, rather than trying to establish a longer-term trend. We have maintained a small overweight in equities relative to government fixed income. This is based on our assessment that valuations, in combination with economic and profit developments, now make the risk-return balance slightly favorable for equities.

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 registered 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 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. 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.