



REVIEW

- 2006 will be remembered as a year of two halves. It began with inflation concerns in the United States, expectations of continued interest-rate increases by the Federal Reserve, a new Federal Reserve chairman and darkening clouds over the U.S. housing market, which, in the spring, led to a significant correction in global financial markets. The second half was dominated by fears of weaker economic growth in the developed world and expectations of interest-rate cuts in the United States.
- Bond markets reacted to the inflation concerns with a sustained sell-off, pushing 10-year U.S. Treasury yields to a four-year high of 5.2 percent. By the summer, however, investors bought into new Federal Reserve Chairman Bernanke's optimistic forecast that weaker economic growth would eventually moderate underlying inflation trends and bond yields globally started a renewed downward trend.
- That's about the same time equity markets started to take off as well. Once the Federal Reserve stopped the steady pace of rate increases, stock markets started a run that would push most major stock indices to their highest levels in five years; in fact, the Dow Jones Industrial Average reached an all-time high several weeks ago.

UNITED STATES

- The U.S. economy started 2006 on a very strong note with a 5.6-percent increase in gross domestic product (GDP) growth. However, as the year progressed, it became clear the housing market would become a major headwind for the economy. Growth slowed to 2.6 percent in the second quarter and an even weaker two percent in the third quarter.
- Housing data deteriorated at a scary pace in the second half of the year. Home sales are running approximately 25 percent below 2005's level, and new housing starts are down roughly 27 percent. However, there is a light at the end of the tunnel. Applications for new home purchases have increased in four of the last five months, and the housing affordability has rebounded in the past two months.

- Another major event was the change at the helm of the Federal Reserve. Many economists thought Ben Bernanke would struggle to fill Alan Greenspan's rather large shoes, yet less than 11 months into his rookie year, he deserves praise for the right call on inflation and his decision back in August to stop raising interest rates.

EUROPE

- The 12-member Eurozone – the countries that have adopted the Euro – is on track to record the strongest growth rate in six years. Stronger exports and business investment started the current recovery, but it was the gradual increase in consumer spending, a result of stronger job growth, that finally pushed Eurozone growth above its long-term growth potential.
- The European Central Bank (ECB) had waited longer than most other central banks before starting the process of normalizing interest rates after a period of extremely low rates between 2003 and 2005. Since then, the ECB raised rates six times and is likely to continue the tightening cycle through most of 2007.

ASIA

- Even though the most recent revisions show quite a loss of momentum in the economy over the summer (GDP growth slowed from an annualized 2.7-percent pace at the start of 2006 to just 0.8 percent in the third quarter), Japan's economic recovery is for real.
- Very strong business investment and surging exports are driving the recovery in the world's second largest economy. However, growth in consumer spending is set to slow substantially in 2006, taking the shine off an otherwise fairly strong year.
- Headline consumer price inflation has increased in Japan, yet the core measure, which excludes food and energy products, has remained in negative territory. Prices might not be falling anymore, yet inflation is not fast enough to justify a significant increase in Japan's interest rates in 2007.

OUTLOOK

- We believe that the U.S. economy is through the worst part of the mid-cycle slowdown. The first half of 2007 will remain sluggish, yet once the housing inventory overhang has been corrected, an increase in activity in that sector is likely to push U.S. growth rates above three percent in the second half of the year.
- Our optimistic outlook for European growth will be tested early on next year. Germany's three-percent VAT sales tax increase could threaten the tentative rebound in consumer spending. However, the most recent improvement in German business and consumer confidence suggests that such concerns, which surfaced during the fall, are easing.
- Our macro outlook continues to support a healthy backdrop for global equities and riskier fixed-income markets such as emerging markets and high yield. Improving U.S. growth prospects will eventually push U.S. Treasury yields higher, yet the abundance of global liquidity and the moderation in global inflation trends will keep yield curves fairly flat throughout the year.



Markus Schomer, Economist

Markus Schomer, AIG Global Investment Group's global economist, is responsible for its top-down fixed-income strategy, including duration and currency strategies. He holds a postgraduate degree in Economics from the University of Bonn, Germany and an M.A. in Economics from the University of East Anglia, Norwich, UK. He is a Chartered Financial Analyst.

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