



## OVERVIEW

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- No doubt, September 2008 will go into the history books as the tipping point; the point in time when financial markets were gripped by a full-scale credit crunch.
- Through the end of August, financial market conditions remained stressed, but the emergency liquidity facilities established by the Federal Reserve appeared to have stabilized the situation. However, when financial markets lost confidence in the ability of U.S. mortgage giants Fannie Mae and Freddie Mac to maintain short-term liquidity, the U.S. Government had to step in and take both companies into conservatorship, severely impacting common and preferred stock holders.
- The unintended consequence of the Government's action was a dramatic loss of confidence in the obligations of all financial institutions. This triggered liquidity crises across the board, and led to a general freezing up of bank-lending markets and the announcement of a U.S. \$700 billion dollar bank rescue plan by U.S. Treasury Secretary Hank Paulson.
- Many financial markets recorded dramatic moves during the month. The large-cap Dow Jones Index lost 6% in value, the broader S&P 500 Index lost 9% — its biggest drop in six years — and the NASDAQ fell almost 12% — its biggest drop in seven years.
- The corollary of the weakness in U.S. stocks was a rally in short-term Treasuries, as investors fled risky assets to the safety of government bonds. The yield on two-year Treasury notes fell 41 basis points, and three-month Treasury Bill yields declined 80 basis points. At the longer end, 10-year Treasury bond yields finished the month virtually unchanged.
- U.S. Fixed Income credit markets posted extremely negative numbers. High yield spreads over Treasuries rose by 226 basis points — a record monthly increase — and the broad Lehman Aggregate Index posted a negative return of 2.6%.
- Finally, the broad trade-weighted U.S. dollar index benefited from the market crisis, rising 2.4% to its highest level in 13 months. This occurred as a result of capital repatriation, as well as global-investor demand for less risky Treasuries.
- So, if we are in — or close to — a recession in September, where do we go from here? Much depends on a successful banking sector rescue package. If confidence can be restored to the short-term lending markets, business investment and consumer spending are likely to rebound.
- However, the longer the current freeze lasts, the greater the damage to the future U.S. growth backdrop. Exports are slowing, but should continue to support growth for a while, as long as imports fall even faster. The pace of decline in construction activity is slowing, but access to mortgage credit will have to be restored before steady housing sales can accelerate the reduction in inventories.
- Finally, consumer confidence will surely be hit by the latest events and the acceleration in the pace of job losses. However, we still believe that falling oil prices, lower mortgage rates, Fed rate cuts and left-over dollars from the Spring rebate checks will cushion the blow to overall household spending. We are looking for a tentative rebound in GDP growth in the first half of next year.

## POLICY

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- As the credit crisis seemingly spiraled out of control in September, the Government response also took on a new much more dramatic approach. Treasury Secretary Paulson presented a U.S. \$700 billion “rescue” plan designed to accelerate the deleveraging process and rid bank balance sheets of bad assets. Clearly, this plan wasn't the silver bullet to end the crisis, but it may have helped to restore some degree of confidence, if the Government was seen as fully engaged in mitigating the crisis.
- Incredibly, Congress failed to approve the bill, sending financial markets into a tailspin. Lawmakers then added U.S. \$150 billion in pork-barrel tax breaks to the bill, and a large enough number of Representatives were sufficiently frightened by the stock market collapse that they changed their vote, and the bill passed the second time around.
- By then, however, the opportunity to boost investor confidence had evaporated. Too many experts had picked over the plan's details and declared it lacking. In the meantime, the Federal Reserve continued to dramatically expand its liquidity facilities. Following the Bear Stearns collapse in March, the Fed had more than quadrupled its emergency liquidity injections from about U.S. \$80 billion to U.S. \$350 billion over the summer.
- The latest count, following the dramatic events of September, stands at an astonishing U.S. \$1.4 trillion. The very latest measures include paying interest on reserves held at the central banks, essentially establishing a floor for interest rates. This allows the Fed to expand money supply, without fearing that interest rates could fall to zero, and establishes a new facility to purchase Commercial Paper (CP) directly from eligible issuers, essentially providing a liquidity backstop to the CP market.
- We are clearly in uncharted territory with regards to Government and Federal Reserve response to the financial markets crisis. The current Emergency Economic Stabilization Act is unlikely to solve the problem sufficiently, and we expect the Treasury department will have to go a step further and inject capital directly into ailing banks to restore the banking system's ability to lend.

## ECONOMY

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- We had been holding off on calling the current macro backdrop in the U.S. a recession, but the freezing up of short-term credit markets in the past few weeks was the proverbial straw that broke the camel's back.
- Two key indicators deteriorated significantly in September. First the Institute of Supply Managers' Manufacturing Survey, a barometer of activity in the sector, fell to its lowest level in seven years, and the latest jobs report showed the biggest decline in employment in more than five years.
- Both indicators reflect the immediate impact that the credit market freeze had on business activity and also highlights the risk of a growing negative multiplier effect, if the banking crisis continues. As a consequence, we have lowered our forecast for U.S. GDP growth to just 0.2% in the second half, acknowledging the dramatic deterioration in the U.S. growth backdrop in September.

- The Federal Reserve is pulling out all the stops and is clearly willing to do what it takes to prevent a greater meltdown in the financial system. Expect further increases in liquidity provisions in the near term to help banks navigate the end of the year.
- However, the emerging weakness in the real economy now also warrants further rate cuts. Earlier in the summer, fiscal policy had taken on the role of stimulating demand through tax rebates. Now the thrust of fiscal spending focuses on restoring the health of the banking system. Monetary policy will once again be needed to address the risk to economic growth, as evidenced by the Fed's recent decision to cut rates by 50 basis points.



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## INVESTMENT OUTLOOK

- Obviously, it is difficult to maintain a longer-term investment strategy in an environment of extreme uncertainty, frozen credit markets and heightened event risk. We had moved our bond/equity allocation back to neutral last month, awaiting the passing of a bank rescue plan. However, the potential positive impact was negated by a slow-moving Congress.
- Within our fixed income strategies, we maintain an overweight in lower risk pass-through mortgages and underweight non-dollar credits. Volatility is extremely high right now, making this an attractive market for day traders, but less so for longer-term investors.
- The downturn in the economy is adding a new risk to the investment outlook, but equity markets are already priced for a recession, and credit spreads are dominated by liquidity spreads well in excess of the intrinsic credit risk, even under recession scenarios. If the slowdown/recession remains shallow, and the rescue plan succeeds in restoring bank lending, risk assets have a chance to start a rebound in the next few months, driven by extremely cheap valuations. However, the risk of a further down leg is significant, given the current state of the crisis.

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