

U.S. Market Watch

April 14, 2009

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OVERVIEW

- The more positive mood among U.S. equity investors, coupled with a handful of more positive economic reports, seem to suggest that we may have reached an inflection point in the current U.S. recession. That is not to say the economy will improve in a straight line from here, but the relentless deterioration since the “Great September Crash” of 2008 may be coming to an end.
- What is not yet over is the search for a solution to the toxic asset problem in the U.S. banking system; a necessary condition for a sustainable recovery. The administration’s latest plan, the Public-Private Investment Program or PPIP, has received mixed reception, and the prospect of banks failing the government-mandated stress test does not yet instill confidence in a sustained stock market rally.
- For now, though, investors seem to be discounting bad news and reacting more strongly to positive surprises. This is best illustrated by the muted reaction to another downbeat jobs report in March.
- Looking at the stock market, the S&P 500 posted a decent 8.5% increase during March, following two down months that started the year. The upward trend appears to be holding in early April. The broader S&P 500 and the Dow Jones are still down about 10% year-to-date, but the smaller, more tech-heavy NASDAQ is already in positive territory for the year.
- 10-year Treasury yields ended March down about 35 basis points, helped by the Federal Reserve’s announcement that it would buy longer-dated Treasuries. However, in early April Treasury yields trended higher again, reversing much of the late-March rally.
- U.S. credit markets had a mixed month, with High Yield and Emerging Markets enjoying further spread tightening and strong index performance, while Investment Grade credit spreads widened for the second straight month.
- Finally, the U.S. dollar lost ground against a broad spectrum of currencies, with the exception of the Japanese yen, which in early April, traded above ¥100 again for the first time in almost six months.

ECONOMY

- There are a few signs of hope in the U.S. economy that point to an earlier rebound than many forecasters had expected. Most notable is the stabilization in consumer spending. Two months into the first quarter, real personal

consumption is up about 1.3% from the previous three-month period, following two sharp quarterly declines in the second half of last year.

- Driving the rebound is the strong advance in real disposable income, which is up about 6% so far in the first quarter. Slower inflation in general, and falling energy prices in particular, are the main driving forces behind the current improvement in household purchasing power.
- Business activity is lagging behind the pick-up in demand, which is reflected in an accelerating inventory decline in the first quarter. However, these trends cannot last long; rising demand and falling inventories should result in new orders, which is exactly what we saw in the most recent Factory Orders report and the latest ISM Manufacturing Index, where “New Orders” jumped to their highest level in six months.
- Yet, significant macro headwinds still persist. Strongest among them is the ongoing dramatic rate of job losses, which is the greatest threat to a sustainable rebound in consumer spending.
- More than 3.7 million jobs have been lost in the past six months alone, representing 70% of the total employment decline since the recession started in January 2008. None of the labor market indicators are showing any sign of a turnaround. Therefore, it’s not surprising to see consumer confidence stuck near record lows.
- The housing market is also not providing a compelling argument for a more optimistic outlook. Although home sales and new housing starts rebounded in February, that bounce only partially reversed the very sharp contraction in both demand and new construction witnessed in January.
- More importantly, home prices have not rebounded, and mortgage foreclosures are still increasing. There is, however, a faint light at the end of the tunnel. I am looking to refinance my own adjustable-rate mortgage right now, and for the first time I am seeing competitive offers for products other than the standard 30-year fixed-rate mortgage; a first sign of an improvement in credit conditions.

POLICY

- The Treasury Department finally released more details of its Financial Stability Plan last month. The Financial Accounting Standards Board (FASB) has eased the mark-to-market valuation requirements for impaired assets that are trading in inactive markets, which should reduce the risk

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of further asset write downs. However, we still have to deal with the existing overhang of legacy securities and loans, which is where the new Public-Private Investment Program comes in.

- The auction-type pricing mechanism will either result in a massive transfer of taxpayer funds to the troubled banks, if the price is higher than the current balance-sheet valuation, or it will increase banks' need for new capital (also most likely taxpayer funds) if the purchase price is below the current balance-sheet valuation.
- Meanwhile the Federal Reserve is pushing further down the road of "Quantitative Easing." The latest FOMC meeting resulted in increasing the commitment to purchase financial assets from the previous target of \$600 billion to a whopping \$1.75 trillion. These measures will substantially boost money supply, which is designed to stimulate economic activity and is also likely to push up financial asset prices.
- The Fed's attempts to directly revive bank lending, through measures not tied to increasing the opportunity cost associated with banks' uninvested cash holdings, are slow to get off the ground. The highly touted Term Asset-Backed Loan Facility, or TALF, is designed to encourage the issuance of new Asset-Backed Securities (ABS) and, consequently, the origination of loans to businesses and households. Although it is in its early days, only about \$6.5 billion of the planned \$1 trillion in available financing, has been taken up in the first two weeks.
- Going forward, we expect the phase of announcing ever more and bigger programs has come to an end. We also anticipate that the Federal Reserve will switch back to a wait-and-see mode and focus on monitoring the slowly growing impact of what it has already promised.
- Our outlook for U.S. stocks remains relatively more optimistic, compared to other developed markets, on the back of a more aggressive government response here in the U.S. This includes the massive fiscal stimulus package now in place, extremely low short-term interest rates, and the start of "Quantitative Easing."
- In addition, we believe earnings expectations have been revised sufficiently, suggesting that we might start to see positive earnings surprises in certain sectors.
- Within our fixed income strategies, we are modestly increasing our allocation to risk assets by reducing our exposure to securitized products and partially covering our underweight position in Emerging Markets. Here funding conditions have improved and strengthening local currencies are adding to the upside potential.
- We see both our current equity and fixed income allocations as a transition from a more risk-averse posture towards one that again embraces future growth and earnings prospects in line with our more constructive outlook for the global economy.

INVESTMENT OUTLOOK

- Our marginal equity overweight versus government bonds is finally starting to work, driven by the implementation of government stimulus programs and a moderate improvement in the U.S. economic backdrop.

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