

# Global Market Watch

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## OVERVIEW

- The title of the latest IMF World Economic Outlook Update says it all: “World Growth Grinds to Virtual Halt.” In this timely publication, the IMF’s economists unveil another sharp downward revision to global economic growth forecasts for 2009. The projected 0.6% would be the weakest rate of expansion since World War II.
- Just three months ago, at the start of November, the IMF was still projecting 2.2% growth for the world economy. The stark contrast in forecasts illustrates the dramatic events that have impacted the global economy in the past few months and the sharp reversal in expectations among economic experts.
- After posting a modest increase in December, global equity markets have started the year in bearish territory. Developed markets slightly outperformed their Emerging Markets brethren, mostly the result of a stronger U.S. dollar. Major stock markets in the U.S., Europe and Japan posted similar returns in local currency, while among the key Emerging Market regions, Latin America clearly outperformed Asian and Eastern European markets.
- The U.S. dollar continued to strengthen, especially against Euro and Swiss Franc and most Emerging Markets currencies. Finally, U.S. Treasuries underperformed most of the major government bond markets, with the exception of the UK and Sweden, on the back of supply concerns and fears that the massive fiscal and monetary stimulus would fuel inflation down the road.

## NORTH AMERICA

- Expectations about the near-term outlook for the U.S. economy vacillate between extremely bearish based on simultaneous economic reports that reflect the dramatic decline in Industrial Production and Retail Sales and the massive job losses in the past few months. This is somewhat offset by hopes that the new administration will enact a large enough fiscal package to at least stabilize the current downturn.
- The \$819 billion package that was just passed in the House of Representatives includes significant tax cuts (about a third of the program) and infrastructure investment (about 25% of the program). The bulk of the package, about \$475 billion, is targeted at bolstering state finances and Social Security programs, such as unemployment benefits and Medicaid. Meanwhile, the banking crisis is still deteriorating, as the recent losses at Bank of America and Citigroup demonstrate.
- The best hope for the U.S. in the near term is a halt in the dramatic cutbacks in output and employment as businesses assess the impact of the stimulus package. Coupled with a rebound in financial markets, such a subtle shift in sentiment could lead to the stabilization we are forecasting.

- Meanwhile, the economic picture in Canada is starting to deteriorate more noticeably, as the impact from the U.S. auto recession and the slump in commodity prices hit the same two key industries in that country. Employment growth, which had sustained domestic demand through much of last year, has now deteriorated significantly.
- The Bank of Canada continues to cut interest rates, and the weaker Canadian dollar should help exporters once global trade resumes. In the meantime, Canada will probably experience the worst phase of the global recession in the current quarter.

## EUROPE

- There are a few tentative signs that the dramatic downturn in Eurozone manufacturing is slowing. However, that won’t prevent further steep job losses. For the currency union as a whole, the unemployment rate has now reached 8%, which is high relative to the U.S., but still a far cry from the peak of 10.8% in the mid-90s.
- Government bond markets have seen a major increase in sovereign credit risk in recent weeks, with spreads on Credit Default Swaps (CDS) widening sharply for countries such as Ireland and Greece. We have seen more fiscal stimulus packages of late, most notably in Germany, but the policy response – both in terms of monetary and fiscal policy – continues to lag behind the U.S. in terms of aggressiveness.
- CDS spreads for the UK have also widened significantly, from a negligible premium of about 5 basis points over Germany to 60 basis points. The UK economy contracted at an annualized rate of 5.9% in the fourth quarter of last year, highlighting the dramatic contraction underway across the Channel.
- It’s hard to fault authorities here given the aggressive rate cuts by the Bank of England, the broad liquidity and solvency support for the British banking sector, and the fiscal stimulus designed to at least partially offset the demand destruction resulting from the credit crunch. The Pound Sterling has fallen to record lows against the Euro, and to the lowest level in about eight years against the U.S. dollar, which should help in the eventual recovery.

## ASIA

- Among the major global economies, the collapse in economic activity in Japan continues to be surprising. There is no housing bubble in Japan, and banks had very little exposure to toxic U.S. mortgages, so they reported significantly fewer losses than their U.S. and European counterparts.
- Nevertheless, industrial output has fallen 16% below last year’s level, and machine-tool orders, a small but high-profile sector given Japan’s dependence on capital goods exports, are down a whopping 72%.

- Japan's case is clear evidence of the collapse in global trade that is hitting Asian economies particularly hard. Japan has enacted a fiscal package, but the country's huge public debt load and the already low interest rate deprive it of a meaningful domestic stimulus. That won't occur unless we see a rebound in global export growth.
- The same evidence can be found throughout Asia. Exports from South Korea and Taiwan, two small economies that have a large export sector, have fallen by over a third, and most of the more developed economies, such as Singapore and Hong Kong, are experiencing outright recessions. China deserves kudos, however, for recently becoming the world's third largest economy, following an upward revision to 2007 GDP growth.
- However, now the focus in China is on how much the economy will slow in 2009. Exports are grinding to a halt, unemployment is rising and real estate values in the East are falling. China has enacted a massive stimulus package, but growth could slow to as low as 6% this year, which for China, with its strong labor force growth, will feel like a recession.

## INVESTMENT OUTLOOK

- We stuck our head out of the neutral zone in December and moved our balanced allocation to a small overweight, believing the dramatic policy action in the pipeline would start to improve investor sentiment and lead to a gradual rebound in forward-looking equity markets.
- That strategy worked well in December, but the new year started on a much weaker note, with stock markets losing substantial ground again. We are still at a point where the current economic news is extremely bearish and the full force of the policy response has yet to be felt. The financial market backdrop will remain extremely volatile in the coming weeks.
- However, we believe an eventual enactment of the fiscal stimulus, the second half of the original Troubled Assets Relief Program (TARP) program and the Fed's latest funding facility designed to boost securitization of consumer and small business loans should go a long way to halt the dramatic cut backs in output and employment among U.S. businesses. Such a development will eventually help the rest of the world address the still large U.S. current account deficit.
- Therefore, we remain overweight U.S. equities and underweight Japan and Emerging Markets in the near term. There is also no change in our fixed income strategies, where we continue to favor asset classes with substantial government demand, such as agency mortgage-backed securities. However, we also maintain significant exposure to High Yield bonds, due to their extremely attractive valuation and gradually improving market liquidity.



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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.

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