



Market Watch

Markus Schomer, CFA - Global Economic Strategist

OVERVIEW

- Nothing seems to scare equity markets at the moment. Seven months after the Dow Jones Industrial Average surpassed its previous record high set in 2000, the S&P 500 Index also soared to a new all-time high. The index rallied in 11 of the past 12 months. Its approximate eight-percent performance for the first five months of 2007 was driven by stable interest rates and positive earnings surprises. The rally occurred despite continued uncertainty about the U.S. housing market and record-high gasoline prices.
- U.S. government bonds sold off toward the end of the month, pushing the 10-year benchmark U.S. Treasury bond yield above 4.8 percent for the first time since February. The increase in yields at the short end was even greater, and the yield curve (the difference between two- and 10-year U.S. Treasury yields) turned negative again. High-yield and emerging market bond markets had a very strong month, driven by increasing risk appetite among investors.
- The U.S. dollar remained weak last month but did not depreciate any further against its major trading partners, after falling to an all-time low at the end of April. The biggest winner was the Canadian dollar, while the euro, Japanese yen and British pound lost some ground in May.

ECONOMY

- The last few weeks brought a few subtle changes to the U.S. macro backdrop. The sharp slowdown in the first quarter's gross domestic product (GDP) growth will likely look even worse after the next revision and could even end up below one percent. However, market attention is shifting toward the growing consensus of a stronger rebound in the current quarter. What divides bulls and bears now is the question as to whether any rebound over the spring can be sustained in the second half of 2007.
- We are fairly confident that the inventory adjustment in the manufacturing sector has ended, and production and job growth in the sector is picking up again. The Institute of Supply Management survey results, industrial production, and new orders for durable goods all point to an increase in the sector at the start of the second quarter. In addition, we are looking for a stronger rebound in U.S. exports, which have been inexplicably weak during the first quarter of the year, despite a weak dollar and evidence of very strong growth abroad.

- Housing is still the main concern as the backdrop remains mixed. New housing construction increased for the third straight month in April, which strongly suggests that residential investment will be much less of a drag on GDP growth in the current quarter. However, more forward-looking indicators, such as new building permits and surveys of home sales, continue to deteriorate, pointing to more weakness down the road. Clearly, we are not out of the woods yet.
- The Federal Reserve not only left interest rates unchanged at May's Federal Open Market Committee (FOMC) meeting but also its inflation bias. Many economists expected a further softening of the inflation language and recognition of increasing growth risks. Instead, the unchanged policy bias further dimmed the prospects of near-term interest-rate cuts.

INVESTMENT OUTLOOK

- Our general investment outlook has not changed. We remain optimistic that U.S. equity markets will continue to perform well. The combination of stable interest rates and moderate growth provides a supportive fundamental backdrop for stocks. In addition, corporate earnings have surprised on the upside so far this year, supporting further multiple expansion. In addition, technical drivers, including record stock buy backs and merger and acquisition activity, provide a bullish undertone in the market.
- The U.S. government bond market has priced out overly optimistic interest-rate-cut expectations and concerns about economic growth. The market has settled closer to a fairly valued level at which we think yields can stabilize for a while as we await more information on the direction on U.S. growth. We still expect further upward yield adjustments once a consensus emerges that the economy is likely to grow again at a faster pace.
- Finally, the U.S. dollar appears to have found a bottom against other major currencies, helped by the recent increase in U.S. bond yields but also a loss of momentum in terms of overall economic activity abroad. With growth improving in the second quarter, it seems unlikely that the dollar will test the cycle lows anytime soon. On the contrary, we are starting to look for evidence that the dollar is staging a comeback.

Markus Schomer, Global Economic Strategist for AIG Global Investment Group (AIGGIG), is responsible for providing macro-economic forecasts, analysis and commentary for all AIGGIG 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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