

OVERVIEW

- After a string of aggressive moves by the Federal Reserve and signs the government is ready to support the slumping housing market, financial markets have finally started to trade with a more positive tone in recent weeks. As with previous scenarios, the collapse of an iconic corporation – Enron in 2003 and Bear Stearns in 2008 – may once again mark the peak of the crisis or at least the peak of a market panic; it's hard to see what might still surprise investors. The economy will remain weak for at least another quarter, but we still believe the fiscal stimulus package (and, hopefully, better-functioning financial markets) will help the economy rebound in the second half of the year.
- Equity markets stabilized in March still posting a modest decline, but the past few weeks have been more encouraging, as investors shed some of the extreme risk aversion that characterized trading at the start of the year. In the fixed income markets, Treasury yields ended the month lower again. Yet, in the credit markets, mortgage-backed securities posted positive returns, and, in the past few days, High Yield and Investment Grade corporate bonds have registered narrowing yield spreads compared to Treasury bonds. Finally, in the currency markets, the dollar continued to lose ground in March, with the Euro and Japanese Yen soaring about 4% each.

ECONOMY AND POLICY

- We are starting with policy this month, because this is the area where we have seen the most significant changes. It seems the decision-makers are finally embracing the full extent of the financial market crisis. The Federal Reserve cut interest rates another three-quarters of a percent, bringing the total this year to 225 basis points. More importantly, though, new liquidity-support measures totaled a stunning \$400 billion, and eligible collateral broadened to include mortgage-backed securities. Another significant move was the expansion of the Fed's "lender of last resort" function to include brokerage firms; this decision goes a long way to guarantee the short-term liquidity of the remaining brokers.
- The Fed's measure won't solve the underlying housing problem, but should stop the irrational cash hoarding among banks and brokers that fear for their own survival. The government is also moving closer to announcing significant financial support for homeowners hit by falling home prices to stem the tide of foreclosures and mortgage defaults. The plan emerging is likely to allow home owners with negative home equity to refinance into a smaller loan, lowering the probability of a mortgage default. Looking ahead, further rate cuts are not off the table. However, growing dissent within the FOMC – two members voted against that last rate cut as a result of the deteriorating inflation backdrop – suggests the Fed is likely to leave interest rates unchanged at their next meeting at the end of April.

ECONOMY

- Meanwhile, on the home front, the economy has clearly slowed more than we expected just a few months ago. The housing sector is still deteriorating sharply, although home sales are showing tentative signs of bottoming. Financial-market dislocation still prevents sufficient credit flow for willing home buyers, but mortgage rates have started to decline again. This was helped by an increase in the amount of mortgages that government-sponsored agencies, such as Fannie Mae, can purchase from the banks. Home prices relative to household income have fallen back to their long-term trend, and home builders have been reporting low, but stable, sales in the past few months.
- The biggest surprise in recent weeks has been the weakness in business activity. New orders have declined notably, and investment spending is likely to record a small decline in the first quarter. Evidently, businesses have reacted swiftly to the deteriorating U.S. macro outlook, despite lean inventories and strong export demand. The latter continues to balance part of the domestic weakness in the U.S. economy and is the primary reason we are likely to avoid slipping into an outright recession. Neither inventories nor payrolls look bloated, suggesting business spending should contract only modestly, which is exactly what the Institute of Supply Management (ISM) manufacturing index is telling us.
- Consumer spending has also slowed notably on the back of rising inflation and dwindling real income growth, but consumption has not slipped into the red, as of yet. Consumer confidence has fallen dramatically in recent weeks, indicating the barrage of negative headlines is clearly impacting sentiment. However, the key drivers of household spending are jobs and income. We are not expecting a sharp decline in company payrolls, and income growth has remained strong enough to keep real consumer spending growing between 0.5% and 1%.

ASSET ALLOCATION

- The recent tentative improvement in financial market conditions is most obviously felt in the Fixed Income credit markets, where spreads have started to narrow from record levels, in many cases. However, as the financial market cycle starts to improve, the economic cycle continues to deteriorate. In such an environment, volatility is likely to remain high, yet we are starting to seek opportunities in asset classes that have suffered the most in recent months. We are gradually increasing our exposure to High Yield and Investment Grade credit in our Fixed Income strategies, which is consistent with our overweight in U.S. equities.
- Here, the latest news of much higher-than-expected asset write-offs by German banks reinforces our view that – despite the problems – U.S. markets are more transparent and further ahead in uncovering and addressing the credit crisis.

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.

AIG Investments is a group of international companies that provide investment advice and market asset management products and services to clients around the world. AIG Investments is a service mark of American International Group, Inc. (AIG). Services and products are provided by one or more affiliates of AIG.

Certain information may be based on information received from sources AIG Investments considers reliable; AIG Investments does not represent that such information is accurate or complete. Certain statements contained herein may constitute projections, forecasts and other forward-looking statements that do not reflect actual results and are based primarily upon applying retroactively a hypothetical set of assumptions to certain historical financial information. Any opinions, projections, forecasts and forward-looking statements presented herein are valid only as of the date of this document and are subject to change. AIG Investments is not soliciting or recommending any action based on any information in this document. AIG Investments Europe Limited is authorised and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by AIG Investments Europe Limited.