

Global Market Watch

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OVERVIEW

- The past few weeks brought a number of significant changes in global economic and financial market trends. As an initial, there is growing evidence of a broader slowdown in the developed world, which has triggered a reversal in commodity prices, and an adjustment in the currency markets. This benefited the U.S. dollar, especially against European currencies and the Japanese Yen.
- This combination is ringing in the next stage in the current business cycle, which involves a more stable outlook in the U.S. and a downward revision for growth and profit estimates in other developed economies.
- The second current theme is the transition of growth momentum away from commodity exporters in Latin America and the Middle East back to the energy-intensive, normally fast-growing Asian economies.
- The third trend is the inflation problem, which has dominated the global macro backdrop and is about to become more complicated. Oil prices are down more than 20% since peaking in the middle of July. The main consequence was a sharp decline in headline inflation indices in August, which might lead some to believe that the inflation problem is over.
- However, we are looking for a broadening in core inflation pressures, as companies try more successfully to pass on their costs, pushing inflation in the producer sector. Inflation here is running at a much faster pace, compared to the still fairly benign trend in core consumer prices.
- The decline in oil prices has the potential to develop into a stimulus for U.S. consumers that could rival this Spring's Tax Rebate program, soothe fears the economy could slip into a recession at the end of the year, and open the door for price increases that may drive core inflation higher.
- Looking further ahead, another, longer-term investment theme is the emergence of U.S. leadership in the current business cycle. This suggests that the U.S. economy will lead the rebound out of the current crisis. But any recovery will be much more muted than in previous downturns, as a result of the impaired banking system.
- So far, the credit crisis has not had much of an impact on the real economy. The contraction in credit supply in the past 12 months has been accompanied by a simultaneous contraction in credit demand. Hit by a sharp slowdown in real disposable income, households reduced their spending, and corporations, hit by input cost shock, reduced production.
- Going forward, rising credit demand will collide with banks unwilling to expand supply, thereby hampering the forces that usually lead to a turnaround in the economy. We are now forecasting below-trend (~2.5%) growth in the U.S. for at least another year.

EUROPE

- A much more notable slowdown is currently unfolding in Europe. Official growth data was quite distorted in the first quarter. It reflected very strong GDP expansion, whereas activity surveys, such as the Purchasing Managers Indices, already pointed to a loss of momentum during that period.
- Official data now shows a broad-based decline in economic growth in most European economies. The underlying growth momentum has most visibly turned bearish in the UK, where the double whammy of rising inflation and a U.S.-style housing crisis have started to depress business investment and consumer spending. The Eurozone might not have the same housing problems, but inflation is weighing on consumption and business activity in the same way. Add to that the strong Euro and the erosion of export competitiveness, and the seeds are sowed for a slowdown/recession scenario to unfold in the next few quarters.
- Although growth is slowing everywhere, European monetary policy is still going in different directions. The Bank of England, which reduced policy rates three times since last November, has downgraded its outlook for the UK economy. This suggests the Bank might be moving closer to another rate cut, as the evidence of a more significant downturn in the economy grows.
- The Swedish Riksbank surprised markets in February with a rate increase to combat surging inflation pressures. The sharp slowdown in economic growth in the second quarter might strengthen the hand of those on the Executive Board willing to ease policy again in the near term to support the ailing economy.
- Finally, the European Central Bank (ECB) raised policy rates just two months ago. Yet, in recent statements, President Trichet adopted a more conciliatory approach in response to growing evidence of a more meaningful economic slowdown. Indeed,

NORTH AMERICA

- Not much has changed in the current U.S. outlook. The economy posted the expected rebound in the second quarter, which is likely to be revised to an astonishing 3% growth rate in a few weeks.
- However, the main source of the newfound strength comes in the form of a much more dramatic decline in import volumes; themselves a reflection of the underlying weakness in U.S. domestic demand.
- The tax rebates delivered an initial boost to consumer spending, but households have only spent about a third of the rebate amounts so far, foiling a more notable rebound in consumption.
- Evidently, uncertainty about housing, jobs and gas prices has increased precautionary savings among U.S. consumers. However, this also means there is additional spending power that is likely to trickle back into the economy in the coming months.

second-quarter GDP growth declined for the first time in five years. However, we don't expect the ECB to lower interest rates until there is a more sustained decline in Eurozone inflation pressures.

ASIA

- Japan followed the rest of the developed world in posting a sharp decline in real GDP growth in the second quarter after a stronger-than-expected start to the year. Inflation is an issue, even in an economy that has suffered from decade-long deflation. With nominal income growth close to zero, even a small increase in headline consumer prices is causing the same real household income drag that is slowing growth in the U.S. and in Europe.
- On the positive side, Japanese banks are in much better shape compared to their global competitors, suggesting the slowdown in the world's second largest economy is likely to remain short and shallow. The government has started to talk about a fiscal stimulus package, which could be exactly the kind of stimulus we thought the Japanese economy was lacking. In addition, the weaker Yen will help Japan's competitiveness, helping Japanese exporters at a time when demand is clearly slowing around the world.
- Bigger changes are in store for the rest of Asia. The turn in the commodity price cycle portends a transition away from an environment that benefits commodity producers (such as Latin America) to high-growth, energy-intensive economic regions, such as Asia. However, the weakness in U.S. domestic demand will force Asia to increasingly abandon the export-driven growth model over time, which has led to massive current account surpluses and the accumulation of large foreign-exchange reserves.
- Instead, growth will be based on domestic infrastructure spending and the emergence of a consumer middle class, which will help restore balance in the global economy. Therefore, Asia will not be a deflationary force in the future, but is likely to contribute to the gradual upward trend in underlying consumer-price inflation. The decline in commodity prices will ease the pressure on consumers and government budgets, which had subsidized many energy products, to shield consumers from extreme commodity price increases.

INVESTMENT OUTLOOK

- Evidence of weaker global growth, renewed concerns about the financial market crisis and the bounce in the U.S. dollar are the key near term investment themes this month, and none of those are helping to shake us out of the current cautious stance in both our equity and fixed income strategies.
- Global equities have posted a decent rebound since the middle of July, but the current market volatility has not convinced us that this is the start of a sustained upward trend. Within our equity strategy, our overweight in the U.S., relative to Europe and Japan, has worked out very well. Of course, this was helped by sharp dollar appreciation in August. We also benefited from positive performance in Asia ex-Japan equities, while our underweight in Latin America proved to be the right call.
- We don't envision any dramatic changes in our strategy, as we were already positioned for a stronger U.S. dollar and a transition away from commodity exporters in Latin America towards energy consumers in Asia.
- Within our fixed income strategy, we remain comfortable with our high yield exposure, given the current market valuation. However, the problems at Fannie Mae and Freddie Mac have caused even highly rated residential mortgage-backed securities to underperform. Consequently, we reduced our exposure to this asset class in favor of Emerging Markets, which benefit from better economic fundamentals and their ability to participate in the U.S. dollar rally.
- What to watch for going forward? There are actually three signs that could indicate major changes ahead:
 - 1) Further declines in oil prices, which could ease recession fears for later in the year.
 - 2) Broadening inflation pressures, which could increase the hawkish rhetoric coming from FOMC members as the next step towards an eventual rate increase by the end of the year.
 - 3) A stronger rebound in Asian stock markets, driven by the realization that growth in a post-Olympic China is not slowing.



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