AIG Investments℠

Global Market Watch

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OVERVIEW

- The sharp widening of credit spreads in the U.S. and the spillover of volatility into global financial markets was clearly the key event last month. Among the major global stock markets, Japan's Nikkei index lost almost 5%, and most European stock indices ended the month about 4% lower, far exceeding the losses in the U.S. markets. Concurrently, government bonds around the world rallied, pushing the yield on 10-year Treasury bonds down 23 basis points and outperforming bonds in Europe and Japan, which recorded smaller yield declines.

- While the re-pricing of subprime mortgage-backed assets represented a fundamental change in the value of the underlying assets, the spillover into the wider corporate credit market and the sell-off in equities was mostly technical in nature. A rise in risk aversion, as a result of uncertainties in the U.S. mortgage market, collided with a spike in the planned supply of bonds and loans to finance the recent wave of private equity buyouts. We still believe the economic impact of the financial market turmoil will be very limited.

- Global currency markets also reacted strongly to the rise in risk aversion. The unwinding of carry trades pushed the Japanese Yen up almost 4% vis-à-vis the U.S. dollar; the biggest monthly gains in almost 3 years. The trend gathered steam (especially in the second half of the month) with most major currencies losing significant ground against the U.S. dollar – led by the New Zealand and Australian dollar – until then, two of the market's favorite 'carry currencies.'

United States

- Is the new consensus among U.S. economists (steady economic growth and no Federal Reserve rate cuts) crumbling already? The steady stream of bearish housing market data, combined with fears the subprime credit crunch could spill over into the wider financial system, resulting in renewed expectation of a quarter-point rate cut at the end of the year. In fact, at the end of July, the Fed Funds futures market was pricing in a 86% probability of such a move; three weeks ago the market was priced for just a 6% chance of a rate cut.

- We believe rate-cut expectations are overly optimistic. So far, there has been little economic impact from both the subprime crisis and financial market turmoil. With corporate balance sheets still in good shape, and household spending driven by strong underlying income growth that is a result of tight labor market conditions, the U.S. economy still seems in strong enough shape to weather the present turbulence. The current uncertainty in the financial sector suggests the Federal Reserve might leave interest rates unchanged for a longer period than we have been forecasting, but we still believe the next move will be a rate increase.

EUROPE

- Last month brought little new information on the state of the European economy, but that is actually good news. Strong exports to Asia continue to fuel business activity and corporate profits, while structural reforms are bringing down unemployment and stimulate consumer spending. However, the most recent activity indices are suggesting the Eurozone rebound is starting to lose momentum. Tighter financial conditions, as a result of rising interest rates and the strong Euro, are having a negative impact on business confidence. Over time, this could lead to a downscaling in business spending and new job creation.

- The ECB is still likely to raise interest again to 4.25% in the near term. Yet, listening to recent ECB board members, it seems the rhetoric is becoming less aggressive, reflecting a higher degreed of uncertainty about the growth and inflation backdrop. The Bank of England is also still focused on raising policy rates. After a brief inflation scare just a few months ago, the Bank is still worried about credit growth and the strong UK housing market. We are looking for another rate increase in the next few months.

ASIA

- China's strong influence on the global economy continues. The IMF just recently raised its growth 2007 and 2008 growth forecasts for China by 1.2% and 1%, respectively, to 11.2% and 10.5%, clearly still the fastest pace among the major economies. However, the strong Chinese economy, plus rising global energy and food prices, have started to push up domestic inflation. This has prompted the authorities to implement measures ranging from implicit tax hikes for exporters and faster Yuan appreciation, to tax increases on stock market investments designed to slow the torrid pace of economic growth to a more sustainable pace.

- In Japan, a rather uninspiring economic backdrop was further complicated by the ruling LDP's heavy defeat in July's Upper House elections, which is threatening the survival of Prime Minister Abe's government. At best, this development suggests a slowdown in Japan's reform process. Meanwhile, Japanese corporations enjoy strong profit growth and have started to increase the pace of new hiring, which should eventually stimulate stronger economic growth down the road. The Bank of Japan is still facing a deflationary backdrop and will find it hard to justify rate increases in the near term.

OUTLOOK

- Despite the financial turbulence, we remain positive on the medium-term prospects for global equity markets. The underlying fundamentals that have supported stock markets haven't changed significantly. The financial sector will bear most of the losses from both the subprime mortgage origination boom and the revaluation of risk premia. However, the much greater diversification, compared to previous episodes of financial market turmoil, suggests systemic risks are still low, and the Federal Reserve is not likely to intervene. In such an environment, once the investment climate calms down, bond yields should retrace most of their gains from recent weeks.

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