



Market Watch

Markus Schomer, CFA - Global Economic Strategist

OVERVIEW

- Despite the ongoing uncertainty regarding the U.S. macro-economic backdrop, equity markets continued their bull run in April. The Dow Jones Industrial Average pushed through the 13,000 mark and now stands 13 percent above its 1999 record; the S&P 500 moved within a mere three percent of its record in 2000. Earning reports for the first quarter have thus far surprised mainly on the upside which, together with stable interest rates, continues to push stock prices higher.
- Sentiment among bond investors turned more bullish again throughout last month. After reversing about two-thirds of the 40-basis point February rally, 10-year U.S. Treasury yields started to head lower again toward the end of April. The yield difference between 10- and two-year bonds, which had been negative since the middle of last year, flattened in April, suggesting that bond investors were less concerned about recession risk.
- While U.S. equities are soaring to new highs and bond markets appear more stable, the U.S. dollar continues to lose value. In fact, it fell two percent in April, which was its worst month in a year. Stocks and bonds exhibit tentative confidence in the U.S. economy, yet the consensus about continued positive foreign growth is much stronger. Investors are buying the certainty of strong growth in Europe, Canada and Australia and selling the uncertainty in the United States.

ECONOMY

- At the risk of sounding like a broken record, the macro backdrop in the United States remains uncertain. We continue to believe that the underlying fundamentals are more consistent with a typical mid-cycle slowdown, which will be followed by a growth re-acceleration – rather than the beginning of a more serious slowdown or even a recession. The lack of consensus among the major Wall Street economists remains a key source of financial market volatility.
- The first quarter's U.S. gross domestic product report was a great example of how difficult it is right now to read the tea leaves on the U.S. economy. On the surface, the weaker than expected 1.3-percent growth rate was the lowest in four years. Closer inspection, however, revealed that the two most important long-term drivers of economic growth, consumer spending and business investment, grew at a much stronger 3.6 percent. Also slightly encouraging was the smaller drag from housing compared to the previous two quarters.
- The biggest surprise, however, was the overall negative contribution from trade. This is the first decline in exports in almost four years. In an environment in which growth among America's main trading partners is very strong and the U.S. dollar is at record lows, it seems

inconceivable that exports would decline. This environment indicates that either an upward revision to the first quarter numbers or a stronger rebound in the current three-month period is on the way.

- The Federal Reserve is holding its ground amid the uncertainty about the U.S. growth backdrop. One could argue that there has been a subtle shift away from the prevailing inflation bias in recent months. The last Federal Open Market Committee meeting yielded a change in wording that broadened the risk factors at which the central bankers are looking, and a prominent Federal Reserve official recently stated growing concern about the housing market.
- Inflation trends moderated a touch more than expected in April, pushing the key core personal consumption deflation (a mouthful, but this is the Federal Reserve's favorite inflation gauge) to within a tenth of the bank's one- to two-percent comfort zone. However, with oil prices still above US \$65 a barrel and evidence of increasing price pressures in the manufacturing sector, it is likely that the Federal Reserve will maintain the current, albeit marginal, inflation bias.

INVESTMENT OUTLOOK

- The backdrop for U.S. equities remains positive. Despite the uncertainty about the economy, the backdrop for earnings growth remains solid. The fact that companies are still generating healthy profits supports our view that the main demand components of the economy continue to grow at a healthy pace. The weakness of the U.S. dollar has also not deterred foreign investors who continue to channel funds into U.S. financial markets.
- Bond markets will continue to ebb and flow with the prevailing sentiment in the U.S. economic data calendar. However, we believe that a consensus will emerge over the next few months that the economy is not headed for recession and consequently the Federal Reserve will not cut interest rates. That will push bond yields higher toward the current 5.25-percent Fed Funds target rate.
- Finally, in the short term, the U.S. dollar remains prone to further weakness as long as uncertainty in the United States persists and the rest of the world continues its strong economic growth performance. However, the same emerging consensus that we expect to lead to higher bond yields should also support a stronger U.S. dollar later in the year.

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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