AIG Investments

U.S. Market Watch

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OVERVIEW

- To paraphrase Paul Krugman, Princeton Economics Professor, 2008 Nobel Prize winner and New York Times columnist, now that the June job report has settled in, it's clear that a bigger stimulus will be needed. Krugman, who has become a leading voice for more fiscal spending, noted that some economists, as well as investors, are losing confidence in a U.S. economic rebound in the second half of the year.
- From our perspective, to argue that the lack of improvement in underlying economic trends five months after signing the "American Recovery and Reinvestment Act" into law proves that the stimulus was too small from the outset seems to be missing the point, as only a mere 10% of the funds set aside for discretionary spending have been disbursed so far. The size of the package is not the problem, but the speed with which it is being spent.
- U.S. stock markets have lost ground again in mid-July, and the large-cap S&P500 and the Dow Jones are back in negative territory for the year. However, after rallying almost 40% from the early March lows, the S&P500 has given back only 15% of those gains in the current correction. Treasuries have rallied since peaking at 3.94% in early June, reflecting fading expectations about a stronger growth rebound and evidence of well subscribed government bond auctions.
- During this period, the rally in the U.S. credit markets has slowed. Cushioned by high yields, most fixed income asset classes are still in the black in mid-July, despite moderate spread widening. Finally, the U.S. dollar is having a mixed July so far, losing ground against the Japanese Yen and the Canadian Dollar, while appreciating against the Euro and British Pound.

ECONOMY

- The jobs report that Professor Krugman is referring to is the dismal June Employment Report, which showed a renewed acceleration in the pace of job destruction. A net 467,000 people lost their jobs last month, which is an improvement from the 691,000 average in the first quarter, yet still worse that the biggest monthly job loss in each of the two preceding recessions. Additionally, the Unemployment Rate, currently at 9.5%, stands at a 26-year high.
- It's not really surprising then to see consumer confidence slipping back again in June. Retail Sales, outside of gasoline and automobiles, remains stagnant. Household income growth is growing again, but entirely due to government transfers, while the downdraft in wage and salary income is still accelerating. As a result, consumers are still boosting precautionary savings, rather than expenditures.
- If not the consumer, who is left to drive the U.S. rebound in the second half? One area that continues to improve is manufacturing, not just here, but abroad. We have written about the unfolding inventory cycle before, but there is also growing evidence of improving conditions in economies such as Canada, Australia and Asia. The result is a rebound in U.S. exports, especially to the latter region.
- It's still early days to call this a new trend, but it is consistent with other activity data in the region. Other signs of rebounding manufacturing activity stem from the most recent Durable Goods Orders report for the month of May, which showed the strongest increase in 17 months, and the widely watched Institute for Supply Management Manufacturing Survey, which showed production and new order activity stabilizing in June.

POLICY

- Professor Krugman and others are pushing for another fiscal stimulus package, arguing that the first round at US $787 billion, or 5.5% of U.S. GDP, was insufficient to make a meaningful impact. However, the government has spent only a small amount of the current funds available since the middle of February. In fact, about US $174 billion in discretionary-spending funds have been made available so far, yet only US $60 billion have been spent.
- Clearly, spending such a huge amount of money was always going to take time. But the current momentum is building, and the U.S. is on track for spending about US $150 billion this year, which should add about 1% to GDP growth. Other measures, such as tax cuts and additional unemployment and health care benefits, are supporting households, but their effect on boosting aggregate demand is obviously more difficult to measure.
- The Federal Reserve has increasingly moved to a "wait-and-see" mode. Over the past few months, demand for the Fed's emergency liquidity facilities has slowed notably, and first steps were made to reduce the funding made available since September of last year. At the peak, banks were drawing more than US $1.3 trillion from those facilities, but, in mid-July, demand had fallen by 75% to just about US $325 billion.

- In response, the Fed has reduced the size of its biweekly auctions from US $150 billion to US $125 billion, which could be considered the first small step towards an exit strategy. The Fed's money market support programs have also seen a significant drop in demand, while the asset purchase program continues as planned.
- Thus far, the Fed has purchased about US $740 billion in Treasuries, agency bonds and mortgage-backed securities, which still represents less than half the US $1.75 trillion in planned purchases. We expect no dramatic changes to Fed policy in the coming months, but will keep a watchful eye on further program reductions.

INVESTMENT OUTLOOK

- The loss of steam in global equity markets in the past six weeks has justified our cautious approach to increasing risk in our global portfolios. We still carry a moderate equity overweight, but we had expressed concern that the equity market rally was outpacing the actual improvement in the economy.
- However, in our view, a proper economic recovery is still on the agenda in the second half of the year, so we are not looking for a renewed testing of the March market lows. Our view on Treasuries is quite similar. We thought the sharp sell-off in early June was not supported by current economic conditions, and the subsequent rally in Treasury yields has brought the market back in line with our expectations for the rest of the year.
- We are still looking for 10-year Treasury yields to remain below 4% for the rest of the year, before starting a more pronounced upward move in 2010. Finally, within our fixed income credit portfolios, we continue to shift the focus away from U.S. dollar-denominated assets toward Emerging Markets and International Sovereign bonds. Here we see stronger performance potential in the next few months as a result of latent dollar weakness.