

Global Market Watch

August 20, 2009

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OVERVIEW

- In a reverse of Newton's Law of Gravity, "What goes down must come up again." Today, as the halting recovery continues, the global economy looks more like a coiled spring than a complicated system of interdependent economic sectors and regions.
- Our 2009 growth forecasts for the key economies around the world were based on the aggressiveness of economic policy and the flexibility and resilience of the underlying economies. Yet, as the numbers continue to be posted, it appears the countries that experienced the biggest decline in their real GDP are now celebrating the biggest bounce.
- Japan is leading the procession, generating a 3.7% annualized growth rate in the second quarter. Meanwhile the U.S. and the UK remained mired in recession in the same period, registering declines in real GDP of 1% and 3.2%, respectively.
- The tempo in the global stock market rally has slowed notably in recent weeks following another strong increase in July. Not surprisingly, emerging market equities fare worse during periods of investor pull-backs, and they have posted a small negative return in August at the time of writing, while developed markets were unchanged for the month.
- Interestingly, so far this month, there is not much differentiation between the three major markets, U.S., Europe and Japan, which all reported small declines in their major indices.
- Within emerging markets, Asia is struggling the most in August with China leading the sell-off, whereas Latin America continued to generate positive returns. The U.S. dollar is benefiting marginally from the temporary decline in risk appetite, gaining about one percent against the currencies of its major trading partners. The Japanese yen experienced the biggest gain, while British pound and Canadian dollar lost the most ground half way through August.

NORTH AMERICA

- In the U.S., the recessionary momentum slowed significantly in the second quarter, yet the economy posted another decline in real GDP growth, the fifth in the past six quarters, extending the peak-to-trough decline in the current recession to 3.9%.
- Looking ahead, we still expect a fairly vigorous growth spurt in the second half of the year fueled by a rebound in housing, a slowdown in the dramatic pace of inventory liquidation and continued positive contribution from exports.
- Moderate rebounds in consumer spending and business investment will extend the rebound into next year. However, we still see substantial risk of a double-dip slowdown later in 2010, when rising short-term interest rates may crimp consumption, exacerbated by the fading fiscal stimulus and inventory rebuilding.
- Canada's economy is sending out mixed signals regarding its underlying growth trend. GDP growth in that country is still

expected to post another significant decline in the second quarter, which should merely slow the ongoing recessionary momentum similar to its large southern neighbor. One reason for the lack of a proper rebound is the fact that Canada experienced only a mild recession with GDP down just 2.7% from the peak. Rising unemployment has been a major problem and the Unemployment Rate has shot up almost three percentage points to an 11-year high 8.6%.

- However, Canada's Purchasing Managers Index for the Manufacturing sector has jumped back above the critical 50 mark signaling a rebound in industrial activity, which should stabilize the employment backdrop in the coming months. The country also stands to benefit from the sharp recovery in the U.S. automobile sector, which should be reflected in stronger growth forecasts for the second half of the year.

EUROPE

- The rebound in second-quarter GDP growth in Germany was one of the biggest surprises so far. We expected Europe's largest economy would take longer to emerge from recession, given its dependence on exports and weak underlying consumer fundamentals. However, following a dramatic 13.4% annualized decline in the first-quarter, GDP registered a moderate 1.3% rebound, ending a four quarter recession that reduced economic activity by a total of 6.7%.
- A similar rebound in France helped cushion persistent weakness in other parts of the currency union. Overall GDP declined 0.4%, suggesting continued severe recessions in Italy, Spain and other Eurozone economies.
- Looking ahead, we are skeptical about the durability of the growth rebound in the Eurozone. Purchase Managers Indices are still well below the expansion/contraction threshold of 50, signaling continued recession conditions in both the Manufacturing and Service sectors. While exports are likely to rebound further in the coming quarters, stubbornly high unemployment and cautious businesses are likely to keep growth rates well below what we are forecasting for the U.S. economy.
- Among the major developed economies, the UK showed the least progress on the road to recovery in the second quarter. GDP declined at a 3.2% annualized rate and following the dramatic contraction in the prior two quarters, the UK economy has shrunk a full 6.3% during the current recession, very much in line with the overall loss of output in the Eurozone.
- Going forward, Purchasing Managers Indices are signaling a marked improvement over the summer, and the economy should emerge from recession in the current three months period. More help is also on the way. The Bank of England increased the size of its quantitative easing program, providing additional liquidity to the economy, and the subsequent improvement in both financial and housing market conditions should help ease the headwinds against a sustained recovery. However, the UK, even more so than the U.S., will pay a hefty price for averting an even deeper

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recession as a result of a massive increase in government debt issuance and surging interest payments.

ASIA

- The other economy that posted a welcome upside surprise in the second quarter was Japan. Still the world's second-largest economy, Japan experienced the most dramatic decline in economic activity during the current recession. Over the past four quarters, Japan's GDP declined a stunning 8.3% in real terms, by far the worst post-war contraction. After such a dramatic collapse, a moderate rebound isn't really that surprising, and the 3.7% increase in GDP growth in the second quarter, driven by a rebound in consumption and exports, would have looked even better had ongoing inventory liquidation not shaved another 1.9% off the quarterly growth rate.
- However, nominal GDP posted a small 0.7% decline during the same period, exposing much of the rebound in real GDP growth as the result of falling prices, rather than expanding volumes. In the future, it is hard to see how Japan's growth momentum can be sustained. The country's strong rebound in exports is likely to moderate, but should indeed provide further support for the economy. However, consumer spending is likely to weaken again, and we expect a renewed decline in real GDP growth in the second half of the year.
- China was another positive surprise in the second quarter, engineering a successful reacceleration of economic growth amid the still-prevailing global economic weakness. The Chinese government deserves much of the credit for managing such a fast turnaround due to a combination of aggressive policy interventions from a massive expansion of fiscal infrastructure spending, ordering the still very large state-owned enterprise sectors to expand production and requiring that the country's banks keep originating loans. All these measures combined have averted a more serious slowdown, which could have had much more serious social consequences.
- That being said, some clouds have appeared in the form of concerns over a growing mountain of non-performing loans and the lack of a recovery in U.S. consumer spending, which could further weaken the Chinese export sector. The first issue needs to be watched very closely. A financial crisis in China in an improving, yet still precarious, global financial system could have massively negative consequences around the world. Consumer spending – not exports – will be the main driver of China's next stage of development.

INVESTMENT OUTLOOK

- Among our major investment convictions, optimism in a strong, long-term expansion in Emerging Markets remains at the top of

the list. The current correction in Asian (and especially Chinese) equity markets compels us to short the region, yet we maintain a longer-term, positive bias towards Asia. Another region with strong growth prospects is Latin America, which is at a very different stage in their development, yet clearly helped by strong commodity prices.

- The normalization in global investor risk appetite continues to weigh on the U.S. dollar; a process we expect will continue for the rest of the year. Therefore, we are increasing exposure to non-U.S. assets in both out equity and fixed income strategies.
- The notion of U.S. leadership in the current cycle has lost its appeal. Rather, Asia/Pacific, including Australia, has emerged as the clear cycle leader. However, as we stated above, the growth surprises in Europe and Japan have not catapulted those regions ahead of the U.S., but are rather the result of a deeper contraction in the current recession. We expect growth in those two regions will fall back behind the U.S. in the second half of the year.
- We expect global equity markets have a few more months of strong fundamental tailwinds ahead, as we see evidence of a stronger economic rebound in the U.S. and stronger profit growth around the world. However, we believe a shift in focus away from the recovery towards potential monetary policy tightening could bring about a correction in risk appetite, which could herald a more difficult backdrop for global equity markets in 2010.
- Similarly, government bond markets around the world have so far only experienced mild upward pressure on bond yields despite massive fiscal deficits around most of the developed world. Evidence of a stronger recovery should increase the risk of a more pronounced upward drift in bond yields, something central banks will want to veer away from by raising policy rates from near-zero levels to demonstrate willingness to combat inflationary expectations. Failure to do so risks a more serious increase in long-term bond yields, which could threaten the rebound in corporate borrowing and precipitate another housing collapse.



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