

# Global Market Watch

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## OVERVIEW

- Over the past two months, the financial market crisis has evolved into a full-scale economic crisis, the extent of which became evident in the recent forecast revisions by the International Monetary Fund (IMF). Not that long ago, in July, the IMF actually raised its 2009 global growth forecast by a tenth of a percent to 3.9%.
  - In the most recent iteration, the fund slashed its prediction to just 2.2% — the slowest growth rate since 2001. Most developed economies will experience outright recessions, and growth in many Emerging Markets is slowing more notably than we had expected over the summer.
  - Although the current economic backdrop is bleak, the seeds are slowly being sowed for the next rebound. Oil prices are falling sharply, many countries around the world are readying fiscal packages to stimulate domestic demand, and central banks are slashing interest rates.
  - Once the dust settles we will undoubtedly be left with a world where governments have a much greater direct stake in the economy and at the same time face increasing refunding cost in the future. This all points to a less dynamic world with slower potential growth.
  - October was one of the most dramatic months for global financial markets in decades. Global Equities followed up a miserable September with even worse performance in October. The MSCI World index fell 17% last month and is on track for a similar decline halfway through November.
  - Emerging Markets underperformed Developed Markets in the past few months, and U.S. equities suffered greater losses than European and Japanese markets through the middle of November.
  - U.S. Treasury bond yields rallied sharply in the past six weeks — predominantly at the short end — but benchmark 10-year Treasuries joined the rally in the first half of November, as inflation fears gave way to recession concerns. Most other developed government bond markets fared even better and outperformed U.S. Treasuries in the past two months as the recession spread around the globe.
  - Despite the weakness in domestic markets, the U.S. dollar had its best month ever in October against a basket of major currencies and continued to strengthen into November. Finally, commodity prices are posting dramatic declines led by Oil, which is down 43% in the past 6 weeks; even Gold is not benefiting from the uncertain market outlook, losing 18% over the same period.
- We expect that the official record keepers of the business cycle will date this recession from the fourth quarter of last year to the first quarter of 2009. Financial market conditions have improved from the extremes following the Lehman collapse, as evidenced by the steady decline in LIBOR rates, but lending standards remain extremely tight.
  - All eyes are now on the Government and another large stimulus package is urgently needed to boost aggregate demand, while the Fed and Treasury are still working on restoring stability in financial markets. GDP growth will be extremely weak in the current quarter, but we expect a stabilization in the first half of next year.
  - The Canadian economy is clearly impacted by the decline in commodity prices and the crisis in the U.S. auto industry. The economy slipped into recession at the start of the year. However, the contraction in GDP growth is likely to remain shallower, compared to the increased volatility south of the Canadian border. The main reason is the residual strength in domestic demand.
  - In Canada, the unemployment rate has barely moved from the generation-low 5.8%, and the economy has generated more than 200,000 jobs this year, compared to the 1.18 million jobs lost in the U.S. As a result, it's no surprise that Retail Sales are still growing at a 4% clip from a year ago. The Bank of Canada has been in growth-support mode all year and has cut rates already by 225 basis points to 2.25%. We are looking for rates to bottom out at 1.75% before the year is over and growth to rebound next summer in line with the U.S. trend.

## EUROPE

- The European Central Bank had focused more on financial market stability in the past adding liquidity to the banking system, but standing pat on interest rates. The sharp reversal in the inflation outlook and the dramatic deterioration in economic activity have shifted the bank's priorities and started the process of more aggressive monetary easing.
- The ECB joined a group of six major monetary authorities cutting policy rates by a half point in early October and followed up with another 50-basis-point policy rate cut at their regular October meeting, bringing rates down to 3.25% — the lowest level in 2 years. We expect the bank will push rates as low as 2% by the spring of next year.
- Growth has started to contract in the second quarter, and the recession in Europe is likely to last through the first half of 2009. Many Eurozone governments are enacting fiscal stimulus programs, and the recent decline in the Euro should help exporters. Although that won't be enough to avoid a recession, it should help prevent more dramatic declines in the next few quarters.
- The crisis is even more palpable in the periphery around the Eurozone. In the UK, manufacturing activity continues to deteriorate rapidly, layoffs in the financial services industry are increasing, and the pace of house price declines is still accelerating. In fact, declining housing wealth is transmitting a greater negative shock to the consumer sector compared to the Eurozone. Additionally, unemployment has started to increase for the first time in 17 years.

## NORTH AMERICA

- The "Great September Crash" has done significant damage to U.S. economic activity. The freezing over of short-term funding markets transmitted the financial-crisis shock through the rest of the economy rapidly, and the negative multiplier is now in full swing. Manufacturing activity has fallen to the lowest level in 26 years, the Conference Board Consumer Confidence index has fallen to an all-time low, and the Unemployment Rate just hit a 14-year high. Clearly we are in the midst of a recession.

- Eastern European economies find themselves in even deeper trouble. Accession to the EU triggered economic booms in many countries and attracted massive portfolio and investment capital inflows, the reversal of which is now causing dramatic economic adjustments. However, the poster child of the crisis has to be Iceland, where the collapse of the banking system, with assets worth around 10 times the country's GDP, has thrown the economy into a deep depression. Here is an example where banks can go from "Too-Big-To-Fail" – the situation in the U.S. and Europe – to "Too-Big-To-Save," where the damage exceeds the ability of any individual country to shoulder the fallout alone.

## ASIA

- Japan is increasingly exhibiting the same recession pull that has caused dramatic downgrades in growth expectations in the U.S. and in Europe. Household spending was hit by inflation shock earlier in the year. Even though oil prices are falling, October consumer confidence hit a new record low since the start of the survey in 1986.
- Adding to the negative multiplier effect now is a dramatic contraction in manufacturing triggered by the global credit crunch in September and the shock of a rapidly appreciating currency. The Yen rose more than 7% against the U.S. dollar last month, but almost 20% against Euro and Korean Won; the currencies of two closer trading competitors.
- The Bank of Japan cut its key policy rate by 20 basis points to 0.3% last month, and the new government under Prime Minister Aso announced another economic stimulus package. Still, we expect Japan's recession will last farther into 2009 and track the European cycle more closely.
- The current crisis is clearly elevating China's role in the world. Not only have we lost confidence in the role of markets here in the West, but we are clamoring for more government, not less. We are also now banking on China to keep their economy going and bail out the rest of the world with its superior economic growth potential and \$2 trillion of foreign exchange reserves.
- The irony is hard to miss, but the Chinese are living up to their new role. Not only have they turned a blind eye to protestors during the Olympic Games this summer, but their RMB 4 trillion stimulus package, which will stretch over the next two years, representing 6% of GDP each year, is sizable enough to make a

difference. Yes, Chinese growth will slow regardless of the stimulus, although we expect that the country will be successful at maintaining an overall growth trend sufficient to prevent the significant increase in unemployment plaguing many developed economies right now.

## INVESTMENT OUTLOOK

- We maintain a cautious risk profile in most of our portfolios. Within our Balanced Strategies, we maintain a neutral weighting between bonds and equities expecting more volatility during the current bottom-building phase. The dramatic swoons in global stock markets reflect the tug-of-war between new evidence of the dismal current economic situation and improving expectations every time a new fiscal or monetary program is announced.
- Within our global equity strategies, we maintain an overweight in U.S. equities based on the assumption that the policy reaction here has been swifter and more decisive, and the U.S. will lead the rest of the developed world out of the recession. However, as a result of the more aggressive rate cuts in Europe, we covered our underweight to that region. Instead, we opened a small underweight position in Japan, where fiscal and monetary policy is still constrained following the 1990s banking crisis.
- We also reduced our exposure to Emerging Markets. Generally, the fundamental backdrop is still better compared to the developed world with central banks cutting rates and governments using fiscal policy to stimulate domestic demand. However, the dramatic portfolio outflows from the asset class have caused great damage across many emerging equity markets.
- We made a similar move in our fixed income credit portfolios where we increased our weighting in Global Developed Market Bonds at the expense of in Emerging Markets. As we commented already in a previous report, we need to see evidence that the efforts to unfreeze credit markets lead to a rebound in economic activity, something we haven't seen yet.
- Today, global governmental action is occurring almost everywhere, which adds to the sense of uncertainty among investors. The upcoming G20 Financial Crisis Summit could become an incubator for a new set of rules and regulations that will govern global financial markets. This could be the first step to creating a solid foundation for investor confidence.



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Markus Schomer, Global Economic Strategist for AIG Investments, is responsible for providing macro-economic forecasts, analysis and commentary for all AIG Investments 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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