

Global Market Watch

May 1, 2009 | Markus Schomer, CFA – Global Economic Strategist

OVERVIEW

- The nature of a business-cycle inflection point is that it is defined by elements that both bulls and bears favor – for very different reasons.
- At the current inflection point, bears will likely point to the continued problems occurring in the U.S. and European banking sectors. Earnings at financial institutions appear to have rebounded during the first quarter of 2009. However, the U.S. government's stress testing has revealed continued capital shortages at a number of large U.S. banks and the International Monetary Fund's (IMF's) most recent Financial Stability Report puts the global total losses from the financial markets crisis at a staggering \$4 trillion. Add to that the new threat of a swine flu pandemic, and it is not hard to see why some investors remain extremely cautious.
- However, we prefer to take the "glass-half-full-view." We agree with those commentators highlighting the most recent improvements in the economic backdrop, not just here in the US and in Europe, but especially in Asia.
- The financial markets also seem to have been on our side over the past few weeks. Global equity markets significantly outperformed government bonds in April. Additionally, Emerging Markets posted higher returns than the more developed regions for the fifth straight month, emphasizing the gradual decline in risk aversion. Within Developed Markets, Europe marginally outperformed the U.S. The worst performer, and the region where we have our largest underweight position, was Japan.
- Among the three main regions in Emerging Markets, although we see the greatest potential for an economic rebound to be in Asia, surprisingly, Latin America and EMEA both outperformed.

NORTH AMERICA

- The gloom is slowly lifting off of the U.S. economic backdrop, and the shape of the recovery is slowly coming into focus. The most recent first-quarter GDP report showed another dramatic decline in aggregate economic activity. However, it also revealed important positive changes in the economy's main sectors.
- Job losses grew by two million during the first quarter, but consumer spending rebounded stronger than expected, driven by the dramatic decline in energy prices. In spite of a rapidly expanding unemployment base, the household-savings rate jumped a full percentage point to almost 5% during the first quarter.
- Finally, stronger demand led to a sharp acceleration in the pace of inventory liquidation. This resulted in a rebound of factory orders and is expected to stimulate industrial production over the next few months. Renewed production should eventually be expected to spur employment growth later in the year. So the momentum is

building toward more "green shoots," or signs of hope, for the U.S. economy; and all before the massive fiscal stimulus package even begins to work its way into the economy.

- The coming rebound won't be smooth, however. The overlapping cycles of inventory rebuilding, government spending, and a rebound in housing, as well as business investment have the potential to generate bursts of stronger economic growth, even with our assumption of a below-par recovery in personal consumption.
- In Canada, the central bank finally caught up with the Federal Reserve, cutting interest rates to 0.25%, although stopping short of instituting a "Quantitative Easing" program. The Fed remains one of the most aggressive central banks, announcing in March its intention to purchase up to \$1.75 trillion in assets to keep interest rates low and boost the money supply.
- Economic conditions in Canada have deteriorated dramatically; the Bank of Canada expects that the pace of contraction probably doubled during the first quarter, compared to the previous period. The destruction of jobs in Canada has been on par with the sharp decline in U.S. payrolls, yet Retail Sales and the Manufacturing PMI index are pointing to an improvement in the current quarter.
- Rising commodity prices should help exporters, although the crisis in the U.S. auto industry remains a significant risk for Canada's manufacturing sector. Canadian government bonds have outperformed U.S. Treasuries in recent months, yet, so have local equity markets, which suggests Canada's superior fiscal and current account balances are helping financial markets, despite the ongoing economic difficulties.

EUROPE

- The recent G20 summit in London highlighted important philosophical differences in the crisis response between the economies in the Eurozone and the United States/United Kingdom: The U.S. and the UK unleashed massive fiscal stimulus packages, allowed central bank balance sheets to balloon, and set up billion-dollar programs to absorb toxic assets. To date, European governments have been unable to agree on substantial government spending programs to stimulate domestic demand.
- The European Central Bank has been much slower to ease monetary policy compared to its peers. Even though the recession in Europe appears deeper when looking at the numerical decline in GDP growth – the IMF forecasts the Eurozone economy will contract by 4.2% this year, compared to a contraction of just 2.8% for the U.S. – the impact on the household sector is less dramatic. While unemployment rates have risen far less than in the U.S., automatic stabilizers, such as more generous unemployment benefit schemes and continued health-care coverage, serve to prevent a more dramatic deterioration in household finances.
- In the United Kingdom, economic activity declined by 7.4% during the first quarter, the largest drop in 30 years. But the biggest challenge is the deterioration in public finances. The recession

Global Market Watch

May 1, 2009

has laid bare the UK's dependence on housing and financial services and caused a sharp increase in the country's structural budget deficit. The government projects an overall budget shortfall of 12.4% of GDP this year, the biggest gap since the end of World War II.

- As a consequence, the UK is running out of room to stimulate demand. In fact, in his latest budget, Chancellor Darling announced a dramatic income tax increase, which will push the top marginal tax rate in the UK to 50%; well above those in other European economies. The ratings agencies have started to raise concern regarding the UK's sovereign rating, given the fact that even the government is predicting budget deficits well in excess of 5% for at least the next five years.

ASIA

- What about signs of an inflection point in Japan? The collapse in activity in what is still the world's second largest economy has been stunning and revealed a much greater export dependency than many economists expected. Quarterly GDP declined by a stunning 12.1% during the last quarter of 2008, and the IMF is looking for an overall 7.2% contraction this year.
- There are, however, a few faint signs of hope that a pickup in regional trade is stirring an improvement in Japan's industrial sector. In fact, Reuters' monthly version of the widely watched Tankan business survey has stabilized in the past few months, March Industrial Production posted a small increase, and the decline in export volumes appears to have stopped.
- A few weeks ago, the government announced its fourth fiscal stimulus package in six months, but it will be the resumption of global trade that is most likely to provide the spark for a recovery in Japan.
- In addition to the U.S., the other region that is showing the most convincing signs of improvement is Asia ex-Japan, where the aggressive policy response by the Chinese government is starting to arrest the decline in economic activity in the broader region. For example, bank-loan generation in China is hitting record highs, and the economy posted a stronger 5.8% increase in the first quarter. Korea's economy eked out a small increase during the first quarter, and Taiwan's exports to China have rebounded.
- In contrast to SARS or the avian flu outbreak a few years ago, the epicenter of the current "swine flu" pandemic lies in the Western Hemisphere. However, Asia's dependence on international trade could turn into a weakness again, if countries in North America or Europe decide to restrict air travel or close shipping ports. In the long run, Asia's importance in the global economy will continue to grow, not just due to demographics, but also due to their healthier economies, improved fiscal balances and the lack of overleveraged private sectors.

INVESTMENT OUTLOOK

- Our cautious approach to increasing risk in our equity and fixed income portfolios is starting to pay off. We had a small equity overweight in our balanced strategies as we started to tilt our portfolios towards the "Global Reflation" theme, and an eventual economic rebound. In addition, the gradual rotation away from the larger, more liquid developed markets towards areas with greater growth potential is proving to be the right strategy, as well.
- We still do not have an outright overweight position in either Emerging Market equities or bonds, but we increased our exposure to both asset classes last month. The reflation theme suggests that, within both Developed and Emerging Markets, economies with more aggressive crisis response should continue to outperform; hence our overweight in the U.S. and Asia ex-Japan.
- Finally, attractive valuation and signs of stabilization in financial market conditions continue to support our small overweight in High Yield credit in our fixed income strategies. Over the short-term, investor risk appetites may be curbed by the "swine flu" scare. However, we believe the improving economic backdrop and the continued aggressive policy response will support our current modestly constructive posture in both our equity and fixed income strategies.



Markus Schomer, Global Economic Strategist

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.

Past performance is not indicative of future results

AIG Investments is a group of international companies that provide investment advice and market asset management products and services to clients around the world. AIG Investments is a registered mark of American International Group, Inc. (AIG). Services and products are provided by one or more affiliates of AIG.

Certain statements provided herein are based solely on the opinions of AIG Investments and are being provided for general information purposes only. Any opinions provided on economic trends should not be relied upon for investment decisions and are solely the opinion of AIG Investments. Certain information may be based on information received from sources AIG Investments considers reliable; AIG Investments does not represent that such information is accurate or complete. Certain statements contained herein may constitute projections, forecasts and other forward-looking statements that do not reflect actual results and are based primarily upon applying retroactively a hypothetical set of assumptions to certain historical financial information. Any opinions, projections, forecasts and forward-looking statements presented herein are valid only as of the date of this document and are subject to change. AIG Investments is not soliciting or recommending any action based on any information in this document. AIG Investments Europe Limited is authorised and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by AIG Investments Europe Limited.