

Global Market Watch

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GLOBAL OVERVIEW

- Another month went by with mainly bearish economic and financial market news. The financial market crisis is still intensifying, spreading to the municipal bond market in the U.S. and affecting bond spreads within the Eurozone government bond markets.
- Meanwhile, the U.S. is inching closer to a recession, and a number of developed economies are starting to experience weaker macro fundamentals. At the same time, inflation pressures in many countries are still increasing, forcing central banks to choose which battle to fight. In fact, despite the global nature of both the inflation threat and the financial markets crisis, global monetary and fiscal policy remain unaligned.
- Financial markets experienced another very difficult month in February. Global equities posted a 1.9% decline in February, extending its losing trend to four months, and the sell-off intensified in early March. The U.S. underperformed most other developed markets, while emerging markets enjoyed a stronger rebound, which has already fizzled in the last few days. The Treasury curve continued to steepen, with two-year yields falling 48 basis points, while the yield on 30-year bonds increased 8 basis points.
- Credit markets had a particularly bad month. High yield spreads widened 77 basis points, but the biggest underperformer were commercial mortgages, with spreads a whopping 117 basis points wider and the asset class posting a 3.7% decline. The U.S. dollar fell to a new all-time low against a trade-weighted basket of major trading partners, and commodities, led by oil and gold, registered another sharp price increase.

NORTH AMERICA

- The macro backdrop in the U.S. continues to deteriorate. The latest employment report underscored the broadening weakness in the economy. The ISM surveys for the manufacturing and service sectors are pointing to 0% growth in February.
- Anecdotal evidence from major retailers suggests that consumer spending was probably marginally positive last month. However, the weakness in the jobs market suggests the rest of the economy is not balancing the ongoing weakness in housing and financial services anymore.

- We still believe growth will pick up in the second half, on the back of lower interest rates and the coming fiscal stimulus, although we have pared down our forecasts for the full year from 2% to 1.8%. The Federal Reserve is already massively increasing the liquidity provisions to the banking system and will no doubt cut interest rates further this month and again at the end of April, probably by 50 basis points in each case.
- Similar to the U.S., the Canadian economy experienced a sharp slowdown in economic growth in the fourth quarter of last year. However, contrary to the U.S., domestic demand has remained very strong, with consumption up 4.7% last year and business investment growing 4%. However, net exports deteriorated notably last year, posting a negative balance for the third year in a row.
- Despite firming commodity prices, the strong Canadian dollar and the slowdown in the U.S. manufacturing is starting to have a meaningful impact on exports. Consequently, the Bank of Canada lowered interest rates by 50 basis points in early March. With low inflation, the Bank has the flexibility to do more in response to the deteriorating outlook in the U.S. economy.

EUROPE

- The most significant development in the Eurozone is the increasing divergence of growth prospects among the primary member states. The most recent Purchasing Managers Surveys reconfirmed the rebound in German and French manufacturing activity. Italy, and even more dramatically, Spain, continues to suffer from a deteriorating manufacturing backdrop. Consumer spending has been quite disappointing Eurozone-wide, posting an outright decline in real terms in Q4 for the first time in 7 years.
- Clearly, the positive impact from falling unemployment is not balancing the slowdown in real income growth anymore. The ECB has thus far shown very little inclination to follow the Federal Reserve and lower interest rates, given the strength in money supply growth and above-target inflation. However, the surging Euro currency could tilt the scales towards a rate cut by May or June to prevent a more serious slowdown in Eurozone net exports.
- Economic growth in the UK held up better than expected in Q4 of last year. However, a closer look reveals weakness in both consumer spending and business investment, while only a sharp drop in imports led to a positive contribution from net exports. Home-price appreciation has continued to

slow, which should weigh on consumer spending, although retail sales actually accelerated in January – very much against expectations.

- The Bank of England left rates unchanged in March, but remains on a gradual easing course, given a similar exposure to housing and financial market turmoil compared to the U.S. The reason the Bank is not in full panic mode, like the Fed, is the fact that the domestic economy is still holding up better.

ASIA

- The economic backdrop in Japan remains quite volatile. Despite much stronger-than-expected GDP growth in Q4 of last year, some forecasters are looking for a more serious slowdown in 2008. Industrial production has weakened notably, but consumer spending is holding up fairly well.
- Going forward, the question is whether a weaker industrial backdrop and rising inflation will spill over into the consumer sector, or whether robust exports can pull up business activity in the coming months; we still consider the latter scenario as the more likely one. The Bank of Japan will leave rates unchanged in such a case, though a growing number of forecasters are looking for actual rate cuts in Japan.
- Australian economic growth also slowed in Q4, but at 2.4% remained well ahead of most other major developed economies. However, as in Canada, trade is deteriorating, and exports actually declined in Q4, posting the worst quarterly result in more than three years. Main growth drivers are consumer spending and business investment helped by strong profit and income growth, as well as falling unemployment rates.
- While the Bank of Canada is worried about the future impact of a weaker U.S. economy, the Reserve Bank of Australia is focusing on current inflation pressures and March interest rates that rose for the seventh time in the past two years to 7.25%. While the Bank left the door open for more, we expect rates to remain in this range for the rest of the year.

GLOBAL OUTLOOK

- The deteriorating fundamentals in the U.S. are validating our more cautious investment strategy. While very inexpensive valuations in many equity and fixed income markets look tempting, continued market disruptions in the world's credit markets and further downward pressure on earnings expectations suggest the timing is not right to increase our risk exposure.
- In such an environment, we remain underweight on equities versus bonds. Within our equity market allocation, we continue to prefer the U.S. over Europe or Japan, given the greater degree of transparency regarding banking problems, and greater willingness to support growth through accommodative monetary and fiscal policies.
- Commodity prices have remained very firm, and, in some cases have increased even further. For example, oil prices were trading well above \$100 at the start of March. Rising oil prices are beneficial to oil exporting countries, which are positively impacted by rising incomes from oil exports. The result is often strong job and income growth, which more than balance the increase in gas prices at least from a macro perspective. This trend bolsters our positive stance on emerging markets – especially Latin America and Australia – as these are the areas that are the most positively impacted by rising commodity prices.

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