



Market Flash

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ASSET ALLOCATION PRE AND POST THE JANUARY CHILL

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The Equity Markets in Perspective

- For several years now, we've been constructive on equity markets and until this summer, we had an overweight position, but as the sub-prime crisis broke mid-year 2007, we reduced the equity weight to a neutral position in balanced accounts and, at the end of 2007, went underweight equities.
- The way we explain these moves is based on our interpretation of the monetary cycle. At the end of the last recession or slow down in the United States, we had massive monetary stimulus driving down short rates to 1 percent. That set the ball rolling for a massive liquidity creation in the global economy and what followed over the next several years was what typically follows these kind of monetary injections: we had strengthening economic growth and increased risk tolerance on the part of investors, and in typical fashion, this led to excesses.
- We ended up with extremely low risk premia, both in equity markets and in credit markets.
- We know that eventually when the monetary cycle turns and the Fed starts to increase rates and other central banks follow, we will have a break somewhere. When the Fed tightens, this regularly results in a financial crisis somewhere, and normally this occurs where the excesses have been the largest. This time, it was the U.S. mortgage market, the U.S. housing market and particularly the sub-prime sector that broke first. The other part or the topping out of the monetary cycle is of course a slowdown in the U.S. economy, perhaps associated with slowing economic activity in other parts of the world. 2007 was a good year for the U.S. economy, but towards the end of '07 we have had a lot of weakening tendencies.

Risk of Recession

- All of the above attempts to explain how we ended up where we are, but the question is what to do now? The monetary cycle is certainly turning again. We just had the dramatic out-of-session 75 basis point cut by the Fed following the earlier cuts last fall, so we are again in the positive phase of the monetary policy cycle.
- There are, of course, several main uncertainties at the moment. One is if there is indeed a slowdown or recession, how deep will

it be? The other question is how severe could the financial crisis be? One of the troubling aspects of the developments over the last several months has been that in spite of Fed action and in spite of monetary injection and other support from central banks around the world, the problems in the credit markets have not yet gone away.

- In fact, in November and December we had a new wave of worries around counter-party risk that led to a drying-up of liquidity and a slow down in trading volumes in some parts of the credit markets. Thus, there is a real fear here that the constraints in the financial system will lead to slower credit expansion, slower liquidity creation and a resulting deepening of the economic malaise.

Stabilizing Factors

- Looking at the situation today, there are a number of encouraging facts to take into consideration. It is certainly positive that the Fed and other central banks now seem keenly aware of the dangers involved and have shown their willingness to act. Another positive aspect is that a recapitalization of banks' balance sheets has started to occur. We've had a lot of well-publicized injections of capital by sovereign wealth funds and other investors into the balance sheets of U.S. and European banks. A lot of the problems are being addressed, questionable assets are written off, and there is also action in terms of cost cutting and dividend cuts. This will improve capital ratios and the potential for credit creation.
- So, from a medium-term perspective, we should be looking at a recovery. In the short-run though, we don't know the exact situation among individual banks and other financial market participants. In the current situation of turmoil and volatility, it wouldn't be surprising if some market actors end up in a troublesome situation. Therefore, we need the mental preparedness to absorb some further bad news.

Balancing Growth and Inflation

- Our main assessment is that we can see a recovery in credit markets, but it will probably be awhile before we get confidence back into the system. For the longer-term assessment, it is important to bear in mind that the Fed still has to consider the balance between supporting growth and containing inflation. In the shorter-term, the Fed has clearly tipped its hand, but the

risk of future inflation has not gone away. Emerging markets overall are struggling with inflationary tendencies and we have, of course, very high commodity markets and energy markets. This, combined with a weak dollar, makes it risky for the Fed to be too aggressive.

- However, with the worries of a very negative development in equity markets and the repercussions this could have on the real economy, clearly the Fed decided to favor growth and stability in financial markets, at least for the short term.

Outlook for Equity Markets

- So what do we think about the trajectory for equity markets? Looking at the short term, it is probably right to look for opportunities right now. We have had many signs of capitulation trades in markets over the last several days. We have witnessed the selling of past winners and of stocks with strong fundamentals. The combination of capitulation selling and decisive central bank action ought to add up to a good buying opportunity, at least in the short term.
- On the strategic level, we are still underweight equities in balanced accounts, but here our sentiment is also turning more positive. Whatever we think about growth in '08, we can now start to become more optimistic about growth in '09. With the sharp drop in markets that we have experienced it must be right to start thinking about how much bad news is already discounted in valuations.

Regional Allocation

- When we look at the allocation among markets, we have had a positive view on the U.S. relative to other developed markets for some time now and that positioning remains. It is true that the U.S. is the center of the current problems, but it is also in the U.S. where we have the fastest and most determined policy response. Also, the U.S. market is benefiting from the previous weakness in the dollar.

- When we look at trade flows, we have had for some time now an acceleration in U.S. exports in combination with a stagnation in the volume of imports. This trend is likely to continue.
- Therefore, given the very high foreign earnings content in the S&P 500, international business ought to support the U.S. market, especially the large caps. In the rest of the developed markets, in Europe and in Japan, the argument is the other way around. Here it is clearly the exporting blue chips which may face headwinds, whereas the more domestic oriented medium and smaller companies should do better.
- Finally, we remain slightly overweight in emerging markets relative to developed markets. This is a reflection of strong economic growth in these markets. There has been a lot of discussion about decoupling or recoupling between the developed world and emerging markets. The way we look at the situation, this is not a question of black and white. Of course, when the world's largest economy — the U.S. — slows there will be an impact on the rest of the world, including emerging markets. The question is the degree of that impact.
- The good news here is that there are structural arguments why the growth cycles that many individual emerging markets are in may prove resilient relative to what happens in developed markets. We just have to look at all the infrastructure investments that are taking place in emerging markets and we should also consider the acceleration of consumer demand happening in many places.
- Thus, we remain overweight in emerging markets although we are well aware that they are normally more volatile than developed markets. ■

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