



U.S. Market Watch

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OVERVIEW

- It's official: The U.S. economy is formally in recession. At the end of November, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) announced that the latest expansion peaked in December of 2007, and the current recession started in January 2008. So we are already four quarters into a recession, although even the longest recession in the past 60 years never lasted more than six quarters.
- Of course, this is a backward-looking view; what investors really want to know is how deep the recession will be and how long it will last.
- U.S. equity markets posted a tentative rebound in early December after falling to the lowest level in more than 11 years at the end of November. The real story last month, however, was the dramatic rally in the government bond market. Yields on 10-year Treasury Bonds posted the biggest decline in 26 years, pushing yields to their lowest level since 1955.
- Extreme risk aversion is also still very much evident at the short end of the Treasury yield curve, with 2-year yields dropping below 2% for the first time ever and 3-month Treasury Bills essentially trading with zero yields.
- High Yield spreads continued to widen in the U.S. fixed income credit markets, but last month the Commercial Mortgage-Backed Securities (CMBS) sector stole the show, posting a stunning 18% decline in the month of November alone. Clearly, fundamentals in the commercial mortgage market are deteriorating; another example of the unintended consequences of government intervention. Supporting the agency mortgage market through the Treasury buy-back program caused investors to abandon the commercial and non-agency sectors.
- Finally, currency markets had a much quieter month, and the dollar continued to gain against most major currencies. However, the Euro has managed to stabilize, and the Japanese Yen continued to appreciate on the back of capital repatriation from overseas investments.

ECONOMY

- The current economic news flow in the U.S. is fairly dismal. The two monthly Institute For Supply Management (ISM) surveys are probably the timeliest measures of the underlying growth momentum. In November, the manufacturing index fell to the lowest level in 26 years, and the service sector index trades at the lowest level since the this association began publishing the non-manufacturing survey in 1997.
- Factory Orders are plummeting, Consumer Confidence surveys are at — or close to — record lows, and Retail Sales have declined for four straight months. Additionally, the vicious housing cycle is still in full swing. Rising mortgage delinquencies are pushing more foreclosed properties on the market, which creates more downward pressure on house prices. Lower prices are fueling existing home sales, but crowd out sales of new homes and trigger more delinquencies.
- The greatest shock so far was the November jobs report, which showed the biggest employment decline in 34 years. However, it's not all bad news. The report also included a pick-up in wage growth. Combined with the collapse in oil and gasoline prices, this is raising consumers' purchasing power.

- Looking ahead, we have downgraded our near-term forecast for U.S. GDP growth again and are now looking for a more significant contraction in the current quarter. The recessionary environment is likely to persist in the first two quarters of 2009, but we expect a tentative rebound in economic activity in the second half of next year.

POLICY

- Following last month's Presidential elections, for awhile it looked as if outgoing Treasury Secretary Paulson wasn't going to ask Congress for the second installment of the \$700 billion TARP fund and leave further fiscal measures to the next administration. Predictably, equity markets crumbled and fell to a new cycle low, forcing Paulson to reverse his decision and restart negotiations to utilize the rest of the money.
- The immediate focus now has shifted from banks to the auto sector. After a couple of days of embarrassing Congressional testimony, the Big 3 received only a short-term band-aid that won't last long and passes on responsibility to the next Congress. Meanwhile, President-elect Obama has raised great expectations of a massive fiscal stimulus package. Clearly, it will be much easier for the next administration to implement a significant stimulus plan which we believe will help stabilize the economy in the second quarter.
- We are looking for another quarter-point rate cut at the next FOMC meeting to support investor sentiment, but the main focus of the Federal Reserve remains on more unorthodox policy initiatives. The liquidity position of U.S. banks and brokers doesn't seem critical anymore. This is reflected in the lack of interest in recent TAF auctions, through which the Fed auctions off reserve funds traditionally available under the Discount Window.
- However, most lending markets remain frozen, and the record low short-term Treasury Bill yields suggest that risk aversion among investors remains extremely high. The next possible step is outright "Quantitative Easing," where the Federal Reserve purchases Treasury bonds — with the intention of pushing longer term yields towards zero — financed by an increase in money supply.

INVESTMENT OUTLOOK

- We know it will be difficult to time the next major market move in the current, extremely volatile environment. However, we decided to stick our neck out and move our previously neutral bond/equity posture to a marginal equity overweight.
- Yes, we are still facing serious risks, and the economy is still deteriorating rapidly. However, we believe the magnitude of policy response has caught up with the severity of the recession. With quantitative easing by the Federal Reserve and an FDR-style infrastructure program, coupled with tax cuts and other measures on the horizon, we believe a more serious rally in the U.S. stock market is possible.
- Within our fixed income strategies, we further reduced our exposure to Emerging Markets and moved up our allocation to Mortgage-Backed Securities. Given the existing lack of liquidity in the credit markets, we believe it is too early to dial up the risk exposure in our fixed income portfolios this month.

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