

## OVERVIEW

- Inflation is clearly the most dominant global macro theme right now. Household income growth and corporate profitability are eroding as a result of rising inflation, which is the main driver of weaker economic growth in the U.S. and Europe.
- Oil prices have doubled in the past 12 months, intensifying the pressure on consumer spending and business investment. Higher-than-expected inflation has also reduced the policy options available to central banks, forcing those in the Eurozone, UK and Canada to adopt a more hawkish policy stance.
- Meanwhile, fiscal policy is becoming a more important growth contributor. In the U.S. the US \$150 billion stimulus package is just starting to trickle down into the economy, and Congress is moving closer to agreeing on a US \$300 billion mortgage support program.
- In the UK and New Zealand, authorities have cut taxes, and more expansionary fiscal policy is likely in many of the Eurozone economies.

## NORTH AMERICA

- The current inflation shock has greatly increased the recession risk in recent weeks. Real household income has started to decline as a result of rising inflation pressures.
- The tax rebates are providing a much needed boost to both income and spending, but the effect will likely wear off after the summer, and consumption will again be driven mainly by real income growth. Further increases in oil and gasoline prices could push consumer spending back into the red in the fall.
- Faster inflation is undercutting the help that monetary policy has provided so far in stabilizing economic growth. The Federal Reserve was able to deal with the domestic demand shock from falling housing activity and credit supply shock from the financial markets crisis. However, the global inflation shock is forcing a change of strategy in the FOMC, which is now swapping its growth support for a fight against credibility-destroying inflation.
- Lastly, inflation is already much more prevalent in the business sector, where producer prices for intermediate goods are running at a 13% annual growth rate.

- Companies are forced to intensify cost-cutting efforts, which are the main driver of the current decline in payrolls and the reduction in industrial output. If oil prices continue to increase in the coming weeks, an outright U.S. recession can no longer be ruled out. For our forecast of a moderate growth rebound in the second half to be realized, oil prices must peak soon and retrace back towards US \$125 per barrel by the fall.

## EUROPE

- Rising price pressures have already pushed a number of authorities in Europe to tighten monetary policy to keep inflationary expectations in check.
- The European Central Bank (ECB) and central banks in Sweden and Norway raised policy rates in the last few weeks, despite growing evidence of slowing economic growth. The ECB is clearly worried that rising inflation expectations are feeding into demand for higher wages in a wage-bargaining system with much greater union influence.
- However, evidence is accumulating that the Eurozone economy is entering a more pronounced downturn. So far, resilient growth in Germany, driven by business investment and exports, has prevented a broader slowdown. However, rising inflation pressures in the business sector are starting to weigh on investment and job growth.
- Outside of Germany, signs of a slowdown are much more evident, especially in Spain, which is suffering from a housing recession worse than the one in the U.S., and in Italy, which is suffering from stagnant consumption and falling business investment.
- More clouds are also on the horizon in the UK. Evidence of an unfolding downturn in the economy is preventing the Bank of England from raising rates, despite a significant inflation overshoot. The decline in house prices is accelerating, sentiment in the construction sector has fallen to a 12-year low, and both manufacturing and services sector activity are declining, suggesting that the UK economy is close to sliding into a recession.
- Consumer spending has remained surprisingly resilient, but the negative wealth effect from falling house and stock prices, and the negative real income effect from accelerating inflation, are likely to weigh on consumption in the coming quarters. Similar to the U.S., inflation is undercutting the monetary policy support that so far has helped avert greater damage to the UK economy.

## ASIA

- Inflation is also the dominant driver of macro trends in Asia. In Japan, after a decade plagued by deflation, rising headline inflation is now weighing on real household income growth, depressing real consumption in the same way as it has in other developed economies.
- Businesses are suffering from similar cost-push inflation eroding profit margins in the U.S. and Europe. However, exports are picking up again, as a result of the recent weakness in the Japanese Yen, and overall corporate profitability remains high.
- Other Asian economies are even more affected by rising inflation. Central banks in India, Indonesia and Taiwan have already increased policy rates, which adds to the increasing growth headwinds in the region.
- However, we still believe monetary tightening will go hand-in-hand with easier fiscal policy to maintain current economic growth, which should prevent a more pronounced economic slowdown in Asia.

## INVESTMENT OUTLOOK

- We maintain a cautious approach in our global investment strategies. Earlier in the year such a stance seemed warranted in the face of great uncertainty about the impact of the liquidity crisis in the global banking system. Today, it's the uncertainty surrounding the global monetary policy outlook that is weighing on our risk appetite.
- Within developed equities, we maintain our preference for the U.S. market with its greater exposure to large and stable growth companies, in contrast to the more cyclical composition of other major developed markets.
- In addition, we believe the U.S. continues to lead other economies in the current business cycle. While Europe and Japan are showing signs of a more notable growth deceleration, the U.S. economy is benefiting from strong fiscal and monetary policy support that is lacking elsewhere.

- Within our global fixed income strategies, we see greater potential in Canadian and UK government bond markets, where growth is slowing more notably compared to the U.S. market. Norway and Australia remain attractive given the very attractive spread over U.S. Treasuries. With the ECB rate hike out of the way, attention in the currency markets will likely turn to the Federal Reserve and the likelihood of the start of a series of rate increases towards the end of the year. We are still looking for a stronger U.S. dollar, but changes in central bank policy expectations have pushed a more significant rebound further out into the early part of 2009.



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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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