



# U.S. Market Watch

January 2009

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## OVERVIEW

- There is a new year and a new U.S. President, yet the gloomy mood in the global financial markets remains unchanged. Three weeks into January, the S&P 500 is already down 10%. In the Treasury market, 10-year bond yields fell to 2.05% at the end of December; the lowest level in 58 years.
- Since then, yields have bounced back almost 50 basis points, and the Treasury yield curve has once again started a new steepening trend. Meanwhile, the recovery in U.S. fixed income credit markets continues. The interest-rate spread between High Yield and Treasury bonds narrowed some 100 basis points, and most credit asset classes started the year with positive total returns.
- Credit markets reflect the gradual improvement in market liquidity, which is primarily the result of the Federal Reserve's aggressive policy measures. Equity markets, on the other hand, are reacting to the ongoing deterioration in the U.S. economy and renewed evidence that the banking crisis is far from over.
- In fact, U.S. authorities had to draw up another \$138 billion support package for Bank of America and Citigroup, which announced sweeping asset sales to stave of bankruptcy. Most commentators estimate that despite \$1 trillion in losses thus far, the global banking system is only halfway through the crisis.

## POLICY

- On January 20, the world watched the inauguration of a new U.S. President who takes office "amidst gathering clouds and raging storms." The analysis of the economic crisis in President Obama's inaugural speech was blunt; his offered solutions straightforward. "The state of the economy calls for action, bold and swift, and we will act," he noted, mentioning numerous spending projects designed to restore growth and create jobs. Most importantly, he understands that restoring confidence represents an integral part of any rescue package.
- We expect Congress will act fairly swiftly and enact a massive fiscal stimulus package along the lines that have already been broadly publicized. The plan will likely include substantial tax cuts of about \$300 billion and targeted spending of about \$600 billion. The total package is likely to grow even bigger as the bill progresses through

Congress, and the President is unlikely to stand in the way of further add-ons.

- The biggest risk is a delay in the implementation, which might prevent the stimulus from starting to impact growth and employment before the summer. We assume the tax cuts will support a modest rebound in consumer spending by the middle of the year, and the additional fiscal spending will add about 3.5% to second-half GDP growth. This positive-growth impulse should balance the continued drag this year from falling business investment and weak residential-construction activity.
- Meanwhile, the Federal Reserve has engineered the greatest expansion in narrow money-supply growth in its history. However, this is also a reflection that banks are not using the billions of funds that the Fed is offering to restart lending. Rather, they appear to be hoarding the cash based on predictions of further massive write-offs and losses.
- Although monetary policy has helped to improve credit markets to this point, it appears to have lost the ability to stimulate economic activity further; all the Fed is achieving right now is preventing an even faster de-leveraging in the banking sector, which would withdraw even more capital from the private sector and lead to an even deeper recession.

## ECONOMY

- Financial markets remain worried about the current slew of very bearish economic reports — and rightly so. The annual rate of decline in Industrial Production last month was the worst since 1975, December Retail Sales were down almost 10% from a year ago, and the latest Employment report showed the economy has now lost almost two million jobs since the "Great Crash" in September. All this adds up to a dreadful fourth quarter. We are looking for a substantial decline in real GDP growth of up to 6%, which would easily make it the worst three-month period in almost 27 years.
- Looking forward, however, the first reports covering January are mildly encouraging. This suggests the dramatic downward momentum at the end of last year might not carry over into the current quarter, and the economy could indeed stabilize in Q2 as we are forecasting.

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Consumer confidence has improved modestly on the back of a rebound in real disposable income growth — itself the result of falling inflation rates. Regional business surveys are also perking upwards from very depressed levels; however the surveys also show companies are still cutting at a fairly rapid pace.

## INVESTMENT OUTLOOK

- The Dow Jones fell more than 300 points on the day that President Obama was inaugurated, only to reverse most of those losses that day after. Evidently, this is still a difficult environment for strategic asset allocation decisions. We tilted our equity strategy modestly in the direction of a rebound in equity prices last year, which we believe will be the initial reaction to the administration's fiscal stimulus plan. Consequently, we also remain overweight U.S. equity markets.
- Within our fixed income strategies, we are already

positioned to take advantage of the extremely attractive carry yields in the High Yield markets and potentially further spread compression as market liquidity improves. The risk of a broadening sovereign credit crisis is still weighing on our Emerging Markets posture with relative underweights in both bonds and equities.

- Reflecting back to President Obama's inaugural speech, we shouldn't forget that financial markets are anticipatory and that the willingness (and the ability) to take risks is the essence of capitalism. We expect risk takers to come back into the market once the economy bottoms even before we see convincing evidence of a rebound.

KEY U.S. ECONOMIC FORECASTS				
Annual Average Changes (%)				
January 22, 2009	2007	2008	2009(e)	2010(e)
<b>Real GDP</b>	2.0%	1.1%	-1.0%	1.9%
Private Consumption	2.8%	1.1%	-1.8%	2.0%
Residential Investment	-17.9%	-20.6%	-12.6%	1.3%
Business Investment	4.9%	3.0%	-2.2%	1.7%
Net Exports ( <i>contr. to GDP</i> )	0.6%	1.3%	0.2%	-0.2%
Unemployment Rate	4.6%	5.8%	7.9%	7.4%
Industrial Production	1.7%	-1.8%	-5.3%	2.9%
Housing Starts	1,341	902	555	550
Federal Funds Rate ( <i>End of Year</i> )	4.25%	0.25%	1.00%	3.00%
10y Treasury Bond Yields ( <i>End of Year</i> )	4.03%	2.22%	3.85%	4.35%
U.S. Dollar / Euro ( <i>End of Year</i> )	\$1.46	\$1.40	\$1.10	\$1.20
Yen / U.S. Dollar ( <i>End of Year</i> )	¥111.33	¥90.60	¥110.00	¥125.00

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