

Global Market Watch

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OVERVIEW

- Having grown up in Germany, I have been very focused on the World Cup, and not just because my team was doing well until the semi-finals (congratulations to Spain!). Performance in major sporting events often runs parallel to economic realities; just look at the Olympics, where the richest nations fight it out for medals and rankings.
- I would highlight the struggles of several European teams and the initial success of many of the emerging market (EM) nations in the tournament. However, as we reached the final days of the competition, “Old Europe” started showing strongly once again.
- Could this be a metaphor for the current fiscal crisis? At the moment, Europe seems to be facing the biggest challenge, but it is finally addressing its problems. In a few years, budgets will be balanced, and debt ratios will be improving, so I wouldn’t write off the continent just yet.
- While, the US did well in the World Cup, economically, it is without a credible fiscal exit strategy and is actually still trying to boost fiscal spending, which left the US largely isolated strategically at the last G20 meeting in Toronto.
- Having said all of that, deficits don’t seem to be the main driver of financial markets right now. Rather, investors are focusing on the deteriorating global growth backdrop expected in the second half of the year.
- Global equities lost more than 12% in the quarter that ended 30 June, 2010. Not surprisingly, developed markets, where we find most of the problems that are clouding the global growth backdrop, significantly underperformed EM. Among the former, the US fared much better than Europe, while Asia outperformed the other EM regions. Bonds were the darlings of the second quarter.
- The global government bonds generated 3.3% of performance and is up about that much for the year so far, beating global equities by a sizable 13 percentage points. The global fixed income credit markets lost a little ground in the second quarter, but is still up for the year.
- Alternative asset classes didn’t fare much better than stocks. The S&P GSCI Commodity index lost more than 10% last quarter, and is down even more than global equities, while both global real estate (the EPRA/NAREIT

index) and hedge funds (the HFRX Global Hedge Fund Index) showed smaller losses both last quarter and year-to-date compared to equities.

NORTH AMERICA

- It looks like we have reached a peak in the first stage of US recovery and are now heading for the second-half slowdown that we have been forecasting for awhile.
- Almost all the major US Gross Domestic Product components are under pressure. The inventory cycle is over, consumption is slowing as households adjust the pace of spending to slower income growth, and housing just fell off a cliff again with the expiration of the second installment of the “First-Time-Home-Buyer Credit.” In addition, businesses remain extremely cautious on investments or payroll expansion, public spending is contracting as state and local governments balance their budgets, and weaker global growth is likely to weigh on US exports in the coming months.
- All of these issues are combining for a period of slower growth in the next few quarters before the US recovery will gather steam again by Spring of next year.
- Canada enjoyed a much stronger rebound around the turn of the year, which was not just driven by fiscal stimulus and inventory rebuilding like the rebound in the US.
- Canada’s strong rebound in domestic demand driven by a sharp increase in employment and household income did the trick. It has already recaptured most of the output lost during the recession, while the US recovery has closed just about two thirds of that gap.
- Looking ahead, we expect the growth momentum in Canada to ease somewhat as a result of weaker growth in the US and Europe, Canada’s biggest export markets. That should also keep a lid on domestic inflation and slow, if not halt, the fledgling process of policy-rate normalization. All in all, Canada retains one of the best macro backdrops with no – or at least very little – debt problems, strong commodity exposure to fast-growing Asia and healthy domestic labor-market growth.

EUROPE

- Purchasing Managers Indices (PMI) show a slowing recovery momentum across the Continent, yet there are differences among the countries.
- Germany is clearly benefiting from a weaker euro and, most surprisingly, is enjoying a steady drop in unemployment. On the other side of the spectrum, Greece is clearly back in recession as a result of the extreme fiscal retrenchment necessary to remain compliant with the agreed-upon deficit-reduction targets.
- Overall, the recovery in the eurozone has been quite anemic. Three quarters of positive growth since July of last year has recaptured a mere 12% of the output lost during the recession. Fiscal tightening and weaker global demand are sure to slow the momentum even further in the second half. However, domestic demand should prove sufficiently resilient to allow the eurozone to avoid a double-dip recession.
- We are forecasting just 0.9% growth for the calendar year, with Germany and France outperforming Italy and Spain.
- The new conservative/liberal coalition government in the UK wasted no time in announcing aggressive measures to reverse the country's surging fiscal deficits, which looked almost as bad as Greece's. Most surprising was the non-ideological manner in which Chancellor of the Exchequer George Osborn, a member of the Conservative Party, addressed the problem using a combination of tax hikes and spending cuts to shape his budget.
- Looking ahead, a sustainable recovery in the UK will depend on a rebound in the financial services industry. That, however, is still a few quarters away. Both the Bank of England and the European Central Bank (ECB) are far away from even considering raising rates, so funding rates will remain extremely low. The conclusion of the EU-wide bank stress tests at the end of July should reduce, if not eliminate, concerns about bank balance sheets.
- However, what is still lacking is private-sector loan demand, which will require a more significant improvement in both consumer and business confidence

to stage a sustained rebound. Our forecast for UK growth this year of 1.2% is only marginally better than the eurozone average.

ASIA

- If the slowdown has global dimensions, Japan won't be spared. Fiscal tightening in Europe is just one reason to expect weaker global growth, and Chinese policy-tightening to reign in an overheating economy is the other. Japan's recovery, so far, has been driven predominantly by export demand, and the new government is now looking at tax hikes to address the country's fiscal crisis.
- Also, the Japanese yen is the best-performing of the major currencies against the US dollar; not what a heavily export-dependent economy needs. What doesn't fit the bill is the ongoing improvement in business confidence, which suggests investment spending and probably employment are likely to improve further in the second half. Full-year growth should still be close to 3%, but that is the result of the strong expansion at the turn of last year; for the second half we are looking for just 1% real GDP growth.
- Tracking China's growth slowdown has become critical to forecasting the global macro backdrop for the next few quarters. We know that the massive stimulus program, which according to some economists totaled 20% of GDP, did such a good job stimulating growth that the Chinese economy was close to overheating at the turn of the year.
- Consequently, the government tightened bank-lending targets and monetary policy to lower the rate of growth to a more sustainable clip. What has sent shivers down investors' spines is the recent slowdown in the monthly PMI, which tracks activity in the manufacturing sector, to a reading barely above the expansion/contraction threshold, suggesting the sector may be close to slipping back into recession. The PMI index is based on five key indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.
- We continue to veer away from a bearish China view for mainly two reasons. First, while external demand

remains volatile, domestic consumption continues to expand at about twice the rate of overall GDP growth. Anecdotal evidence of rising wages and continued job creation suggests the expansion in household spending can maintain the current pace. Second, the government has the ability – and clearly the willingness – to reintroduce stimulus measures should the economy slow below the desired growth path.

- A third consideration is the fact that growth itself is not the yardstick with which to measure China, but rather job creation and retail sales. If the economy switches from less labor intensive, export-oriented growth to more labor-intensive domestic services, then a certain rate of job creation can be achieved with slower nominal GDP growth. That's likely the direction China is heading in the next few years.

INVESTMENT STRATEGY

- Equity markets were in free fall last month, giving back about a third of the gains accumulated since March 2009. Meanwhile, bond yields are back at levels we last saw before stock markets bottomed last March, when the US economy was still in recession and a sustained recovery seemed wishful thinking. Looking at these valuations, we would argue that, if you don't believe in a US double-dip recession, then stocks are cheap and government bonds are expensive.
- The fundamental story laid out above doesn't point to a sustained stock market surge, but the sell-off has gone too far, and we expect stocks will end the year above current levels. Similarly, government bond yields reflect a renewed surge in risk aversion, which has overly depressed yields. A normalization in risk attitude in the coming months should push yields back into the range that persisted in the first three months of the year.

- We still like credit markets in the current uncertain environment, but the sell-off in global equities seems to have gone too far. After reducing risk all the way to neutral, we are tweaking our multi-asset class strategies back towards a small equity overweight.
- Our Capital Market Line (CML) model, which relates internal forecasts of asset class risk and returns, remains positively sloped, suggesting it still pays to take risk. Right now, economists are only gradually lowering their growth forecasts, which serves to justify the bearish market sentiment. However, by the end of the summer, investors may turn more positive again once the realization sets in that we are not falling into another recession. At that point, fixed income credit and equity markets will start to trend higher again.

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