

U.S. Market Watch

June 5, 2009

Markus Schomer, CFA - Global Economic Strategist

OVERVIEW

- There has been a lot of talk of “Green Shoots” of recovery in the past few weeks. Green Shoots is a euphemism economists use to describe a situation where expectations of a rebound in the economy are improving, but actual evidence is still lacking. That is not to say that a rebound is highly unlikely, it just means that more optimistic forecasters, like myself, have little concrete proof to support their predictions at this time.
- Nevertheless, financial markets have firmly bought into the concept of Green Shoots, posting strong rallies in both equity and credit markets during the past few months. It’s not all smooth sailing, however, as indicated by the sell-off in the U.S. Treasury markets and the surprisingly sharp decline in the U.S. dollar.
- Stock markets followed their strong March and April performance with further gains in May. These gains pushed most U.S. indices back into positive territory for the year. The S&P 500 rose another 5.3% in May and is up 36% from its March low. The larger Dow Jones index is lagging behind a bit, up “only” 30% from its respective low this year.
- Credit markets are very much part of the recent rally in risk assets. So far this year, the Barclays Capital U.S. High Yield Credit Index has increased by more than 26%, with yield spreads versus Treasuries down more than 900 basis points. Investment Grade credit markets could not match that torrid pace, but also posted strongly positive returns in the past few months.
- Concerns that an explosion in bond issuance will be needed to finance the surging government deficit have pushed Treasury yields significantly higher in the past few months. The yield on the bellweather 10-year Treasury bond has jumped 80 basis points since March and the yield curve — the difference between 10-year and 2-year bond yields — has steepened to a new record high.
- A corollary to the sell-off in U.S. Treasuries is the weakness in the U.S. dollar, which gathered pace in May. The Trade Weighted U.S. Dollar Index fell almost 7% in May, with the Korean won, Australian dollar and Swedish krona among the major beneficiaries, all appreciating in excess of 20% vis-à-vis the dollar.
- Traditional income sources, such as wages and investment income, are down about \$145 billion so far this year. Yet, sharply higher government transfers and lower tax payments increased household purchasing power by about \$420 billion.
- So far, very little of that has gone into consumption, but rather fueled a sharp rebound in the Savings Rate from virtually zero a year ago to 5.7% in April; the highest rate in 14 years.
- Rebuilding savings seems rational, as long as confidence remains depressed. However, in recent months, consumer confidence has started to improve, suggesting spending is likely to follow in the near future.
- Housing is another sector showing promising improvements. Home sales have staged a decent rebound in the past three months, driven by a sharp improvement in housing affordability. Mortgage rates are still close to historic lows, and house price-to-income ratios are back at their pre-bubble average, suggesting the massive overvaluation in the U.S. housing market has been erased.
- The spark that could ignite a lasting recovery in housing sales could very well be the government’s \$8,000 first time home buyer tax credit, which has been cited as critical in boosting April sales to the fastest pace in more than seven years.
- Nevertheless, the spread between conventional and jumbo mortgage rates remains extremely wide, indicating credit is only flowing again in those parts of the mortgage markets directly controlled by the government — or at least significantly impacted by government actions. And the wave of mortgage foreclosures hasn’t even peaked yet, suggesting more fire-sale-priced properties will flood the market and prevent house prices from starting a lasting rebound.
- Another major impediment for a durable recovery is ongoing dramatic rate of payroll reduction. Thus far this year, more than 2.6 million Americans have lost their jobs, and the unemployment rate has shot up to 8.9%. This is the highest level in almost 26 years, and most economists agree that we haven’t reached the peak yet.
- The pace of new claims for unemployment benefits has not slowed down materially, and the most recent business surveys for both the manufacturing and service sectors show little change in employment conditions across the country.
- The one positive trend is the significant slowdown in layoff announcements. Since peaking in January, the

ECONOMY

- The most obvious Green Shoot is the strong rebound in real disposable household income, which grew at a rate of 3.7% from a year ago in April, the fastest growth rate in 11 months. This occurred in spite of the ongoing dramatic pace of job losses.

U.S. Market Watch

June 5, 2009

level of announced layoffs has traced back more than two thirds of the way towards its long-term average. However, the current phase of restructuring the U.S. auto industry holds significant risks of further large-scale job losses that could threaten the most recent improvement in consumer confidence.

POLICY

- The fiscal and monetary-policy response to the financial crisis is now receiving less emphasis, due to the many actions of the U.S. Treasury and Federal Reserve. With expectations of an economic rebound growing, the pressure to broaden current stimulus measures has subsided, and the focus instead has turned to increasing the efficacy of existing programs.
- Fed actions to tackle the liquidity crisis in the banking system have clearly been successful. The spread between LIBOR, the rate at which banks lend to each other, and Treasury Bills, the safest form of investment, is a good indicator of the degree of liquidity risk aversion. The initial spread widening at the start of the crisis in 2007 did not exceed the previous record from 1987.
- However, following the “Great September Crash,” liquidity concerns exploded, and the spread blew out a full 50% beyond the '87 high. In the last few weeks, the spread has fallen back to its pre-crisis level, signaling the sector's return to normality.
- Meanwhile, the government's attempts to restart the lending process and deal with banks' "toxic assets" have been rather unsuccessful and painfully slow. Many economists, including myself, had high hopes for the \$1 trillion TALF facility, designed to take up the slack in demand in the asset-backed securitization market. But, to date, a meager \$27 billion has been disbursed in the past three months.
- The government's “Stress Test” and the desire to pay back TARP funds had the positive effect of incentivizing banks to raise fresh capital in the private market. However, attracting capital to purchase and manage distressed assets and clean up bank balance sheets is proving much more difficult. As a result, the road to a more meaningful recovery in bank lending will depend on a rebound in profitability and successful capital raising. Combined with the relaxation in

mark-to-market rules, this could allow banks to gradually climb out of the hole.

INVESTMENT OUTLOOK

- Psychology always plays an important role in making investment decisions. Yet it seems like we had greater conviction adding risk to our portfolios at the beginning of the year, when the economic backdrop was still extremely negative, compared to today, where the question is not *whether* we will see a recovery this year, but *when*.
- We have maintained a marginal overweight position in global equities versus global government bonds in the past few months, but believe equity markets have run ahead a bit too far of fundamentals and might face a period of consolidation. A small correction may even occur as the economy and profit expectations catch up with the sharp rebound in equity prices.
- The U.S. and Asia ex-Japan, which we still believe will lead the rest of the world in the coming recovery, remain the key overweights in our international equity portfolios, with Europe, Japan and in Eastern Europe on the other side of that trade.
- Within our fixed income strategies, we remain overweight in U.S. High Yield credit, where we still see further potential for spread tightening. But we removed our underweight in international fixed income as a result of the current U.S. dollar weakness. The sell-off in U.S. Treasuries in the past few weeks has run much further than we had expected.
- Inflation remains extremely low, and the Federal Reserve has committed an admittedly small sum of \$300 billion to purchase Treasury bonds. Any recovery will be sluggish at best, and the sharp increase in government bond issuance is met with a significant increase in savings, domestically and around the world. This should allow governments to finance increased deficits in the near term, without much of a problem.
- On balance, we remain constructive on the outlook for financial markets in the coming months and continue the process of gradually adding risk to both our equity and fixed income strategies.

AIG Investments is a group of international companies that provide investment advice and market asset management products and services to clients around the world. AIG Investments is a registered mark of American International Group, Inc. (AIG). Services and products are provided by one or more affiliates of AIG.

Certain information may be based on information received from sources AIG Investments considers reliable; AIG Investments does not represent that such information is accurate or complete. Certain statements provided herein are based solely on the opinions of AIG Investments and are being provided for general information purposes only. Any opinions provided on economic trends should not be relied upon for investment decisions and are solely the opinion of AIG Investments. Certain statements contained herein may constitute projections, forecasts and other forward-looking statements that do not reflect actual results and are based primarily upon applying retroactively a hypothetical set of assumptions to certain historical financial information. Any opinions, projections, forecasts and forward-looking statements presented herein are valid only as of the date of this document and are subject to change. AIG Investments is not soliciting or recommending any action based on any information in this document. AIG Investments Europe Limited is authorised and regulated by the Financial Services Authority (“FSA”). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by AIG Investments Europe Limited.

Certain statements provided herein are based solely on the opinions of AIG Investments and are being provided for general information purposes only. Any opinions provided on economic trends should not be relied upon for investment decisions and are solely the opinion of AIG Investments.