

# Investment Update



February 2012

## Big Games

An individual's enthusiasm or engagement in a championship game for any sport depends on many factors. Is he or she a rabid or casual fan, or perhaps neither? Is there a home team in the game or did a competitor beat the home team out for a spot? Intense, lifelong fans can recite heroic or calamitous plays sometimes from many years in the past.

While fans can be keen observers of a game, ultimately the players themselves feel the greatest impact. A last second end zone catch pinned against the helmet or a shanked field goal that loses the game can leave an indelible impression. Some investors speak of "playing the market," but it never feels like a game to me. Likewise, investors' proximity to markets as we have experienced over the last few years has felt at times similar to being hit by a defensive lineman. The accumulation of these body blows has left even the most seasoned investors leery.

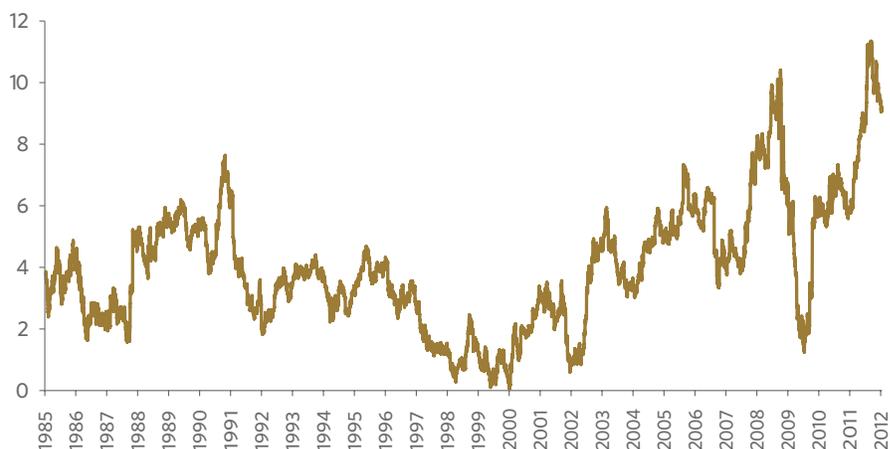
We commented last month that, despite entering the year with many of the same risks, headwinds, concerns and economic expectations, we did not expect 2012 to be a carbon copy of 2011. This primarily was because—after being dragged about the field so much last year—strategists and investors alike had almost any remaining positive expectation knocked right out of them.

The chart below shows equity risk premium levels over time. When the risk premium is high, it often indicates that concern and consternation have pushed stock prices lower, or that prices have not kept up with earnings gains, such as was the case last year.

An elevated equity risk premium indicates that at least some of the collective caution *already* is reflected in stock prices. So, even though this year began with many valid concerns we felt that expectations were low enough that, even if some of the feared events failed to materialize, equities could move higher.

## Equity Risk Premium

(S&P 500 Earnings Yield minus Real U.S. 10-Year Yield)



Source: BNY Mellon Investment Strategy & Solutions Group.

## The Other Side of the Coin

Many of the risks investors grappled with last year will continue in 2012 and beyond. Numerous headwinds—including consumer and financial sector deleveraging, dysfunctional policy making, government austerity plans, potentially more restrictive fiscal policy (through expiration of tax cuts), geopolitical risks stemming from instability and regime change, and currency concerns—will continue to contribute to an environment of uncertainty. Faced with this lengthy list, investors likely will continue to seek safety, yield and stability and be cautious about how they are willing to pay for future years'

company earnings. However, in light of what we view as some clear environmental improvements, it seems that many investors remain too pessimistic. Perhaps they suffer from crisis fatigue, brought on by the 2008 U.S. financial crisis and subsequent related shocks.

Yet reasons for optimism, or at least less pessimism, do exist. Several of the significant “tail risks” that so dominated 2011 appear to have diminished. Although increased liquidity provided to European banks does not solve the European debt crisis, it has greatly reduced the likelihood of a bank run or near-term disorderly breakup of the euro. It also gives time for policy makers to perhaps take more proactive steps to address the crisis. Additionally, it has brought yields down in several key countries to more sustainable levels.

Meanwhile, the U.S. economy entered 2012 stronger than many investors had feared in the third quarter of last year, when a return to recession felt frighteningly close. Also, while too early to say definitively, China so far has avoided the hard economic landing that could have occurred due to its slowing exports to Europe and tight monetary policy. While global growth is likely to be negatively affected by a probable Eurozone recession, we think the U.S. and China can withstand this impact and avoid recession. Global inflation seems to have hit an inflection point and appears to be diminishing. This is allowing an increasing number of central banks, including China and the ECB, to pursue more accommodative policies that should further improve the liquidity environment and provide stimulus.

### “What Could Go Right?”

Despite countless meetings with clients and their advisors across the country, I don’t think I have been asked the question above for well over a year! With all of the challenges, negativity and inept leadership exhibited in the recent past, this is understandable. Still, it is at least worth the exercise of considering developments that might contribute to improved market conditions.

Investors’ concerns have pushed the price of some “safe” assets to levels from which it may be hard for investors to receive adequate compensation over time. We think the mantra should shift from

“safety at any cost” and “yield at any cost” to “safety and yield at the right price.”

The three main legs for a bull market are Liquidity, Valuation and Economic Growth. Ample and increasing global liquidity, moderate-to-attractive valuations for many equities, high-but-diminishing correlations among equities and across asset classes, and potentially better than expected economic growth could in combination allow equity market gains. We saw this exhibited to a surprising extent in January.

Many investors continue to hold high levels of cash, cling to Treasury bonds for utmost safety (despite very low yields) and so far have been unwilling to reallocate back toward equities. While 2012 still will have many challenges, we anticipate that it may be less fraught with peril than 2011. If more investors begin to feel that some of the fog is clearing, markets could move higher. We are a long way from good, but for now “less bad” holds healing power.



Christopher Sheldon

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