

Investment Update



March 2013

Buckle Up

While boarding a recent flight from Miami to Boston, the pilot promised a smooth flight. However, 30,000 feet over North Carolina it was obvious we were in for a bumpy ride. As a seasoned traveler, I'm accustomed to unexpected, but not exceptional, turbulence and have mastered the ability to remain calm, but I could certainly sympathize with some of my neighbors' obvious concerns.

In many ways, stock market movement has a similar effect on market participants. The market is inherently volatile and skews towards turbulence, especially when faced with uncertainty or a negative surprise. There are times when this volatility should be taken seriously and protection should be pursued. At other times, however, volatility is simply part of the ride and, very often, investors can capitalize upon market weakness. The key is knowing the difference.

This March, we reach the four-year anniversary of the current bull market. Since that day and during its climb upward, the market has been obsessed with three major themes: the European sovereign and banking issues, the U.S. government's fiscal and monetary policies, and the pace of global growth. As I write this *Update*, two of these issues are once again in the forefront of investors' minds—the Italian elections and the recent sequester deadline.

Strong Headwinds

The Italian elections have brought the painfulness of austerity to center

stage, illustrating how challenging it is for countries to make the difficult choices necessary to curtail spending and promote growth.

While Pier Bersani and his Democratic Party won a majority of the 630-seat Lower House, they failed to win enough seats in the Senate. Forging a coalition will require that Bersani work with his rival candidates, Silvio Berlusconi and Beppe Grillo, a task that cannot begin until the new parliament convenes on March 15. The lack of a decisive direction, never mind the players involved (a disgraced ex-Prime Minister and a comedian), has done nothing to eliminate economic uncertainty in Italy and, by proximity, other struggling European nations.

In the United States, we have been wrestling with the sequester deadline, when the process of \$1.1 trillion in mandated spending cuts over 10 years took effect. The only question now seems to be how long these severe cuts will last before our elected officials work together to create a sustainable solution.

It seems that both parties had an incentive for the sequester to take effect. Democrats continue to insist their approach considers both tax increases and spending cuts. Republicans, instead, believe the sequester is the best way to enact meaningful entitlement reform. This polarity illustrates why both parties allowed the sequester to take effect. The best ending to this issue would be to replace the sequester with a measure of tax and entitlement reform but, in our opinion, this remains unlikely in the near term.

As the sequester continues, two dates may provide some potential for resolution. The first of these is March 27. In the absence of a budget, the federal government has been operating under a series of resolutions that establish limits on discretionary funding and provide operational funding for much of the government. If no additional appropriations are provided by March 27, nonessential functions will cease to operate. This date could therefore foreshadow even more spending cuts.

The next date of importance focuses on our debt ceiling. In December 2012, Congress suspended the statutory limit on federal debt through May 18, 2013. If no action is taken before this date, the Treasury will not be allowed to issue additional debt. This will mean, once again, that the Treasury will have to resort to extraordinary measures to keep the government running.

The markets have responded to all of this uncertainty by selling off, as expected. Bond yields fell, as money moved back to safer havens. The issue, as it was last year, is whether the current situation is a bump in the road or something that should cause much greater concern. After all, since the low of 2009, the stock

market is up about 125%. If an investor reacted to every turbulent event over that time that investor would have ended up missing much of the overall rally.

Some Wind Beneath Our Wings

Acting to counterbalance the fiscal concerns in Washington and Europe is Federal Reserve Chairman Bernanke. He continues to keep interest rates extremely low and likely will continue to do so into 2015. He also continues to pump \$85 billion each month into bond purchases in an effort to keep longer-term rates low on Treasuries and mortgage-backed securities, a process known as Quantitative Easing (QE). In a recent statement Bernanke said that the benefits of asset purchases, and of policy accommodation more generally, are clear. He is fully cognizant of the risks posed by balance sheet expansion, in terms of encouraging investors to pursue yield and of fears of how QE can be safely unwound. Right now, however, the Fed does not see those risks outweighing the benefits. Bernanke also remains confident that the Fed has the tools necessary to tighten policy further should the time come. This direction by the Fed chairman leads us to believe that monetary policy will remain accommodative until substantial improvement is seen in the labor market.

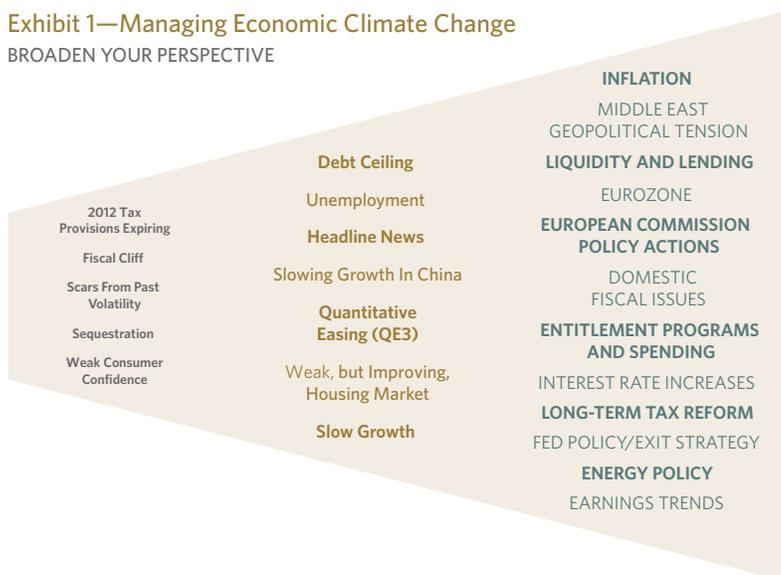
Investors should be aware of the Fed's statements. One of the oldest adages on Wall Street is "don't fight the Fed," said by the late Marty Zweig. While there are many examples to the contrary, the general theory is that stock markets move higher when rates are declining, and markets consolidate or correct when rates move higher or when Fed policy is restrictive. The Fed and other central banks, therefore, continue to play a role in accelerating growth in the global economy.

Passing the Time on a Flight: Chess or Tic-Tac-Toe?

In closing, I would like to draw your attention to Exhibit 1. The chart looks like a megaphone with the factors on the left being what has been on the minds of investors lately. To the right are the factors that have longer-term ramifications for market returns and for the general state of the economy.

Exhibit 1—Managing Economic Climate Change

BROADEN YOUR PERSPECTIVE



While investors continue to focus primarily on the left-hand side of this exhibit, instead we believe it is critical, when looking out 5-10 years, to pay even more attention to those factors on the far right.

It is important to remember that investing in both stock and bond markets should be more like playing chess than tic-tac-toe. Grandmasters in chess have been found to have an ability to see upwards of 10 moves ahead. They beat lesser players mainly because of this strategic outlook. We all lose interest in tic-tac-toe for the opposite reason; it's too easy.

Those who look on the left-hand side of Exhibit 1 and try to make longer-term investment decisions based upon current headlines are playing a game similar to tic-tac-toe. However, the market already has fully discounted the most likely outcome of these shorter-term scenarios, so to play based on these criteria rarely is successful. At BNY Mellon, we approach the economy and markets more like chess, evaluating today's issues, but always in the broader context of the longer-term variables that drive future returns, and position portfolios accordingly. Given ongoing turbulence and uncertainty, the tic-tac-toe player in all of us would say to stay in cash, or even take some off the table. At this point in the economic cycle, however, the chess player favors buckling up because it likely is going to be a bumpy—but worthwhile—ride.

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