

Investment Update



BNY MELLON
WEALTH MANAGEMENT

May 2011

Looking in the Wrong Place

The Easter egg hunt has been a long-standing annual tradition in my family. I fondly remember competing against my brothers for the ultimate prize — bragging rights for being the best egg hunter. Invariably, the loser was left looking downtrodden, dejected over his less-full basket. Some years, our parents would attempt to remedy the situation through a heavy hand of redistribution. Years later, the spirit of the hunt lives on through my daughters, who compete with the same vigor. Even the neighborhood children get in on the act.

Recently, during the less relished tradition of the annual spring yard cleaning, I found debris from a plastic egg. Presumably, it had been overlooked during last year's hunt. Given the large number of participants, I was surprised to find this lonely, overlooked egg. Despite their valiant efforts, the searchers ended up looking in the wrong place.

This story might remind some of the Federal Reserve's assertion that it sees no sign of inflation in the core CPI measure — which, of course, excludes food and energy. The average person may find this claim hard to square with, given their daily experience. We see examples of higher prices all around us. After all, while flat screen televisions at Walmart may still be cheap, we can no longer afford to drive there to buy them.

In our November 2010 *Update*, we highlighted the risk QE2 might impose if it became too successful in boosting asset prices: It would contribute to inflation fears. While the Fed has called attention to QE2's success in lifting stock prices, we believe this achievement must be counterbalanced by the rise in energy prices and decline in the dollar. To be fair to the Fed, excess liquidity and quantitative easing have not solely caused the change in energy prices. Prior to this year, much of the price increases stemmed from improving global economic growth, especially in emerging markets. More recently, energy prices have risen on supply disruptions and fears of more significant interruptions. While the real-world interrelationships between those variables contributing to higher energy prices are quite complex, we think that U.S. monetary policy has played some role in the rise.

A simplified illustration of the cycle of the Fed's possible impact might look something like this: Excess liquidity and negative real interest rates cause the dollar to fall and assets to move out of the U.S. This, in turn, increases the relative price of oil and other commodities. Higher energy prices cause hoarding and speculation, and contribute to political instability. At the same time, higher raw materials' prices increase producer price inflation and raise expectations of more generalized consumer price inflation.

In countries where central banks do not have a dual mandate of full employment consistent with price stability, or in places where more widespread inflation is a significant and current issue, a tightening of monetary policy results. We see this today through the inflation problems found in China and Brazil, and through the inflation concerns seen in the EC. Regardless, higher non-U.S., short-term rates put further downward pressure on the dollar, and the cycle we describe risks repeating.

The View Depends On Where You Sit

Is headline inflation, which includes food and energy, the most appropriate measure of inflation, and will it continue to move higher? The answers depend on where in the world you sit. In China and India, where nominal economic growth is near 20% and labor market conditions are considerably tighter, inflation is a current concern. Commodity prices, especially food, represent a much higher percentage of total household expenditures in many emerging markets. As these costs rise, people demand higher salaries to compensate.

China recently granted widespread double-digit wage increases. Until recently, monetary policy in China had closely mirrored that of the U.S., where an accommodative stance is arguably more appropriate. This position caused Chinese policymakers to fall behind the curve in fighting inflation. More recently, China has begun taking steps to allow its currency to rise by raising reserve requirements and implementing other techniques to decelerate growth. This development is encouraging, but more tightening is likely as growth rates remain high.

Inflation – A State of Mind

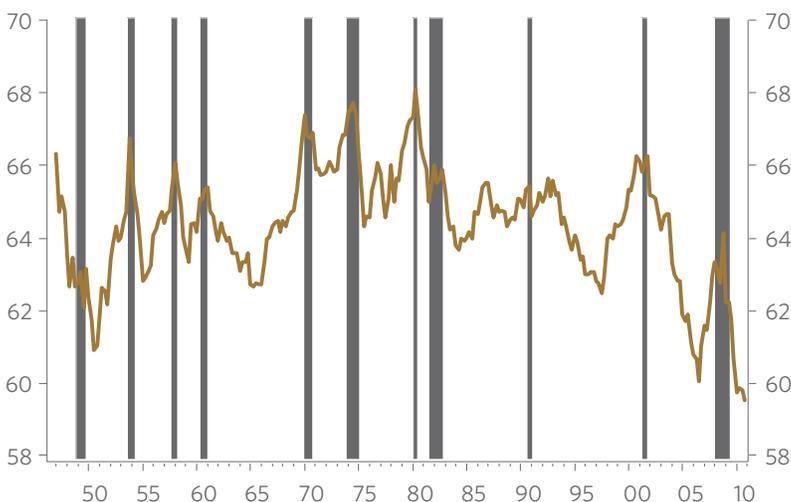
In the U.S., Fed speakers such as Ben Bernanke, Janet Yellen and others have commented on the rise in energy prices, but view the increase as “transitory.” In other words, they do not expect it to be long lasting. Although we do not think that focusing solely on core inflation is appropriate, we agree with the Fed’s view that the U.S. at this time lacks a key ingredient for a more generalized rise in aggregate prices — wage growth.

Exhibit 1 shows compensation as a percentage of corporate GDP. During the recession, companies became highly focused on productivity and emphasized cost cutting and technology to drive profits, while remaining very restrained in their hiring. These conditions remain today, resulting in much higher unemployment and lower wage pressures compared to what has been seen in more normal recoveries.

Exhibit 1 — Corporations Focused on Productivity

Weak Labor Market with Little Wage Pressure

U.S. Corporate Compensation % Corporate GDP



Source: Strategas Research Partners.

For higher energy prices to pass through to core inflation for a sustained period, we believe labor market conditions will need to be significantly more vigorous than

what exists today. As such, higher oil and gasoline prices at the pump serve as a tax on consumers and will negatively impact corporate profit margins. The current high unemployment is not conducive to workers’ ability to translate these rising costs into higher wages. So, the more energy prices rise, the more the ongoing economic expansion will be restrained.

To be clear, we think that the rise to date in energy prices can be withstood and does not constitute enough of a price shock to disrupt economic growth. While high energy prices did contribute to weaker first quarter GDP growth, other factors — including weather and the disaster in Japan — were at least as much to blame. Absent much higher prices prospectively, we think U.S. economic expansion will be ongoing and return to near 3%. Prospects for increased global unrest are worrisome, but some of this is already reflected in the premium currently embedded in energy prices. Clearly, this is one of the larger near-term risks to markets and to economic growth that must be monitored closely.

Our concern about inflation centers more on the intermediate-term inflationary outlook. If oil prices do not dramatically increase and economic growth accelerates while unemployment gradually falls, at some point, the Fed also could run the risk of falling behind the curve. Current sentiment surveys show elevated near-term inflationary concerns, given the greater prominence that consumers have given to energy prices. However, even the bond market’s inflationary expectations have risen to the higher end of the range that is likely acceptable to the Fed. Like good Easter egg hunters, the Fed must make sure it keeps its eyes open and focused forward to make sure it does not miss things that otherwise might have been clear.

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