

# Investment Update



June 2011

## Bumps in the Road

In 2010, a much feared double dip recession failed to materialize. Today, a host of high frequency economic indicators make clear that growth has slowed at a time when instead it was expected to be on the rise. This has caused some investors to again fear a return to recession. We do not think this will be the case.

Considering the array of negative forces experienced since the beginning of the year, including the Japan disasters, dramatic increases in food and energy prices, fears of a hard landing in China, the Greek debt crisis, droughts and flooding, the recent slowing was unavoidable. While some were natural and others man made, many of these factors are one time, or short lived. It would be better if they had not occurred at all, but at least they came at a time when global economic growth was less fragile than even two years ago.

We believe that U.S. consumers and companies, while negatively impacted, will recover from the laundry list of negatives encountered so far this year. Several indicators that can help to determine whether near-term weakness may be prolonged should temper the weakness of other data. For example, while the durable goods report for May was weak, the trucking and rail components held up reasonably well.

As the prices of many commodities fell sharply on changes in margin requirements, those without corresponding futures markets or significant participation by indexers or speculators generally fell much less. Commercial and industrial loans and the money supply (M2) are beginning to accelerate rather than decelerate. Bank officer surveys indicate banks increasingly are willing to lend. Taken together, the data appear to paint a picture of pronounced but temporary slowing based on shocks and supply disruptions. Assuming no further great negative surprises, we think economic growth will improve as current headwinds dissipate during the second half of the year.

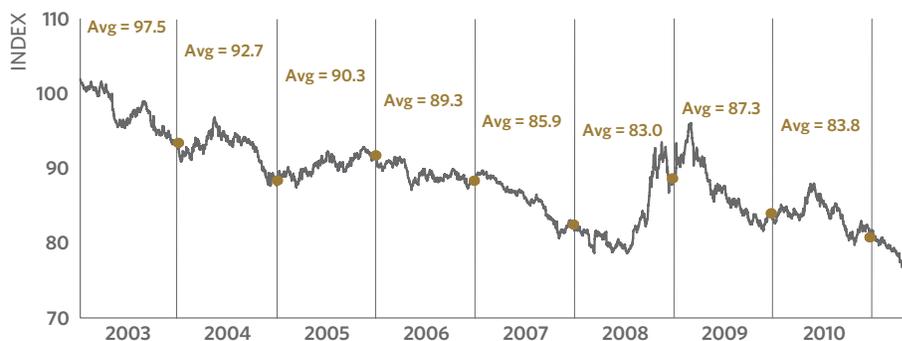
While the U.S. equity market has held up fairly well under the weight of recent events, continued volatility is likely in the near-term. We do not think these issues ultimately will derail the market uptrend, though some patience may be required through the summer. Despite the uncertainties, we continue to find good value, and even income opportunities, in U.S. stocks. An earnings environment that should remain positive for equities, combined with a dearth of attractive alternatives, supports the case for maintaining our current recommended allocations.

## Time For A New Direction?

With the exception of Paul O'Neill, every U.S. Treasury Secretary since the mid-1990s officially has espoused that "a strong dollar policy is in the national interest," while tacitly supporting the dollar's decline. The result can be seen in the chart below, showing that the dollar has primarily trended downward since 2001.

## The Dollar

Trade-Weighted Dollar



As of 5/27/11. Source: Bloomberg.

To date, this decline has mostly benefitted the U.S. The weaker dollar has made the price of our goods more competitive, which is stimulating exports and reducing imports. Roughly half of the U.S. trade deficit today results from trade with China, the other half from petroleum products net imports. Excluding oil and China, the U.S. would be running a small surplus. For much of this period, the declining dollar also has benefitted the stock market (S&P 500) which has had a very strong correlation as a weaker dollar has translated into stronger earnings for most companies.

Many U.S. policy makers adopt a supply/demand view, meaning that the dollar's value is determined by foreign demand. This view, for instance, was recently outlined in an op-ed by Christina Romer, prior chair of the White House Council of Economic Advisers. More recently, we think the Federal Reserve's zero interest rate policy has become the dominant variable in determining the value of the dollar. Other than for a brief point during the financial crisis, real interest rates (after inflation) are more negative than they have been in 30 years. While this may benefit borrowers, it squeezes consumers, who are pinched by rising costs for food and energy without job and wage growth. This effect was clearly seen in the drop in the Conference Board's May index of consumer confidence. People have become more apprehensive about their future incomes and expect inflation to increase at a 6.6% rate over the next year. While this expectation is almost certainly too high, it could indicate that inflation expectations are at risk of becoming unanchored.

Despite the prior benefits of a lower dollar, we may have reached a time of diminishing return. Weak wage growth and falling housing prices, coupled with rising headline inflation and import prices, erodes consumers' standard of living. With unemployment so high while demand for credit and money velocity is so weak, inflation is not likely to be sustained in the near-term. But, we believe current policy does introduce a risk of higher future inflation. As we previously have outlined, we think a weak dollar contributes to a number of the uncertainties we are now experiencing. Conversely, a stable dollar could facilitate appropriate allocation of capital and attract asset flows and jobs to the U.S. The challenge is that to accomplish this, the Fed would likely need to raise rates sooner than it has been indicating it might. While a small minority at the Fed appear to think this would be a good approach, it seems unlikely that Chairman Bernanke would take this risk.

With economic growth again weaker, the Fed seems likely to move to a more neutral monetary policy only slowly. So for now, other than when there are flare ups that induce the "risk off" trade and resulting flight to quality, it seems too early to expect a true shift to a new direction for the dollar.

### Small World

The older I get, the smaller the world seems. In the 1990s, I would occasionally see an annual industry publication entitled *Corporate Bond Strategy Playbook*. It was a stellar work in both quality and quantity. Although I did not know the author personally, I admired him and his team's work for its clarity and insight. Well, as the small world turns, this gentleman, Jack Malvey, recently joined our firm and will be the director of our recently formed BNY Mellon Center for Global Investment & Market Intelligence. Given the shortage of the latter, I am looking forward to his involvement and the benefits it will bring to our Investment Strategy Committee and our clients.



Christopher Sheldon  
Director of Investment Strategy

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