

Investment Update



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Progress Report

Report card time in our family generally finds the students appropriately rewarded for their efforts, so it causes minimal anxiety. Progress reports, on the other hand, can sometimes draw attention to areas of study that might need a bit more attention—a “lost” homework assignment to be turned in, or a make-up quiz to be taken. At times even more interesting to the parents can be the comments attending the scores. “A pleasure to have in class,” for instance. Hmmm. Really? How different from earlier this morning. Perhaps this teacher hit the wrong button or maybe was thinking of a different pupil?

Likewise for investors, before a final report card is issued it may be helpful to conduct a progress report on markets, economies and other factors influencing market performance.

Performs Under Pressure

This comment could apply to the U.S. economy. Despite the challenges of deleveraging and global growth headwinds, the U.S. consumer has fared much better than feared. Small business sentiment has improved moderately as credit access has increased. While employment remains far below normal levels, it has picked up over the last

few quarters. Housing appears to be bottoming (likely a lengthy process) and manufacturing is showing areas of strength. Gasoline’s recent price retreat from its highs should also benefit confidence and spending.

Taken together, these strengths appear to be more than can be explained solely by a mild winter. While we believe that U.S. growth is in better shape than investors give credit, aggregate growth has not yet risen to a level sufficient to be immune from Europe’s emanating growth threats. To change investors’ assessment, more progress must be made.

Learns From Mistakes

U.S. politicians appear not to have heeded the lessons of past mistakes, or perhaps the lure of reelection is just too strong. After last year’s deficit and debt ceiling debacle, the fact that we are even contemplating a repeat with the upcoming Fiscal Cliff—Fed Chairman Bernanke’s term for the expiration of prior tax credits, new taxes and automatic, sequester-required spending cuts—is ludicrous. Immediately after the elections, changes likely will be made to avoid the worst case outcome of the very large hit to GDP growth these measures would deliver.

Even if the Fiscal Cliff is averted, failure to address the obvious risk to the economy prior to the last possible moment could add interim volatility. As witnessed last year, investors may lack confidence that appropriate changes will take place and may act in advance on the concern that the very large changes in taxes on dividends and capital gains could go into effect. Lack of clarity on what will take place at year end also is unlikely to bolster business confidence.

Uses Time Wisely

Policy actions in Europe and from other global central banks in late 2011 engendered a welcome respite from a growing liquidity crisis. This bought policy makers time to begin to enact necessary structural reforms, notably in the area of government spending. Unfortunately, rather than taking steps to improve competitiveness, the focus was on private sector austerity. Heaped on top of already weakening economies with high unemployment, the fact that this approach has proved unpopular with voters and has not been conducive to reelection should not be shocking.

After seeing the fate of thwarted Austerians, the new crop of leaders claim they want growth. The problem is that growth is an outcome or a by-product, not simply a choice. A nation can't create growth by fiat. Throwing more money obtained with more debt at the same failing institutions and programs will not facilitate growth. Someone has to foot the bill. It appears increasingly unlikely that bond markets will continue to be willing participants.

Communicates Clearly

The Federal Reserve has taken great pains to increase the transparency of its decision making. This is a good thing in theory and perhaps in comparison to past practices, where often the goal seemed to be to achieve as much obtuseness as possible. Chairman Bernanke's predecessor was said to have stated, "If I seem unduly clear to you, you must have misunderstood what I said." In practice, achieving transparency is easier said than done.

The Fed has instituted post-meeting press conferences to accompany its Committee's policy statements. In addition, it now publishes, on a quarterly basis, the expected path of interest rates expressed by each individual Fed official (without labeling them by name). This creates another challenge, as individual members' forecasts may differ from the central Committee's final statement. This challenge was reinforced by Chairman Bernanke's recent statement that the forecasts of the various members are only inputs into a broader process. So, while guidance is especially important as rates are already as low as they can go, room apparently remains for continued improvement in the communication process.

When the Report Card Comes

Ultimately, report cards are mailed and final grades received. At that point, it becomes clear whether or not the student has heeded the prior progress report. Today's assessment of global economies, markets, policy makers and politicians indicates that the pupil needs to buckle down, make decisions that will be unpopular for one's social life, and focus on the issues at hand while time still remains to improve current scores.

Not all is lost. Markets grade on a curve. In many cases, current challenges and concerns already are reflected in valuations. While we face ample headwinds and obstacles, potential for improvement exists. Very low current yields in many fixed income areas reflect fears surrounding growth or the potential for a return to a crisis environment. Meanwhile, equity valuations are reasonable. While far from assured, if indicators of U.S. economic growth such as employment and GDP improve, or if policy makers avoid the repeat of acting like the playground bully when it comes time to address the year-end Fiscal Cliff, investors might reward this behavior with higher multiples.

Until positive steps are clearly evident, equity markets likely will be more volatile and range bound. While Europe remains a daunting test, the U.S.—compared to many other places in the world—at least shows promise. Nevertheless, progress needs to be made before investors reward the student with a better grade.



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