

# Investment Update



BNY MELLON  
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## Missing Pieces

During a recent gathering of family friends, our host brought out a large, complicated puzzle for us to assemble. The younger children congregated in one area and began working on the puzzle, while the teenagers, along with some of the adults, started on another section. After some time had passed, we looked down the table at the youngsters' work, and were astounded to see the progress they had made. It far surpassed our progress. Amazed, several of us went over to have a look. We then realized that while the children appeared to be making great strides, in reality, they were cramming together pieces that bore no relation to each other. Upon closer observation we saw gaps and missing pieces, creating an image more like *Dante's Inferno* than the pastoral scene on the box. Regardless, the children were proud of their accomplishment and could not fathom that something was amiss. Who were we to tell them otherwise?

This story is an apt analogy to this month's *Update*, on several levels. First, during the press conference following the Fed's June Open Market Committee meeting, Chairman Bernanke was asked what factors were holding the economy back. He replied, "Part of the slowdown is temporary and part of it may be longer lasting. We don't have a precise

read as to why this slower pace of growth is persisting." He then listed the temporary factors affecting growth, citing some of the headwinds we have discussed over the last few years such as weakness in the financial and housing sectors, deleveraging and debt. He further suggested that these headwinds may be stronger than the Fed had previously thought. Certainly all the issues he noted have contributed to the slowdown but, at the end of the day, we think there is more to it.

The missing puzzle piece seems to be confidence. In past *Updates*, we have discussed the many uncertainties faced by investors and business owners over the last several years. Even today, the list remains long. Yet uncertainty is not the sole root problem. Investors and business owners know how to incorporate the unknown into their planning. Rather, the restraint on the economy stems from the public's perception that every issue or event will result in a negative outcome.

The extreme events we have experienced over the last several years have sensitized investors to how true worst case outcomes can feel. These events have cast a pervasive gloom that shapes investors' collective view, painting a darker picture than what may be justified.

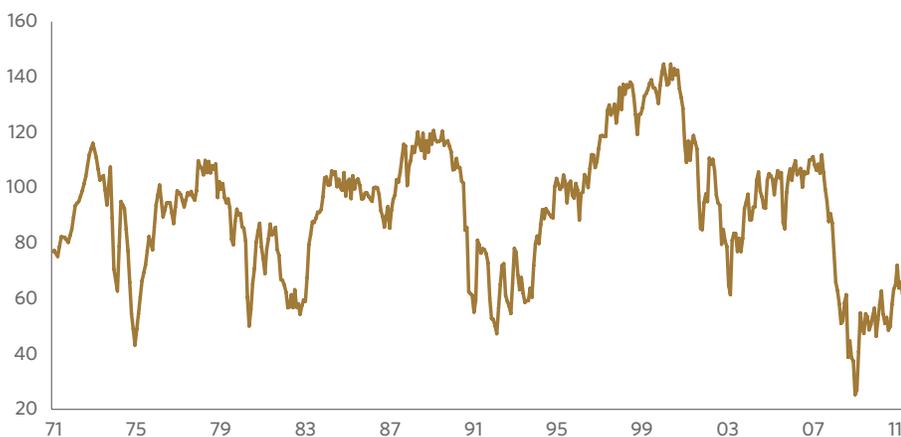
During our recent travels around the country, we have met with many investors who seem to echo this dismal view. Many have expressed their monumental lack of confidence in policymakers, disgust in the degree of political polarity, lawmakers' seeming inability to take decisive action on difficult but vital issues, and dismay over how the U.S. is perceived by the rest of the world. This angst seems only partially captured in sentiment surveys, as seen in Exhibit 1, on back, and in poll questions.

Whether asked about the possibility of meaningful deficit reduction or the direction of the dollar, inflation, housing, employment or the geopolitical situation, most investors are quick to assign a very high probability that most or all of these issues will have negative outcomes. This miasma of doubt, fear and distrust has caused a critical puzzle piece — confidence — to go missing.

When people have hope, they are audacious. They spend, they build and they invest.

## Exhibit 1 — Conference Board's Consumer Confidence Index

Energy Price Increase Weighing On Sentiment



As of 6/28/11. Sources: The Conference Board and Haver Analytics.

### The Wrong Picture

Like the children assembling the wrong puzzle pieces, investors have fashioned a tableau from recent data that differs from the actual picture. Based on the market declines in May and June, the drop in bond yields and negative commentary, many investors have construed weak economic data to imply a more pronounced and longer lasting decline in activity than what we think will actually transpire.

While this year's slowdown is very real, its underlying causes likely will have a more finite duration than those of last year. Most explanations for the current slowdown have been attributed to the impacts from Japan and the resulting supply disruption. Yet even now, those impacts appear to be waning. While investors recognized that the spike in gasoline prices represented a shock to consumers, they may have underestimated the effect it would have on businesses. Fearing that the rapid price run-up would completely curtail consumer spending, many companies cut orders, stopped hiring and prepared for a retrenchment in spending. However, retail sales were not impacted nearly as much as was feared. More recently, concerns about spiraling unrest in the Middle East have abated and an interestingly-timed release of oil from the Strategic Petroleum Reserve has lowered oil and gasoline prices. We believe companies will begin to realize that conditions have improved and should become more willing to spend.

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### A Better Picture

While many important and difficult issues remain, many of the current concerns already are reflected in today's asset prices. Because so many investors expect worst case outcomes, there may be room for global equities to move higher if some do not transpire. At the same time, reduced fears would also likely be accompanied by a rise in interest rates.

The bigger issue to us remains the missing puzzle piece. While tempered by the lack of progress to date, we have some hope that policymakers will increasingly recognize the important role that confidence plays in the economy's improvement.

In a recent conference to attract corporations to his city, Chicago Mayor Rahm Emanuel exhorted, "If you see us willing to shape our future with a sense of confidence, you'll have the confidence then to invest in our city," he said. "We in the public sector, we don't create jobs. We create the conditions so that you can invest and create the jobs in our city."

Finding the words is easy. Lack of economic growth and high unemployment, combined with lack of progress on deficit and debt issues, underscore the reality that no post-WWII president has won a re-election with a rising unemployment rate. Now is the time for policymakers to look at the idyllic picture on the box of what America can be, and contribute to making it a reality.

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