

Investment Update



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Déjà Voodoo

Over the last several years, the same jinx seems to befall the market at this time of year. Markets start off strong, optimism rises, and then, suddenly, conditions deteriorate and it all falls apart again! This year has been no exception, exactly repeating the pattern of 2010 and 2011. In those prior years, however, an investor could find enough positive indicators that countered prevailing forecasts to believe a recession was not necessarily imminent.

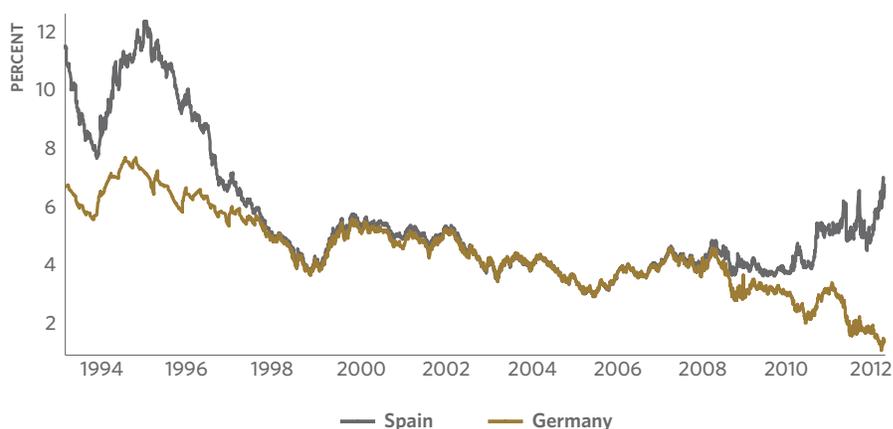
Today, it is clearer that global growth is indeed slowing. The European crisis, a slowdown in China, election uncertainty in the U.S.—and what that uncertainty could mean for the impending fiscal cliff—all are contributing to reduced economic growth from already subdued levels. While our expectation remains that the U.S. will avoid recession and our rational response is that poking pins into a doll has no effect, we admit to feeling unexplained anxiety. Without a new direction or breakthrough, and compounded by the huge looming uncertainties, it is very hard to see how economic growth can pick up substantially. The bright spots of lower gasoline prices, waning inflation, improving housing market conditions and accommodative monetary policy are not enough in the short run to overcome the malaise and uncertainty that overhang consumers, companies and investors.

The Reign of Pain Is Now Also in Spain

Any pretense that the European crisis ends with Greece has long since been shed. The idea that Greece could quit the euro without contagion, or that existing contingency plans, stabilization funds or other half-measures had contained the crisis, have been dispelled by the recent market response. Exhibit 1 clearly shows that intense concern has shifted from the periphery to the core of Europe. In stark contrast to German debt, Spain and Italy both are paying in the area of seven percent for ten-year debt—underscoring the severity of the crisis.

Exhibit 1 – Spanish vs. German Bond Yields

10-Year Government Bond Yields



As of 07/02/12. Source: FactSet.

Unfortunately, consistent with the degree of response over the past two years, policymakers continue to run to catch up to the crisis rather than proactively getting out in front of it. Judging by the ever-shortening length of celebration for each succeeding European action, market participants are becoming wise to the cycle of riot, respond, relief, rally and repeat. While it is certain that there is no easy answer or silver bullet to fix the crisis, policymakers in Europe must escalate the pace and magnitude of response. Yields at such high levels in core euro countries are not sustainable for long.

So Bad It's Good?

Markets are most at risk when policymakers or investors are heedless or dismissive of existing challenges. Myriad indicators show that this is not the case today; most everyone is aware that conditions are deteriorating. Uncertainty is high, sentiment is poor, global growth is slowing, commodities

are weak and bond yields reflect challenging economic prospects and a strong preference for safety and liquidity. Although it is not likely that investors are making the statement overtly, for instance, current negative yields on Treasury Inflation-Protected Securities (TIPS) would suggest investors believe economic growth might decline by 0.5% annually over the next ten years. Unless they seriously are expecting conditions not experienced even during the Great Depression, most likely this trend reflects investors' appetite for safety, liquidity and protection against potential future inflation.

Exhibit 2 – Record Low Yields for TIPS Strong Demand for Inflation Protection and Safety

Treasury Inflation-Protected Securities (TIPS), 10-Year Yield



As of 07/02/12. Source: FactSet and Federal Reserve System.

Given investors' lack of confidence in policymakers, a small silver lining is that even a modest shift toward a new direction could trigger a positive market response. The outcome of the June European summit (the 20th since the crisis began!), while far from definitive, at least hinted that policymakers there finally may be cognizant of the need for urgency. Favorable response, at least temporarily in equity markets, is indicative of how further better news might help to boost markets. Until then, markets will remain captive to the near-term flow of economic and earnings data that is likely to be relatively downbeat.

However, given this uncertainty and how the price and yield of many assets reflect the strong preference for safety, longer-term investors should think hard about becoming significantly more risk averse at this point. While current headwinds will certainly remain well into the future, even modest steps in the right direction could reduce the "safety premium" in bonds and allow equities to move higher.

The Deep Blue Good-by

Writing the *Investment Update* over the past years, I have shared with regular readers more glimpses of my formative experiences than sometimes intended

—far too many to recall here. One example, however, is my love of the 1960s Travis McGee novels by John McDonald. Thus, it feels fitting to end my last *Update* with the title of his first book from 1964.

As you may know, I have moved into the role of Chief Investment Officer of Dreyfus, part of BNY Mellon. It has been a privilege to share our organization's insights through this publication. It is always challenging to attempt to discern how the future may unfold—scrying has never worked for me. While no one can be right all of the time, looking back, a great many of the views we have shared in this *Update* have been borne out by subsequent events. Hopefully our comments also have served to shed light both on market dynamics and our own thinking and recommendations. For that, I thank all of my colleagues who have contributed their insights and experience to this effort and all of our readers who have shared their feedback over the years.

Now, I'm pleased to introduce a new colleague, Jeff Mortimer, who will take up the yoke. Jeff has many years' experience as a market observer and as a strategist with keen insights. He is more than worthy to take up the cause from this point forward and I look forward to frequent collaboration with him in the future. So, finally, from another favorite thing of mine—old-time Westerns—I leave you with the sign-off of the Cisco Kid: "Via Con Dios!"

Christopher Sheldon

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