

Investment Update



BNY MELLON
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No More Cowboys

While the assorted aches and pains associated with getting older have been acquired over time, the actual realization that I have become old appeared suddenly. The specific moment occurred recently at the John Wayne Airport in Orange County, California. While waiting with my family for our flight, my daughter asked, "Who is John Wayne?"

This question threw into sharp relief for me how different the world is today from the one in which many of us grew up. Certainly change has brought many positive innovations. But, at the same time, have we lost our heroes and icons?

Longtime *Investment Update* readers know of my fondness for old cowboy movies. I always liked that you knew who the good guys were. They prevailed over any odds, righted the wrongs and then rode off into the sunset. I also have talked about my lifelong love of science fiction. But mashing the two together in the same movie? Not so much...

Stranger Than Fiction

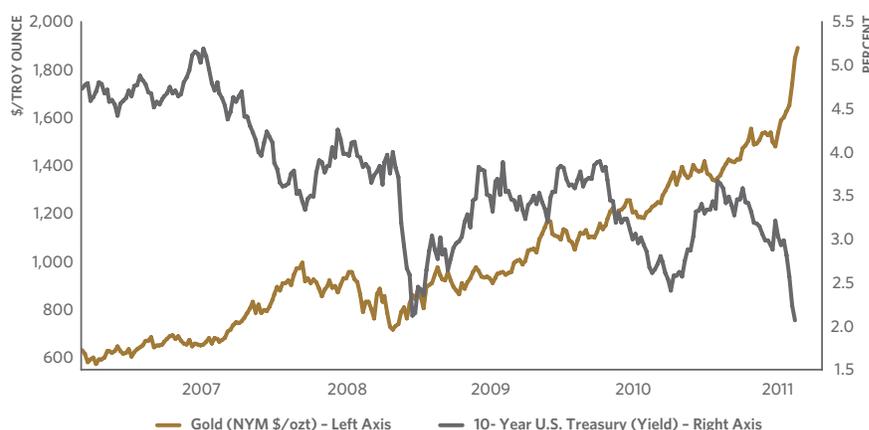
Markets and economic growth have turned lower, reflecting investors' crisis of confidence. The dispiriting spectacle of the debt ceiling debate and brinkmanship, along with the subsequent downgrade of U.S. government debt, may be remembered by many investors as the moment in which confidence in policymakers was completely abandoned. Like the journey of aging, it did not happen all at once.

Both occasions remind me of a character in Ernest Hemingway's *The Sun Also Rises*, who, upon being asked how he went bankrupt, responded, "Two ways. Gradually, then suddenly."

Exhibit 1 — Fear of Policy Mistakes

Simultaneous Desire for Inflation and Deflation Protection

Gold Price versus 10-Year Treasury Yields



As of 8/19/11. Source: FactSet

Exhibit 1 depicts 10-year Treasury yields and gold prices since the onset of the credit crisis in 2007. The performance of these two assets suggests that investors fear sustained deflation, caused by a long, deep recession (indicated by the fall in yields), and persistent inflation (indicated by the rise of gold) at the same time! Clearly both cannot happen concurrently. However, investors seem to be saying that prior market and economic intervention, past policy mistakes and fears of future policy errors have clouded the investment environment so much that the risk of each is high. In fact, investors see these dual risks as high enough to feel the need for protection against both. This phenomenon also can be seen in the inexorable fall of the dollar over much of the last decade.

While understandable, we believe investors' fears have pushed gold and Treasuries to extremes. Gold, in particular, has recently exhibited numerous earmarks of speculative behavior. Barring a return to conditions of late 2008 or worse, which we see as unlikely, the future opportunity provided by these investments appears lower than in the past. The allocation of capital into these "safety" assets, rather than toward investments that help fuel economic growth and jobs, reflects the fear of future policy errors. This fear is greatly contributing to the current crisis of confidence.

End of the Rope. Out of Bullets.

Some investors continue to pin heroic hopes on Ben Bernanke and the Federal Reserve. Even after the Jackson Hole conference, the theme of which was

"Achieving Maximum Long-Run Economic Growth," equity markets rose on hopes that Chairman Bernanke might unveil QE3.

We think the Fed has relatively few remaining policy options, none of which are sure to work and some of which could have potentially negative consequences. The recently announced "pledge" to keep rates low was already what markets expected, so the incremental market impact likely will be minimal. While the Fed could announce plans to change the composition or maturity structure of its balance sheet, the effects would probably be modest. It might suggest inflation targeting, but this practice has been controversial within the Fed. Another round of quantitative easing might lift equity markets, but could also ignite further inflation concerns and increase food and energy prices, which would be unwelcome news for global consumers.

Chairman Bernanke himself seems to believe none of these steps, if taken alone, would likely turn the tide toward positive economic growth. He used his Jackson Hole speech to again, and perhaps more forcefully, remind policymakers that monetary policy is not enough. Impediments to economic growth from the current tax code, regulatory policy and unsustainable federal spending are all issues that must be addressed. More urgently, policymakers across the globe need to recognize how much they have contributed to the pervasive negativity among consumers and investors. If left unchecked, these forces could become increasingly self fulfilling. Uncertainty creates fear, generates selling and causes investment losses. This, in turn, results in cutbacks and, ultimately, a reduction in growth. And the cycle continues.

Wanted: A New Hero

We need a new hero to ride in on a white horse, a new Camelot, a new shining city on the hill. Not so much a single person, but rather an idea or theme that people can identify with and believe in.

Currently, we suffer from high unemployment and low morale created by political polarity, the divide between the rich and poor, the negative climate toward business, unsustainable growth in entitlement spending, and a collective unwillingness to address these difficult, yet critical, issues. No one person can change the situation overnight, but acknowledgement rather than blame would help. Cooperation rather than disparagement would help. Plans and proposals rather than speeches would help. Decisive and coordinated action by policymakers in Europe rather than the muddled response we have seen to date would help. A simplified, revamped tax code with loopholes removed, lowered rates for both companies and individuals, and greater participation by more taxpayers would help. Painful but necessary changes to entitlement programs would help.

Few people believe that positive change will happen. Based on the current trajectory, this view is well substantiated, but there is ample room for an upside surprise.

Today's confidence crisis is quite different from the liquidity and solvency crisis we experienced in 2007-2009. Despite the current fear and malaise, corporations are in good shape. Many have exhibited strong earnings and high free cash flow, and some have the ability to increase dividends, make capital investments, buy attractively valued companies or their own stock, and even hire, assuming they can gain confidence in the prospective environment. Individuals have paid down debt and their spending remains resilient, although more will need to occur. It is difficult to determine when a catalyst will move things in a better direction, yet the above referenced factors suggest to us that longer term opportunity in equities exists, especially in high quality large cap U.S. companies.

While recognizing that volatility may continue in the near term, growth-oriented investors should maintain equity exposure despite uncomfortable swings. Sometimes, it is not the hero who overcomes, but rather the simple town folks who conquer their fears and face the challenge head-on.



Christopher Sheldon
Chief Investment Strategist

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