

# Investment Update



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WEALTH MANAGEMENT

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## **A Swim Meet and the Economy... a Common Thread**

My son is a swimmer. As I waited the seemingly endless 2 1/2 hours between my son's races at a recent meet, I was reminded of the old adage, "If I had but one day to live, I'd go to a swim meet because they last forever."

As we watch the economic events around the world take place—whether the debt issues in Europe, the slowdown in China, or the fiscal cliff and election uncertainty in this country—it seems they may never end. Daily we are bombarded by headlines that discuss how we will be stuck in this malaise for years to come, how we have never faced the issues we encounter today, and how the recent lost decade in stocks is just the beginning. And yet, as I write this *Update*, our stock market is UP over 10% this year.

Given this is my first monthly communication, I thought I would begin by sharing my broad views on overall markets as I see them today. In future *Updates*, I will dig deeper into some of the issues that are discussed here as well as explore emerging themes.

## **Practice Makes Perfect**

*"We therefore confront three problems: the immediate problem of recession and unemployment, the continuing problem of inflation, and the newer problem of reducing America's vulnerability to oil..."*

While this statement certainly rings true today, it was actually spoken by Gerald Ford in 1975. Many issues that we face today are similar to those we have wrestled with for nearly 30 years. Of course, "History doesn't repeat itself," as Mark Twain said, "but it does rhyme."

With an unemployment rate of 8.3%, many people believe we are still in the recession created by the housing bubble and bust. Inflation may not be the immediate worry that it was in the 70s, but all the money printing going on today has many forecasters worried that, once the economic recovery does catch hold, inflationary pressures will not be far behind. Oil has continued to be an issue for over 40 years, as our dependence on foreign oil has not subsided. With a still turbulent Middle East, oil and its effect on our economy remains a constant concern. Although we have successfully wrestled with these (and most other) issues before, investors still feel the need to position their portfolios defensively. However, we believe that an overly defensive posture throughout the next few years may result in missed opportunities for investors with a longer term time horizon.

I do not mean to sugarcoat the challenges we face today. They are real and they are serious. But they also are manageable. These issues are causing this recovery to be among the weakest in history. The recovery seems to be playing out in slow motion, and most likely will continue to do so over the next few years. While many industry experts used to believe that the deeper the recession, the stronger the recovery, the opposite has unfortunately been true this time around. The deleveraging cycle of the consumer is the main reason given for this sub-par pace. But even this relatively weak cycle has not stopped the stock market from doubling since its low in March 2009.

## **Everybody out of the Pool**

Mutual fund flows this year continue to show a high degree of risk aversion by most investors, as money continues to flow out of equity and into fixed income funds. Specifically, as illustrated on the next page in Exhibit 1, since 2006 flows of nearly \$100 billion have left U.S. equity funds, while more than \$1.3 trillion has moved into bond funds. This trend continues year to date.

History is filled with data showing the movement of money flowing indiscriminately into certain asset classes that later go on to be poor relative performers. Large cap growth funds in the late 1990s received such strong flows that many managers had to close their funds to new investors, as the managers couldn't find suitable investments for that newfound money. Although today's flows are directed to more conservative investments, it remains to be seen whether, three to five years from now, they will be followed by underperformance and disappointed investors.

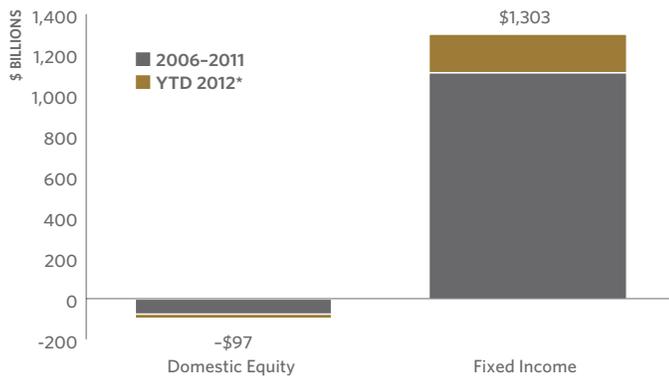
## **Diving into the Deep End**

Strong flows into fixed income investments have helped to keep rates at historically low levels, and may be partially responsible for a potential bubble forming, or beginning to form, within the high quality fixed income market. While rates on the 10-year Treasury bond have reached a low of 1.41%, the stock market's earnings yield, as seen in Exhibit 2, is at levels that have not been seen since the early 1990s. When these yields are compared to 10-year Treasury yields, the case could be made

that what appears safe is now “risky,” and what most perceive as risky is trading at valuation levels that may make it, in many cases, more “safe.” This switching of roles is historically familiar; it most typically occurs at turning points in the relationship of these two asset classes.

### Exhibit 1 – Net Fund Flows

Net Mutual Fund and ETF Flows January 2006–June 2012



\*YTD as of 6/30/12. Sources: Investment Company Institute and Strategas RP.

Fortunately, we can see some bright spots in the U.S. economy. Included in this list would be a housing market which is showing signs of either bottoming or, through more optimistic eyes, rebounding. ISM (Institute of Supply Managers) numbers are consistent with GDP growth of between 1.5 and 2.2% annually. The stock market, long seen as a leading economic indicator, also continues to signal that the economy will continue to grow.

Europe continues to be plagued with too much debt and too little growth. This is evident in interest rates within the Eurozone. Germany’s rates continue to be below those of Italy and Spain, where rates remain elevated and, by some measures, are nearing unsustainable levels. The issues in Greece continue to be monitored closely, with debt payments coming due in the near-term. The Greek Parliament must make some difficult choices if the country is to be eligible to receive its next round of support from the various rescue funds.

China also continues to be a cause for concern. The latest Purchasing Managers Index (PMI) numbers show an economy that is slowing. The Chinese government has already taken steps to prevent a worsening situation by lowering interest rates twice.

### Exhibit 2 – Stocks Attractive Relative to Bonds

S&P 500 Earnings Yield vs. 10-Year Treasury Note



Earnings yield is inverse of P/E for 4-quarter trailing operating earnings. As of 6/30/12. Sources: Standard & Poor’s Corp. and Bloomberg L.P.

Only time will tell how China’s growth trajectory will move but, in the near term, the slowing of one of the world’s fastest-growing economies is causing concern in equity markets across the globe.

Domestically, the second quarter earnings season is nearly complete, with about two thirds of companies beating earnings estimates. While an absolutely strong showing, this is slightly below the normal 70%, which has been relatively consistent over the past two decades. This illustrates that companies were able to beat lowered expectations and that the stock market was able to digest this earnings season well. It also demonstrates that the market is acting as history suggests it should at this part of a cycle, becoming more resilient to bad news while rallying strongly on good news.

Given all the indicators we have touched upon in this short *Update*, it is self-evident that patience and discipline will be needed by investors over the next few years. However, with a plan in place and with a measured approach to its proper execution, the market already provides opportunities for investors who know where to look.

If you ever find yourself at a swim meet in the Northeast, and you look up in the stands and see me there, please come up and say hello. Whether we’re at a meet or interpreting the headlines together over the coming years, I would value the company and your perspective as we at BNY Mellon work to assess the markets’ complex dynamics, and their implications for your portfolio strategy.

Jeff Mortimer, CFA  
Director of Investment Strategy

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