

Investment Update



April 2011

Unknowable Events

The almost unimaginable human tragedy, devastation and economic disruption from Japan's earthquake and tsunami, along with the resulting damage to the nuclear reactors, certainly are examples of the previously unknowable events we described in last month's *Update*. Amid sadness and support for the victims of the disaster, investors must gauge the potential impacts that this tragedy will have on Japan and the global economy.

In the immediate aftermath of natural disasters of such staggering magnitude, images and data flow can be overwhelming and can cause investors to overreact to perceived impacts. The additional specter of nuclear contamination makes it harder to say that the global market sell-offs were overdone. However, at this writing, the worst case risks appear to have diminished and markets have recovered. In keeping with recoveries from other past natural disasters, we do not think that global economies will experience lasting disruption from the earthquake and its aftermath.

Next month, we will write about possible impacts on oil prices resulting from increased scrutiny of nuclear energy, demand from Japan and the ongoing unrest in the Middle East. For today, let Japan serve as a reminder that, while we know that natural disasters

are unfortunately inevitable, we do not know their timing, or their impact. Investors must build into their portfolios the ability to withstand such events, as knee jerk, post-crisis reactions often prove costly and ill-timed.

Anticipatable Events

A colleague recently remarked that the world is suffering from crisis fatigue. Over the last few years, there certainly have been an increased number of extraordinary events compared to what one might have expected. Despite the onslaught of the unexpected, we must not become numb or distracted from developments that reasonably can be predicted and that may have significant consequences. One such area is the U.S. Federal budget deficit which, based on its current trajectory, is unlikely to yield favorable outcomes.

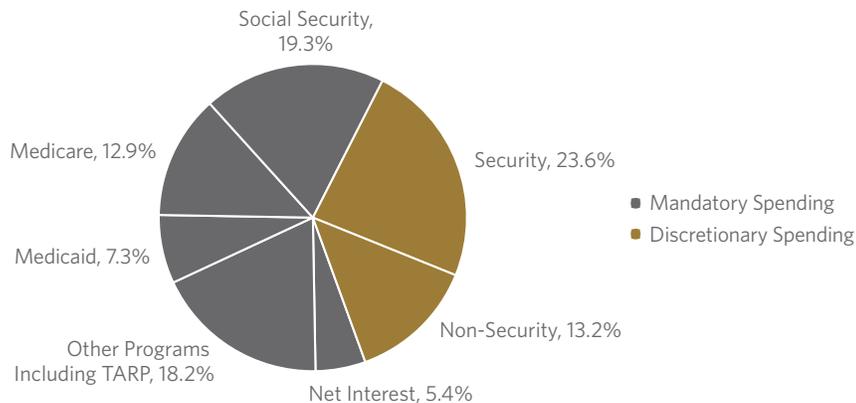
A primary concern we have about the current fiscal policy is not that it will lead to imminent calamity. Rather, holding other global concerns constant, (probably not realistic given the present challenges) we believe that deficits unlikely will impact cyclical economic growth over the next few years. In a low interest rate environment, interest payments on debt are manageable. However, when interest rates rise, interest payments will become a burden. Also, while addressable, tough decisions about spending cuts and tax increases could cost politicians their seats. The political expediency of avoiding angering constituents with proposed cuts, accompanied by deep disagreement on the role of government spending cuts versus tax increases, yields a political hot potato that no one wants to catch. This combination could result in inertia about the need to address deficit spending and foot dragging in the seemingly never-ending political campaign cycle.

A major problem we see is that the Administration's assumptions for the 2012 Federal budget could prove overly optimistic. Real GDP (after inflation) is projected to be 4% in 2012 and 4.5% in 2013. An inflation rate of 1.8% is projected for 2012, followed by 1.9% for 2013. The unemployment rate is estimated to reach 8.6% next year and 7.5% the following year. If these assumptions do not pan out, upward pressure on an already swollen deficit could result. In mid-March, the Congressional Budget Office re-estimated the Administration's 2012 budget, stating that, if enacted, it would result in deficits of \$9.5 trillion over the next ten years rather than the original amount estimated by the Administration of \$7.2 trillion. In either case, even without

higher market interest rates, interest payments on debt and mandatory spending will surge, while defense and discretionary spending are projected to be cut sharply.

Exhibit 1 — Federal Overlays

Fiscal Year 2011*



Source: The White House, *The Budget for Fiscal Year 2012*. *As of end of year.

As seen in Exhibit 1, focusing only on discretionary, non-security will not deliver deficit reduction. The current budget deficit is based on a greatly expanded spending base, which was increased due to the financial crisis and its aftermath. Any results of cuts in discretionary spending will only modestly reduce the deficit's rate of increase.

Surprisingly, even given the level of political polarity, not a single recommendation in the president's Deficit Reduction Commission report — which was discussed at length in our December 2010 *Update* — was included in the 2012 budget. In the *Update*, we said that a patchwork, one-dimensional adoption of proposals — i.e., only spending cuts, or only tax increases — would be counterproductive. Ignoring the recommendations completely is an even less viable, long-term solution. Unfortunately, nobody seems willing to make difficult decisions. Politicians may not want to pass the problem on to future generations, but they appear eager to kick the problem along to their successors. Everyone recognizes the need for shared sacrifices, but they just don't want it to come from their piece of the pie. We see little prospect for any real budget cuts or progress on tax code simplification prior to the next elections. However, hopefully a compromise can be reached to avoid even a brief government shutdown.

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No Free Lunch

Will the markets allow for this languid pace of budget reform? Perhaps for a time, however, people know that rising deficits equate to higher future taxes. Consumers unlikely will increase their spending if they know they will face higher tax bills down the road. At the same time, they are busy remedying their own previous debt binges through ongoing deleveraging, which is already depressing consumer spending.

Investors also know there is no free lunch. Someday the bill comes due. Larger deficits, at some point, will put upward pressure on interest rates and further downward pressure on the U.S. dollar if not addressed in a meaningful way. The question is timing. Interest burdens that currently are manageable will rise as the deficit increases and quickly become untenable at higher interest rates. Foreign investors' willingness to continue to finance our deficits through Treasury purchases greatly depends on their confidence in our policymaking, which currently does not shine as a beacon of leadership and decisiveness. While time to address the deficit remains, markets will not wait indefinitely. Reducing deficits will require difficult decisions, tradeoffs and sacrifices. This self-imposed control is almost certainly preferable to the harsh discipline markets otherwise will ultimately mete out.



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