



The State of the Debate

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Key Investment Debates

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Most of the current investment debates are different versions of the same broad question: are the favorable economic and market fundamentals of recent years sustainable or are we approaching a major deterioration? Is the strong global expansion sustainable? Will rising living standards in emerging countries plus difficulties in finding new reserves drive up the price of energy and other commodities enough to damage the developed country economies? Can a large balance of payments deficit in the U.S. continue to be financed easily? What is the outlook for the dollar and other major currencies? Is there a major problem with internal imbalances in the U.S. linked to excess leverage, budget deficits and a low savings rate? Has core inflation in the U.S. peaked or is it likely to shift even higher? Can high profit margins and a high profit share of GDP in major countries be sustained? How severe and prolonged will the U.S. housing recession prove to be? Will the “great moderation” in economic volatility and inflation volatility continue? Is the global economy vulnerable to a shift from free trade to protectionism? Can the profit share of the economy remain elevated or is it doomed to fall?

Our broad conclusion is that many favorable multiyear trends are likely to persist despite episodes of shorter-term volatility. Even those favorable trends that erode are more likely to stall in neutral rather than shift into major negative trends. A global and U.S. economic system able to respond quickly to free market signals has resulted in a very flexible world economy, which has quickly adapted to economic changes. We expect this to continue.

Global Expansion

The world economy has expanded at the fastest pace in a generation over the last several years. This reflects a positive labor supply and productivity shock. The workforce relevant to the modern economy has doubled as China and the former Soviet Union have integrated into the world economy. In the developing world, productivity has improved rapidly as the benefits of several centuries of cumulative intellectual capital from the developed world have been diffused more broadly. As a rising share of the world's population becomes tooled with advanced technology and modern business practices, world economic expansion has become self-sustaining.

We believe that the global supply shock has contributed to financial liquidity worldwide and will continue to do so. Macroeconomic policy has been supportive of global expansion both in the developed and developing countries. The disinflationary impact of the global supply

expansion on wage inflation appears to have limited the pass-through from rises in energy and materials prices into core inflation over the last several years. This has permitted the major central banks to retain a monetary policy that has been relatively accommodative of economic expansion. Increasing exports in many developing countries have strengthened their external balance sheets as they have accumulated foreign exchange reserves. Growing exports of consumer goods and raw materials have permitted a rise in financial assets in many of these countries and greatly strengthened their external balance sheets and credit ratings. They often tend to have a high savings rate, so much of the proceeds of rising exports have flowed into the world investment markets.

Those who are skeptical of the sustainability of world economic expansion point either to the political risks of a rollback of the free trade system or to elevated asset prices. We concede that a major reversal to protectionism could have a dangerous impact on the world economy. Fortunately,

Issue 10

 Mellon

however, the odds of a large enough shift to protectionism to disrupt the world economy are quite low. We believe that the most likely outlook is for a stall in the world free trade system near its current state of liberalization. While little further progress appears likely, neither does a major reversal.

The other critique of the pessimists is that unsustainable asset price bubbles have been created by low interest rates and tight risk spreads in response to the combination of a global savings glut and a disinflationary supply shock. Our view is that while market fluctuations in response to changing fundamentals and sentiment are inevitable, there are low odds of a systemic financial crisis that damages the net worth of the core financial institutions enough to generate prolonged economic consequences. Overextended asset prices will correct from time to time, but we believe that the central banks will not permit that to trigger any prolonged systemic disruption of the core financial system.

Economic Risk, Systemic Risk, Market Risk

We make a distinction between the “economic risk” of a major economic downturn or adverse inflation shift, the “systemic risk” of prolonged disruption of the core of the financial system and the “market risk” of fluctuations in asset prices.

It is widely agreed that across many markets, the compensation for taking on additional risk dropped sharply in recent years. The optimistic interpretation of this phenomenon is that it has occurred because there has been a sustainable drop in the risk of major downturns in the economy or major adverse shifts in the trend of inflation. As Federal Reserve Chairman Ben Bernanke stated on February 20, 2004, “One of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility...variability of quarterly growth in real output...has declined by half since the mid-1980s, while the variability of quarterly inflation has declined by about two thirds.” Our view is that economic risk has in fact dropped relative to past decades, but that compensation for risk had reached an unsustainably low level by early 2007.

What about the “systemic risk” that prolonged disruption of core financial institutions could have a

major adverse impact on economic activity? Misguided attempts by central banks to pop bubbles in the U.S. in 1929 and Japan in 1989-1990 illustrate the systematic risk that major declines in the net worth of the core financial institutions can generate prolonged negative economic consequences. Fed Chairman Ben Bernanke dedicated much of his academic life to a study of the central bank mistakes of the late 1920s and early 1930s. While he is sensitive to the moral hazard of protecting leveraged speculators from the risk of loss, he has a clear understanding of the consequences of a systemic financial crisis. We put very low odds on the risk that the central banks would prove unwilling or unable to prevent a systemic financial meltdown.

Even in the absence of a systemic meltdown, there is also market risk. With minimal compensation for risk built into risk spreads in early 2007, markets were naturally vulnerable to a “leverage unwind” as excess leverage was reduced. However, such events do little to shift the long-term value of assets, which are grounded in economic fundamentals. We regard occasional market corrections as inevitable and desirable in a capitalist system in order to encourage appropriate pricing of risk in the marketplace.

Commodity Supercycle:

Elasticity Optimists Versus Elasticity Pessimists

There is a broadly accepted thesis that persistent demand for oil and other raw materials from emerging market countries will generate a commodity supercycle of elevated energy and raw materials prices. We support a relatively moderate version of that view. We believe that average real commodity prices are likely to be somewhat higher than in prior decades, but also believe that commodity prices will remain very cyclical, with an alternation between multiyear rises and multiyear declines. We are skeptical about the more extreme versions of the commodity supercycle theory. We believe that the “elasticity optimists” will prove correct, especially in the long run. We believe that the current commodity upcycle is relatively mature, with (1) oil prices past their peak, (2) some metals past their peak, and (3) agricultural prices still in a rising cyclical trend. Government policies and subsidies have linked agricultural prices to energy prices, so agricultural prices are rising in a catch-up to past energy price increases.

Economists use the words “price elasticity” to describe the magnitude of the response of supply and demand to changes in prices. For raw materials such as oil it is often appropriate to be an elasticity pessimist in the short run, because it may take years to develop new reserves or change the average mileage of the existing fleet of vehicles. But it also makes sense to be an elasticity optimist in the long run since price signals generate innovation and cumulative behavioral change over time. Economic history is replete with trend extrapolation forecasts by elasticity pessimists that have been eventually undermined by the adaptive flexibility of supply and demand to changed price signals. The U.S. economy adjusted successfully to the whale oil crisis in the 19th century and it will adjust successfully to the perceived energy crisis in the 21st century.

Advocates of the “peak oil” thesis make a reasonable case that there will be increasing difficulty in replacing oil and gas reserves. In addition, policies to mitigate climate change may add to energy costs in future years. However, we believe that there is likely to be a more favorable balance in the supply and demand for energy more broadly defined than for the narrower oil and gas market. Other sources of energy can grow in response to changing political priorities and price incentives. America may not build new nuclear plants, but other countries will. Energy from tar sands is a proven technology: all that is required is money and time. High prices and government policies will increase incentives for technological improvement. We are optimistic about a positive impact of technological innovation and worldwide technology diffusion in helping to balance the overall supply and demand for energy.

The Imbalance Debate

Differing views about the worldwide financing of external deficits are reflected in the “imbalance debate.” There are three different schools of thought in this debate. The “imbalance pessimists” argue that the persistent rise in U.S. external debt owed to foreign creditors is inherently unsustainable and will trigger a dollar crisis. They also argue that the unwind of excess domestic leverage will trigger severe weakness in the U.S. economy, led by the housing and consumption sectors. The “imbalance optimists” argue that rising U.S. external deficits should prove sustainable because of high savings rates abroad and

the superior long-term investment appeal of U.S. assets. They also believe that the value of assets owned by households will continue to rise much more than the value of liabilities owed, resulting in a persistent uptrend in household net worth over time. While both agree that a weak dollar is inefficient in lowering the external deficits, optimists and pessimists disagree intensely about the implications of that reality. The pessimists argue that this means that the dollar must inevitably experience a sharp decline in order to bring down the trade deficit and the current account deficit. The optimists argue that a foreign savings glut and attractive U.S. investments make U.S. external deficits sustainable and that such a severe dollar decline is unwarranted and unwise.

The third school is that of the “imbalance gradualists.” The view of the gradualists is that many of the imbalance problems are real but can be ameliorated gradually over the course of time, especially if the consumption share of GDP drifts down in the U.S. and the consumption share of GDP drifts higher abroad. We would place ourselves in the camp of the “imbalance gradualists.”

We do not believe that a major decline in the dollar is inevitable in response to a high current account deficit. We believe that it is the Asian currencies that are undervalued rather than the U.S. dollar that is overvalued. The most likely currency outlook should combine a persistent multiyear uptrend in Asian currencies with cyclical fluctuations of the dollar against the euro and the commodity currencies in response to relative economic growth, relative interest rates and relative monetary policy.

The U.S. external balance sheet is still quite strong. The U.S. is not yet subject to a significant external debt service burden, largely because it earns more on its external assets than it pays on its external liabilities. So far, the U.S. has been the most successful hedge fund in history, earning a higher return on its external assets than it pays on its external debts. In addition, the U.S. borrows in its own currency, so that much of the potential vulnerability to currency losses if the dollar declines would be shifted to foreign investors.

Dollar weakness is likely to be relatively inefficient in reducing the trade and current account deficits. The

labor cost gap between the U.S. and emerging Asia is huge and is not likely to be significantly narrowed by currency shifts. The productive capacity to increase U.S. goods exports to the level of goods imports does not exist, even if demand were to increase to that extent. Because the pass-through of currency changes to both import prices and final consumer prices has become more muted in recent years, dollar weakness would not increase import prices that much. Thus the price signal for a slowing of imports by U.S. consumers would also be muted. However, a moderate slowing of U.S. consumption growth is likely even in the absence of much higher import prices. We believe that consumption is likely to grow somewhat more slowly than the overall economy in the coming years, slowing the growth rate of U.S. imports below the growth rate of U.S. exports. Overall, we believe that a gradual resolution of the global imbalances is both possible and appropriate.

The Savings Rate

It is true that the savings rate out of current income is low, but despite this, consumers have succeeded in raising their net worth over the past quarter century due to strong capital gains on bonds, stocks and housing. As a result, we believe that optimists are correct to argue that the low savings rate in recent years was not a major problem for the overall economy. However, we believe the pessimists are correct to argue that an inflection point from exceptional returns to more moderate long-term returns has been reached for stocks (2000), bonds (2003) and houses (2005-2006). As exceptional returns on such assets begin to make a less powerful contribution to the rise in net worth, there is likely to be gradual upward pressure on desired savings. The rich don't need to save and the poor can't save much, but different segments of the middle class have widely differing net worth characteristics. There is a portion of the middle class that has inadequate net worth and should raise its savings rate substantially. However, upward pressure on the savings rate is likely to be gradual.

The Budget Deficit

With respect to the budget deficit, the optimists have proved correct as economic expansion and rising tax revenues have lowered the budget deficit as a share of GDP. We do not expect the budget deficit to be a

major problem in the next several years. The pessimists have a stronger case that fiscal policy has not yet been modified to deal with the demographic strains on the budget deficit, which will intensify over the next two decades. The eventual response is likely to include a combination of higher tax rates, new taxes (a carbon tax or other energy taxes), reduced growth of benefits, higher co-payments and slower growth in non-entitlement spending. The beginning of a long struggle over the demographic deficit stresses is unavoidable due to the scheduled expiration of the Bush tax cuts on December 31, 2010 in an environment of a rising tax take from the Alternative Minimum Tax. But for now, the U.S. is in a calm phase for the budget deficit.

The Debate About Productivity and Trend Growth

Labor productivity is known to be quite cyclical. Productivity tends to be strong when real GDP growth is high, especially early in an economic expansion when there is excess capacity. It tends to grow slowly when real GDP growth is weak or declining, especially once an economy nears full capacity. The U.S. economy probably reached full employment near 4.5%, so that it should be no surprise that a cyclical slowing of productivity growth is now occurring.

There is also a longer-term trend in productivity often referred to as secular productivity growth. A high rate of secular productivity growth can contribute to favorable profit growth, favorable real income growth and moderate inflation. There is currently a debate about whether secular productivity growth is slowing and if so, by how much. Many of the productivity benefits of the technology spending of the late 1990s may have already been reaped. Capital spending has been muted in recent years, which restrains the contributions of technological improvement to labor productivity. Secular productivity growth may be drifting down from exceptionally favorable to merely favorable. However, our view is that the drop in secular productivity growth is relatively limited and that most of the slowdown in productivity growth will prove to be cyclical rather than secular.

A general consensus among many economists is that the long-term trend growth in U.S. real GDP is

declining. For example, the Congressional Budget Office estimates that the annual trend real GDP growth rate in the U.S. will drop to 2.6% in the 2007 to 2017 period from a historic 3.4% pace. This reflects an expected slowing of labor force growth from 1.6% to 0.7% per annum due largely to changing demographics. Such a deceleration in trend growth is quite likely--the main debate is about its speed and magnitude. The pessimists point out that the coming change in the age mix of the population and other factors should lower the percentage of the population actively available in the workforce (the participation rate). The optimists note that the participation rate has recently ticked back up as the labor market has improved. As the U.S. economy strengthened over the last several years, the supply of labor rose to meet the increased demand for labor. To the degree that labor supply can expand flexibly, the slowdown in trend growth may prove somewhat more moderate than currently feared.

The Federal Reserve is uncertain about the trend growth of the U.S. economy. The lower their estimate of trend growth, the lower the pace of U.S. economic growth they are likely to tolerate. Their uncertainty means that they will need substantial evidence of cooling inflation pressure before they will contemplate easing. As a result, a prolonged midcycle slowdown from early 2006 to late 2007 may be followed by sustained moderate expansion rather than a stronger acceleration of growth. An additional implication of a lower trend growth rate in the U.S. should be that the profit growth of domestically-oriented companies may lag the profit growth of multinational companies that have strong business franchises in those foreign countries with strong economic growth rates.

The Housing Debate

The U.S. is still in a housing recession created by a worsening of housing affordability, but we believe there is limited risk of a full-scale recession in the overall economy. The fact that the main cause of the worsened housing affordability this time was the prior rise in house prices rather than sky-high interest rates should have two consequences, one good and one bad. The favorable consequence is that financial liquidity in other sectors of the U.S. economy has not been strained by excessive interest rates and therefore the

magnitude of the current midcycle slowdown in the overall economy should remain moderate.

The unfavorable consequence of starting a housing recession at moderate interest rates is that mortgage rates are unlikely to decline as dramatically as they have in past housing cycles. As a result, we expect the negative impact of the housing recession on the rest of the U.S. economy to be prolonged rather than severe. In the absence of a large decline in mortgage rates, the dramatic rebound in the housing sector observed in past cycles is unlikely to occur this time.

We do not agree with the superbear "housing bust" thesis. The two major triggers for a severe housing bust would be either much higher interest rates or much higher unemployment rates. We do not expect either. Housing should prove both volume adjusting (as the construction of houses remains low) and price adjusting (with modest house price declines nationwide and larger drops where speculation was extreme or economic fundamentals weaken substantially).

What about subprime and other high-risk mortgages, where a sectoral risk crisis is underway? Subprime mortgages were the nexus of undisciplined lending in a sector that was destined for a major cyclical decline after an overshoot in house prices, irrespective of trends in the broader economy. We believe that today's pricing of these assets more correctly values their fundamental prospects than did the pricing when the lending originally occurred. It reflects a "risk normalization." In addition to the hangover from loose credit standards in the past, the sector now faces a sharp tightening of credit terms for refinancing or for new borrowers. This may limit the pool of potential purchasers of the kinds of homes that had been heavily financed by these aggressive loans. This is primarily a sectoral crisis, but it is real and should contribute to the ongoing midcycle slowdown.

The Start of Risk Normalization

The world markets had a quick correction recently in response to a selloff in the Chinese stock market and the surfacing of subprime mortgage problems. There are times when market fluctuations reflect a major shift in the fundamentals, but we do not believe this is

the correct interpretation of this event. We can identify two main causes of the recent market correction. First, there was little margin for error in the pricing of many high-risk assets even though the pricing of many high quality assets appeared to us to be appropriate. Second, leveraged institutional investors are now important enough to the markets that a simultaneous effort to reduce leverage can impact the markets from time to time even in the absence of a major change in fundamentals. Assets have been shifting from decision makers reluctant to increase leverage to decision makers incentivized to increase leverage when their trades are working and reduce it quickly when they are not. This has made the markets more vulnerable to occasional “leverage unwinds,” especially when there is a simultaneous desire to reduce leverage among many portfolio managers with large positions.

After an extended period of low compensation for risk, risk spreads should now begin to normalize. While this should represent the “start of risk normalization,” we expect that the magnitude of the change in the pricing of risk should initially be relatively moderate for most financial sectors. We believe that the shift from optimistic risk spreads towards more normal risk spreads will not prove nearly as big an economic shock as would a shift from normal risk spreads to extreme risk aversion or even to a full-scale credit crunch. However, the sectoral impact on housing is likely to prove painful.

How and why did the financial markets reach such an optimistic extreme in pricing high-risk assets? There were three reasons. First, there has been a “Great Moderation” in economic and inflation volatility in recent years, which helps justify lower average risk spreads. Second, economic fundamentals such as financial liquidity, economic activity and profits were in a favorable phase of the cycle and have only recently begun to transition to a more neutral phase. Third, major shifts in the structure of the financial industry have raised the incentives to take on risk and leverage in rising markets and reduce them quickly when markets correct.

It is generally accepted that there is a credit risk cycle with an oscillation between phases when the compensation for lending to risky entities is low and phases when it is high. The credit risk cycle appears to

be starting a slow, gradual deterioration in response to somewhat less accommodative monetary policy and slowing profit growth. The “borrowers’ market” of easy credit terms has definitely ended for high-risk mortgages and has begun to moderate somewhat for other high-risk borrowers. Aside from high-risk mortgages, credit terms are still relatively easy, even though they have tightened somewhat from their recent optimistic extremes. Very tight risk spreads over the last two years have encouraged borrowers to increase the volume of risky loans. The pool of potential future problem loans has been increased by recent high-risk financing. This is especially true for high-risk mortgages, which are now showing increased delinquencies. However, our view is that a severe deterioration of risk spreads in most parts of the financial markets is unlikely in the absence of a full-scale recession, which we do not expect.

Inflation Targeting and the Fed

We believe that Chairman Bernanke wishes to move the Fed gradually towards some form of an inflation-targeting regime. Ben Bernanke literally wrote the book on inflation targeting. It’s called “Inflation Targeting: Lessons from the International Experience.” Chairman Bernanke’s preference is for a forward-looking inflation target. We believe that monetary policy decisions are likely to become increasingly sensitive to the Fed’s forecast for future inflation. The political barriers to the adoption of an official inflation target by the Fed have risen in the aftermath of the takeover of both houses of Congress by the Democratic Party. A less controversial step in the direction of inflation targeting would be for the Fed to release its economic and inflation forecast more frequently.

While the Fed does not have an official inflation target, leading Fed officials have supported a “comfort zone” of a 1% to 2% inflation rate for the core PCE, which we regard as a “shadow inflation target.” Unfortunately, the rate of change of the core PCE deflator over the last 12 months is somewhat above the upper limit of the central bank’s “comfort zone.” A key argument for inflation targeting is the credibility of the central bank’s commitment to a pre-announced target to help reinforce stable, well-anchored inflation expectations. It would hardly help its credibility if the

Fed were to raise its “comfort zone” to permit an early easing of monetary policy. We believe that it is likely to await convincing evidence that core inflation has begun to cool before it would consider lowering the Federal funds rate. While core inflation has risen somewhat above the Fed’s comfort zone, the intensity of this uptrend is moderate relative to past core inflation cycles. This can be attributed to globalization, technological innovation, weak bargaining power for labor and the effects of a large rise in the Federal funds rate from its cyclical low. Overall inflation rates (including food and energy) have already slowed and we believe that core inflation pressures are likely to ease somewhat as housing-related layoffs weaken the labor markets and rental inflation slows in the coming months.

Profit Outlook

In many countries, the profit share of GDP has risen and the labor share of GDP has fallen. A key question is whether the profit share of GDP will continue to rise, stall near current levels or begin a prolonged decline as the labor share of GDP recovers. Our most likely case is that the rising trend in the profit share of GDP will come to a halt and that the profit share will stall near current levels. As a growing portion of the world’s population becomes productively tooled with modern technology, the world labor supply shock should persist. This should continue to stymie efforts to drive the labor share of GDP back up. However, the relative political power of capital and labor has begun to shift. We expect public policy to begin a modest shift from a capital-friendly stance towards a capital-neutral stance. This should support a stall in the profit share near its current elevated level but not a significant decline in the profit share.

We believe that U.S. profits are at the inflection point from several years of double-digit growth to a major slowdown. The implications of a profit slowdown are more limited when they occur in a midcycle slowdown than when they precede a full-scale recession. While there are many alternate scenarios, in such moderate profit slowdowns, there has often been an upward drift in the price/earnings multiples of quality companies and an associated rotation in market leadership to high quality stocks and mega cap stocks as profit growth becomes more scarce.

Secular Neutral Markets

The bond market was in a secular bull market for nearly 22 years, with 10-year treasury bond yields dropping from 16% in September 1981 to 3.1% in June 2003, as inflation drifted down. More recently, 10-year Treasury bond yields have spent most of their time in the 4% to 5% range. If this continues, as we expect, we would label it a “secular neutral bond market.”

The stock market was in a “secular bear market” of disappointing returns from a peak in the 1966-1968 period to a low in 1982 as inflation and interest rates soared. From the summer of 1982 to the spring of 2000, the stock market was in a “secular super bull market” as inflation and interest rates dropped sharply while profits rose. Neither the dramatic rise in inflation and interest rates nor the dramatic fall in inflation and interest rates is likely to be repeated. As a result, we expect a “secular neutral stock market” to generate a trend of moderate positive returns in coming years since U.S. economic fundamentals are favorable but the profit share of GDP is already high and inflation and interest rates are already moderate.

This report presents the views of Richard Hoey, Chief Economist of Mellon Financial Corporation, and does not constitute investment advice or recommendations by Mr. Hoey or Mellon Financial Corporation. Mr. Hoey's views are current as of the date of this communication and are subject to change as economic and market conditions dictate.

