

Investment Update



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Hope Without Conviction

The skepticism surrounding an economy's ability to recover from a recession has become an age-old story, told through the typical progression of public sentiment that occurs during recessionary times. In the depths of virtually every recession, we hear declarations of "It's different this time; nothing will pull us out of this dive." Next, we hear that the Fed's efforts are not helping, that they are "pushing on a string." When policy enacted to quell the recession begins to succeed, concern shifts to the possibility of a profitless recovery. Finally, when profit growth resumes, many say, "It will be a jobless recovery." This final axiom is at play today. While each recession is unique, including the current one, the progression of sentiment has been remarkably consistent.

In our January 2009 *Update*, we branded the upcoming epoch as the Great Consternation, in stark contrast to the prior twenty years of economic stability coined by others as the Great Moderation. Our outlook is based on the economic and policy headwinds that likely will alter the investment and economic landscape.

We have been struck by the magnitude and pervasiveness of public pessimism and concern. While perspective usually is colored by where one sits and what local conditions one faces, many have been greatly unsettled by the recent crisis — its origins, its impact, and the current and possible future remedies that have been, or are likely to be, applied. We share the public's concern about the longer term implications of the financial crisis, particularly the difficulty in rebuilding trust and confidence. However, we must prevent cynicism and dismay from coloring our thoughts and affecting our judgment of how the future may unfold.

At last informal count, approximately 700 unique global policy initiatives exist, primarily to stem the financial crisis and stabilize the credit markets, but also to reinvigorate global growth. While we may not agree with all of these policy measures, each will have a range of positive and negative impacts on the economy. We believe that the unprecedented amount of stimulus will help to end this recession soon and produce modest economic growth in 2010. While equities and other riskier assets have been appropriately discounted based on the greatly reduced probability of depression, they do not yet fully reflect the improvement in earnings that a recovery — even one that may be subpar — may yield. We see the likelihood for moderate upside in equity prices, especially if equity volatility continues to decline.

A Master of Understatement

In both his House testimony and in a *Wall Street Journal* editorial, Fed Chairman Bernanke took great pains to reassure investors (and remind policy makers) that the Fed maintains and defends its independence. He further asserted that the Fed has the appropriate tools to reduce its current, very accommodative, policy stance and will do so at the appropriate time. While he noted that the Fed's balance sheet is large, he did not elaborate on any future possible actions.

The increase of its balance sheet is a testament to the Fed's flexibility in helping to stem the crisis. However, the sheer size of its reserves may pose a challenge to the Fed's ability to remove its accommodative stance as easily as Chairman Bernanke outlined. The Fed's reserves currently stand at \$800 billion. The prior high, just after 9/11, was \$19 billion. The high prior to that was just under \$7 billion. To say that the current amount is large is a major understatement! This issue has caught the eye of some who argue that near-term inflationary pressure may result. We disagree.

Perhaps Chairman Bernanke read our July *Update*, where we described the rise of near-term inflation expectations to unrealistic levels. In his semi-annual testimony to the House, he labeled inflation fears as "misguided," confirming that expectations of a short-term interest rate increase were unlikely.

He further noted that the Fed's unemployment forecast "...would still leave unemployment well above FOMC (Federal Open Market Committee) participants' views of the longer run sustainable rate." This overhang of unemployed workers is the primary reason we think inflation will not gain traction. Additional factors contributing to a subdued economic recovery also should keep inflation contained: excess global capacity; the higher cost of capital; a tighter credit market; potential government policy initiatives that may create headwinds for economic growth; a return to traditional bank-driven lending; and a continued increase in consumers' savings. These dynamics would appear to preclude the necessary conditions for a rapid increase in inflation.

NAIRU — What Planet Are You From?

NAIRU may sound like the name of the *Looney Tunes* space alien, but it actually refers to an economic concept called Non-Accelerating Inflation Rate of Unemployment. Economists believe that the NAIRU is the lowest unemployment rate that an economy can accommodate without causing inflation. An unemployment rate *higher* than the NAIRU places downward pressure on inflation, whereas an unemployment rate *lower* than the NAIRU puts upward pressure on inflation. Estimates of the NAIRU are based on the historical relationship between inflation and the unemployment rate. While the exact point varies, it generally centers near 5%. As seen in the chart at top, we are far above that theoretical threshold today, and are likely to remain so for quite some time.

U.S. Unemployment Rate, Seasonally Adjusted



Source: Bureau of Labor Statistics

If we consider those who are "underemployed" — such as those who have taken lower paying jobs than their skill level might, in other times, justify, or who have taken on more than one part-time job — the number rises considerably higher. Anyone with a teenager or recent graduate in the house may find that he or she is unfortunately likely to stay there! Although we believe the recession will end soon, we expect growth to be less than what we would see in a normal recovery. Our belief is that it will take a considerable amount of time to return to normal employment levels. One positive result is that inflation is unlikely to gain a foothold, and low inflation can be beneficial for equities.

Postscript: The alien's name, of course, was Marvin the Martian — his avowed goal was to blow up the earth with his Illudium Q-36 Explosive Space Modulator. We trust that this is neither the goal, nor within the power of, the average economist.

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