

# Investment Update



BNY MELLON  
WEALTH MANAGEMENT

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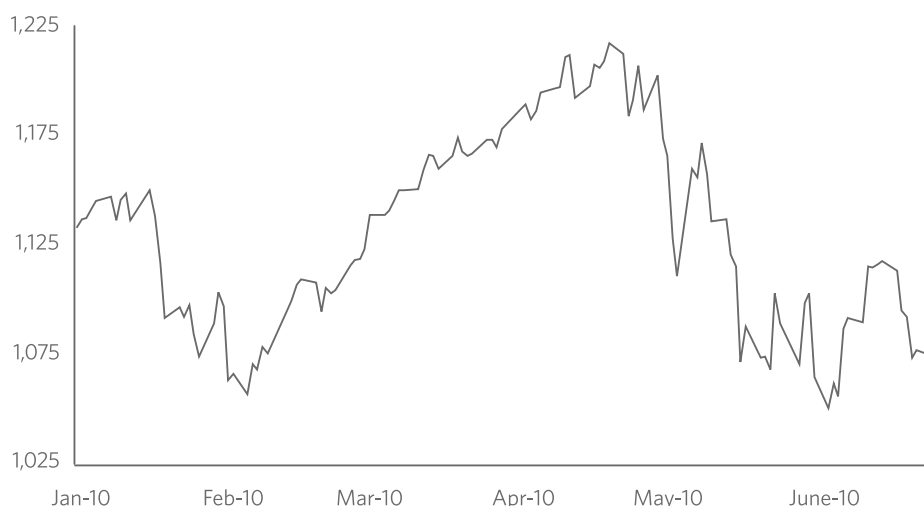
## The Cha-Cha Market

Rarely have we seen investors as conflicted and confused about the investing environment as witnessed today. An unusually wide divergence in expectations has contributed to the “one step forward, two steps back” environment that has been evident in global markets over the last few months. Some investors believe that countries such as Germany are right in adopting tighter policy and attempting to live within their means. Others are concerned that such measures are premature. Some investors fear that China has applied the brakes too hard and that its growth will turn negative. Everyone remains concerned about U.S. unemployment levels, consumer confidence, global spending and the acute difficulties small companies face. Judging by the yield drop in the domestic bond market, many investors also fear that the U.S., and possibly the world, may experience a double-dip recession.

These worries were amply evidenced by the much weaker than expected consumer confidence number released at the end of June. The chart below shows the S&P 500 year-to-date performance, which depicts market movement in steps that look more like the cha-cha than a conga line.

## S&P 500 Index

Year-to-Date Index Levels



As of 6/28/10. Source: Bloomberg LP

## Taxing and Axing

While not universal, many economists believe that the initial response to the financial crisis — dramatic interest rate cuts, fiscal stimulus and emergency liquidity to stabilize the financial system — helped the U.S. avoid a more severe and prolonged recession or depression. Economists differ greatly on what measures should be applied now. Some advocate that spending should be trimmed gradually to reduce

deficits while others believe that additional spending is necessary to sustain economic growth.

Governments are not waiting for the definitive answer. Taking a cue from Greece's struggles in returning to solvency (see "Scared Straight" in last month's *Update*), many countries are now implementing tax increases and spending cuts. While not every U.S. policymaker has this view, voters are becoming increasingly unsettled with the idea of further government spending. In his June 29, 2010 *Wall Street Journal* column titled "Greece Puts Democrats on the Skids," Gerald Seib connected Greece's meltdown with a shift toward fiscal conservatism in the U.S. He observes, "When voters were asked this month which attribute of a congressional candidate would make them enthusiastic about that candidate, support for cutting federal spending came out atop the list."

While it is still too early for concerted austerity in this fragile recovery, we believe that current spending and deficit trends are unsustainable. We cannot spend our way to prosperity. Deficit concerns have, so far, failed to increase Treasury bond yields as investors continue to fear economic slowdown. However, if this concern diminishes while government spending continues at its current pace, the outcome likely would be different. Also, a case can be made that a reduction in government spending could yield more private sector spending and investment, which would be a welcome development.

While ending global stimulus too early could risk a recessionary relapse, we believe that policymakers have learned from Japan's mistakes. The language in the preamble of last month's G20 final communiqué was encouraging:

Strengthening the recovery is key. To sustain recovery, we need to follow through on delivering existing stimulus plans, while working to create the conditions for robust private demand. At the same time, recent events highlight the importance of sustainable public finances and the need for our countries to put in place credible, properly phased and growth-friendly plans to deliver fiscal sustainability, differentiated for and tailored to national circumstances. Those countries with serious fiscal challenges need to accelerate the pace of consolidation. This should be combined with efforts to rebalance global demand to help ensure global growth continues on a sustainable path.

Hear, hear.

## When All the News Seems Bad

Even the most fervent optimist would acknowledge that we face many short- and long-term concerns and challenges. However, with the wounds of the financial crisis of 2008-2009 still so fresh, many investors appear far too ready to assume worst case scenarios. When every piece of news is interpreted as bad, sometimes only a small series of victories can turn the tide.

While we don't expect markets to suddenly spring back into strong rally mode, lost in the gloom are some signs that our expectations for modest recovery from a lower base will, in time, be met. Employment, while weak, shows signs of stabilization. Hours worked and use of temporary workers has risen. All of these factors frequently are precursors to broader employment increases. Due to the forward shift in demand from the tax incentives, housing will not be as robust over the next several months as in recent months. However, we believe that the combination of significant residential home price declines and very low mortgage rates should be enough to improve demand,

perhaps in the fall, after the effects from the tax credit expiration diminish. Also, we believe that economic growth in emerging markets, including China, likely will be more robust than currently feared. Finally, second quarter earnings reports should remain reasonably strong. While future earnings estimates likely will reflect the increased recognition of growth challenges faced by companies across the globe, due to market declines, forward P/E ratios have again dropped below 12.

While we do not see a near-term catalyst to drive markets higher, we believe that opportunities can be identified through selective stock picking. Many companies have considerable cash positions. Although they are very cautious in how they spend this cash, Vince Farrell of Soleil Securities reported that 39 of the top S&P 100 companies increased their dividends over the last 12 months. He noted that 22 of them now yield more than the 10-year Treasury. As companies and individuals regain some degree of confidence, these high levels of cash are likely to find better uses than sitting in cash accounts earning 0%.

Our hope is that time will reveal that most of our current fears will not be realized, allowing markets to gradually move higher upon recognition. Hopefully the summer months will be uneventful and offer some much needed respite. Here is to hoping we can all enjoy the lazy days of summer!



Christopher Sheldon  
Director of Investment Strategy