

Investment Update



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WEALTH MANAGEMENT

June 2009

What Now?

Normally, 60 days seems like such a short time. But over the last 60 days, the world appears to have shifted on its axis. Just two short months ago, the questions on investors' minds were: how bad? how deep? how long? how low? Dire predictions abounded. Six hundred on the S&P 500 loomed far closer than 1,000. Apocalyptic views of depression and nationalization were readily adopted. Predictions of any degree of market rise were sparse — and ridiculed.

During this challenging environment, we have attempted to provide context by using charts, for instance, that detailed historical stock market performance after prior market bottoms, market recoveries prior to economic troughs, historical performance subsequent to dismal ten-year periods and the importance of not selling at market bottoms. While important reminders and empirically sound, such charts undoubtedly can be viewed as arcane intellectual speculation and unrealistic. When all we hear from the media is that “it is different this time,” it is difficult to imagine any upside potential. Yet, now here we are within spitting distance of 1,000 on the S&P 500! The question has shifted from, “What’s next?” to, “Where do we go from here?”

In our April *Update*, we used the saying “less bad is the new good” to refer to economic data that, while still declining, was doing so at a slower rate. Indeed, the continuation of this trend has fueled the market rally and reduced the degree of risk aversion investors exhibited in early March.

The April employment report is a good example of this trend. A number that, in more normal times, would have been viewed as bleak was met with sighs of relief. Who would have predicted a year ago that “merely” 539,000 jobs lost would be perceived as good news? Numerous other green shoots have taken hold and seem less likely to wither. Not only does the massive global stimulus appear to be working, but it may be working sooner than most economists and investors expected. Signs of diminishing negative economic forces, combined with improved functioning in the credit markets, have greatly reduced the appeal of the fear trade. Many of the asset classes that benefited from the flight to safety have underperformed in recent months, as investors have moved away from a maximum defensive position. As investors embraced some increase in portfolio risk, higher beta asset classes such as equities have benefited, while Treasury bond prices have declined with rising yields. At the same time, spreads have narrowed in municipal and high yield bonds and in other credit instruments at the cost of a fairly significant rise in Treasury yields.

Among fixed income investments, we continue to rate municipal bonds and investment grade taxable bonds as more attractive than cash and Treasury securities. With the recent rise in yields, Treasuries are much less overvalued than at the beginning of the year (when we suggested an underweight in favor of TIPs and high-grade corporate bonds). While near-term yields may stabilize close to current levels, we believe that they likely will move higher over the next several years. A looming increase in issuance, improving economic growth and possible future inflation, combined with a larger deficit and weaker dollar, may put further upward pressure on rates.

What should investors who find themselves with too much cash and too little equity exposure do now? From a short-term perspective, it may be wise to exercise a degree of patience. Markets now better reflect the improved conditions we have described. Consolidation of recent gains in equities and a modest pullback would not be surprising. Enduring frequent moderate corrections is a necessary part of long-term investing. We think it is unlikely that markets will continue to rise at the pace we have seen since early March. Over the short run, markets could be susceptible to an interruption in the “green shoots” improvements that have been occurring or to other major market events.

While equities typically move higher in anticipation of recovery, significant further short-term gains will require more investors to become convinced that the trend toward recovery will remain intact. Considerable cash remains on the sidelines. Better economic news and higher stock prices make it increasingly difficult for investors to justify maintaining significant cash positions in light of very low cash yields. Eventually, economic conditions will need to actually turn good, as opposed to less bad, to drive markets higher.

For long-term investors, we continue to believe that stocks will provide more attractive returns over the next ten years compared to the prior ten-year experience. Valuations remain attractive for equities, especially compared to other investment alternatives. Investors who are underweight in equities should consider rebalancing to their long-term targets and to our current strategic asset allocation recommendations.

Two central themes in our current thinking have been that (1) investors had become too risk averse in their (understandable) flight to safety; and (2) while valid in the short run, deflation fears were not likely to be realized over a multi-year period. Our view has placed a greater emphasis on the potential for future inflation and the collective costs and impacts of the massive fiscal and monetary stimulus programs. As a result, we have begun increasing our recommended allocation toward asset classes that may provide protection against possible future inflation or that may benefit as investors continue to demonstrate a willingness to take on modestly higher levels of portfolio risk.

We increased our suggested allocation to emerging market equities and commodities in March, based on early signs that many of the emerging countries, especially China, may benefit from local stimulus programs. Unlike past episodes, we believe that emerging economies actually may lead world recovery. After last year's precipitous declines, we have been encouraged by the very strong run in emerging markets and the recent firming in commodity prices. Given these run-ups, a pause is plausible, but we see attractive current valuations and a compelling longer-term fundamental investment case.

The recent market experience is fresh in investors' minds. Fortunately we endure such dramatic market conditions very infrequently. While the temptation to remain extremely defensive in portfolio positioning is great, the cost in terms of lower expected returns is very high. Short-term interest rates remain low. Therefore, the "cost" of safety remains high. We think investors will be better served by a diversified portfolio that balances the need to offer some degree of protection against extreme short-term declines, similar to those of 2008, with their long-term need to have some exposure to risky assets. While protection against significant portfolio deterioration is a vital portfolio goal, offsetting potential loss of purchasing power due to inflation also should be considered.

A handwritten signature in black ink, appearing to read "Chris Sheldon". The signature is fluid and cursive, with a long horizontal stroke at the end.

Christopher Sheldon
Director of Investment Strategy