

Investment Update



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WEALTH MANAGEMENT

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Able Was I Ere I Saw Elba

A palindrome is a word or phrase that can be read the same way in either direction. A word derived from Greek roots, perhaps the most famous palindrome is one attributed to Napoleon Bonaparte in describing his 300-day sojourn on the Italian island of Elba: "Able was I ere I saw Elba." The recent phase of the financial crisis also stems from Greek and Mediterranean roots.

Prior to the onset of the European crisis, global growth was improving. Now, investors are questioning whether events in Europe will derail this positive momentum. Clearly, the situation has significantly deteriorated over the last month. Investors have become increasingly concerned about the possibility of contagion to other European countries such as Spain, Portugal and Italy, where debt issuance also has risen significantly since the euro's inception.

In Wolfgang Münchau's May 24 *Financial Times* article, he noted, "Before the start of monetary union in 1999, EU countries borrowed at different interest rates, the spreads reflecting expectations about future exchange rate alignments and default probabilities. With the arrival of the euro, spreads almost disappeared. Just as subprime CDOs enjoyed triple A ratings because of the way they were constructed, the entire eurozone enjoyed a triple A rating on the back of Germany's." Greece, Portugal, and Spain capitalized on this, becoming heavy borrowers, which ultimately led to the current unsustainable debt levels.

The unwinding and reduction of this profligacy will be prolonged and painful, and likely will reduce global growth to some degree. However, we do not believe that world economic growth will be completely derailed. Despite the challenges from necessary fiscal restraints, we continue to expect that the U.S. economy will grow between 3 and 4 percent into 2011. Other areas of the emerging world, especially Asia, are likely to grow even more rapidly.

In last month's *Update* we said, "At this juncture, the main risk to equities is the weight of their prior success. As stock prices have increased, investor sentiment has climbed. It will be more difficult to engender

positive surprises from this point forward. In fact, based on historical comparisons of previous market advances, a correction would not be unprecedented. Even a modest reduction in the desire to hold riskier assets could precipitate such a correction. No shortage of worries exists in the minds of investors today; a prime example is the situation with Greece and the EU."

While we felt that a correction was certainly possible, the magnitude of the decline has been larger than what we expected over such a short period of time. Investors' abrupt shift towards risk aversion, coupled with their reassessment of the degree to which they were positioned for strong economic growth and expected inflation, contributed to the recent market drop.

The potential impact of current issues likely will take at least several months to manifest. For this reason, unless investors become convinced that they have overly "de-risked" their portfolios, an alternative near-term catalyst to move markets higher may not exist. However, because of last month's market decline, valuations again are on the attractive side and sentiment no longer is complacent.

U.S. economic data continues to paint a picture of sustainable, albeit modestly paced, recovery. Because we do not believe that global growth has been derailed by the European crisis, we view the recent market decline as a correction within an ongoing bull market. Therefore, although weathering the storm is never an enjoyable experience, our recommendation is that most investors should maintain their current allocations.

While we recognize that many investors remain quite sensitive to losses experienced in 2008 and 2009, we do not believe that wholesale changes to our current investment strategy recommendations are necessary. The only exception might be in the context of reconsidering overall portfolio goals. Despite the correction, asset values remain significantly above the early 2009 lows. For investors who realize that their goals or risk profile has changed, now may be an advantageous time for portfolio repositioning.

Scared Straight

Politicians around the world have accommodated their electorates' insatiable demand for entitlements by issuing debt. For many years, this debt use has delayed the day of reckoning. For Greece, the future has come knocking. Investor confidence has become a fragile thread.

As the European commission dithered, this thread frayed. Bond buyers have suddenly woken up to the fact that not all European Union debt is created equal. Investors are no longer willing to award the same low yield to each country in the European Union. Rates are higher in Greece today compared to several months ago and rates of other European countries with low economic growth and high debt levels also have risen considerably. How could there possibly be a silver lining in this?

First, the problem now is recognized as global and imminent. Investors are unlikely to become lackadaisical about debt levels again. Bond investors will punish governments that do not initiate appropriate measures to reduce deficits. Already, several European governments have announced self-imposed measures to extend retirement ages. Even in the U.S., where the negative impact from high structural deficits is years rather than months in the future, we think that there will be an increased demand for progress in addressing structural deficits.

Second, austerity is a necessary precondition of future prosperity. If the world continues to ignore the rising deficits, a subsequent crisis likely will result down the road. We are relieved that this issue has become increasingly clear. While the large increases in government expenditures were major factors in avoiding a financial depression, such spending level cannot be permanently sustained.

With so many negative developments around the world, it is easy to surrender to fear and uncertainty. Everything seems like bad news. It is hard to feel good when we have an ongoing ecological disaster that we cannot seem to stop. While we are not taking the current global financial situation lightly, we see the potential over time for positive outcomes to develop. The U.S. has a bright future if the right risk policy changes are made. Reining in government spending would be a positive development for long-term economic health. As governments across the world, including the U.S., employ tighter fiscal policies, central banks will remain more accommodative, allowing lower rates for far longer than they otherwise could. This tight fiscal policy, combined with an accommodative monetary policy, may be beneficial for financial asset prices.



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