

Impact from Recent Turmoil: A Macroeconomic Outlook

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EXECUTIVE SUMMARY

Mellon Capital's Global Investment Strategist Jonathan Xiong comments on the market turmoil in August and argues that investors were reacting more to deteriorating macroeconomic conditions in the U.S. and Europe than the actual Standard & Poor's downgrade of long-term U.S. government credit. He says that Mellon Capital's proprietary growth models show a likely drop in U.S. GDP growth but not into negative territory over the next 12 months. He also discusses growth prospects for the rest of the world as well as for equity and credit markets. Mellon Capital's greatest concern, he says, is focused on Europe's sovereign debt problems, pointing out that a full-fledged financial crisis in Europe could alter their current forecasts for the U.S.

A never-before-imagined U.S. sovereign debt downgrade, a deteriorating U.S. economic recovery, political brinkmanship in Washington, and a spreading European sovereign crisis collided in early August to form a potent financial storm. The weeks leading up to the Standard & Poor's downgrade of long-term U.S. government credit and the immediate aftermath provided an uneasy sense of déjà vu, as market conditions evoked memories of 2008 for investors. Correlations spiked among higher-risk asset classes. Sovereign debt rallied, even in light of a possible downgrade of "risk-free" assets. The sell-first-ask-questions-later mentality came to the fore as capital markets displayed signs of extreme stress. Against that background, we attempt to provide some clarity around the recent economic uncertainty and capital market conditions. In particular, we focus on our macroeconomic outlook. For more on the details of the U.S. debt downgrade, please see our recent commentary¹.

MACRO OUTLOOK

In our opinion, the recent market volatility has been driven more by the deterioration of economic fundamentals than the U.S. debt ceiling uncertainty or credit downgrade. *Figures 1 and 2* show the Institute of Supply Management (ISM) manufacturing survey index and our proprietary Global Leading Economic Indicators (designed to indicate global economic expansion or contraction), respectively, which both suggest that softer economic conditions began well before the debt ceiling talks or the downgrade.

¹ Lowell J. Bennett, "Understanding and Responding to the Debt Ceiling Debate," Mellon Capital Corporation, August 2011, <http://www.mcm.com/core/insights/publications/publications.html>

Figure 1: ISM Manufacturing Survey Index
January 2010 to July 2011

Data Source: Bloomberg

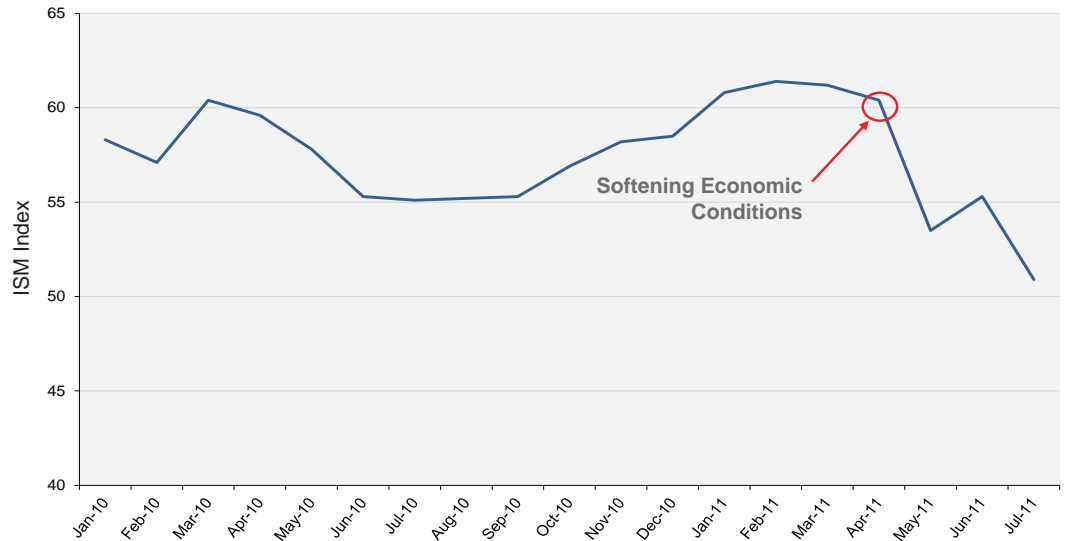
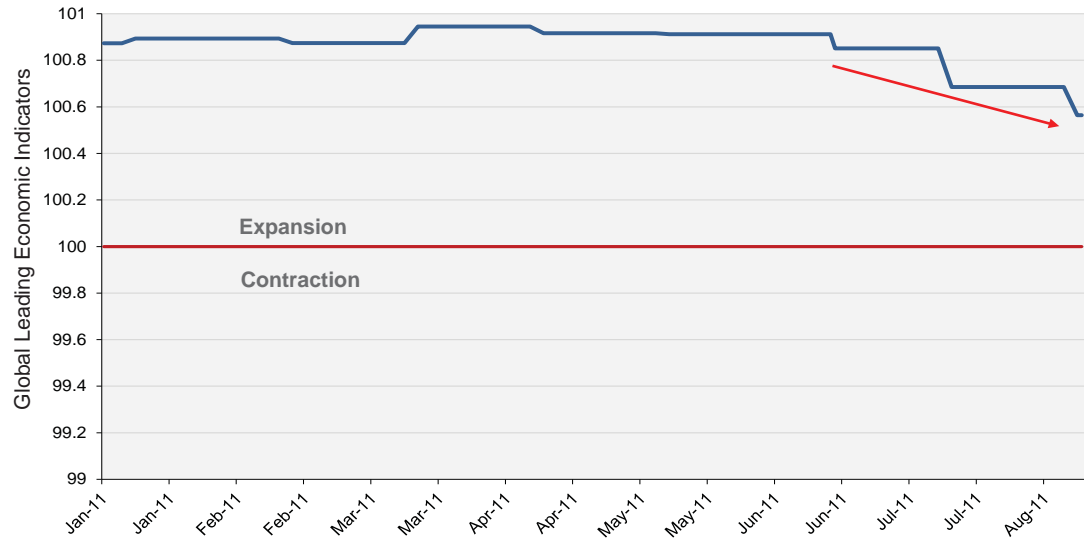


Figure 2: Global Leading Economic Indicators
January 2011 to August 2011

Data Source: Mellon Capital

A Leading Economic Indicator of less than 100 would reflect contraction according to our models.

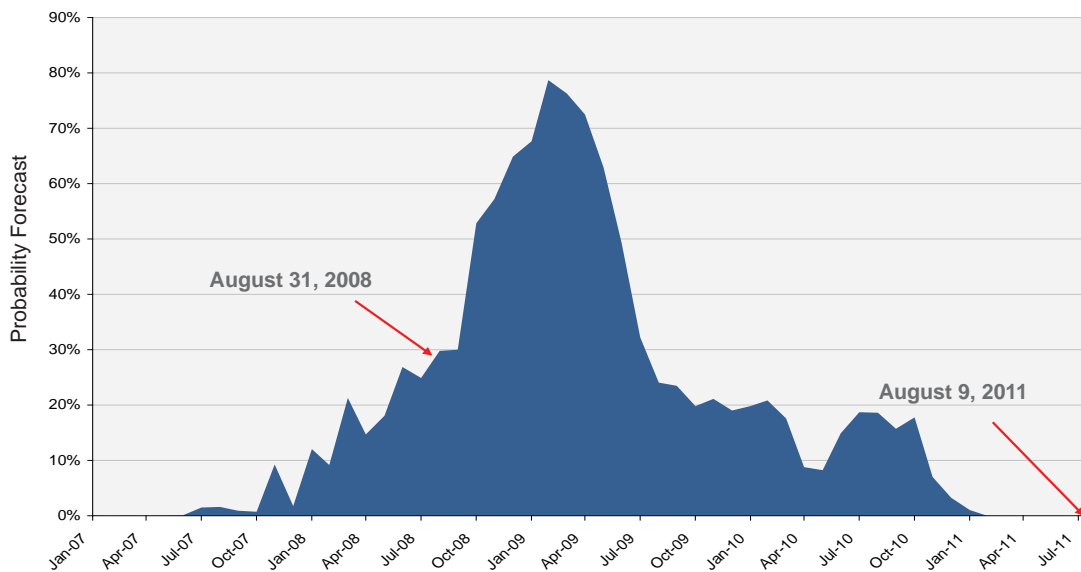


However, political wrangling, coupled with the U.S. downgrade, led to further deterioration in the economic outlook. The political uncertainty that began in July may have resulted in a pause in economic activity, as many businesses opted to wait for a resolution. We believe the August 2nd confirmation of austerity plans in the U.S. might reduce expectations of economic growth, as the government attempts to rein in spending. Similar to the economic events of the Great Depression, balancing the budget in such a weak economic environment can have a harmful effect on economic growth. The establishment of a debt panel charged with finding \$1.5 trillion in additional budget savings, in our view, creates still more uncertainty for business leaders and taxpayers.

Our proprietary macroeconomic model suggests that growth in the U.S. will decline from 3.1% in June to 2.0% over the next 12 months. There is an 8% probability that growth may fall into the range of 0%-1%. The reduction in our forecasts is due in large part to the impact of policy uncertainty on fundamentals during a soft patch. On the bright side, our forecasts exhibit 0% probability that U.S. GDP growth in the next 12 months will be negative. This is a very different scenario than August of 2008, where probabilities for negative GDP growth rose to 30% before the Lehman failure. Please see *Figure 3*.

Figure 3: Probability Forecast of Negative U.S. GDP Growth 12 Months Forward January 2007 to August 2011

Data Source: Mellon Capital



In conjunction with what we view as a weakening macroeconomic outlook, we expect corporate earnings in the U.S. to be affected as well. We expect the S&P 500® earnings growth rate for the next 12 months to be approximately 6.8%, far below the consensus earnings forecast of 14.1%. *Figure 4* shows that, since March of 2011, our proprietary earnings forecast model has projected earnings growth to be below consensus expectations as a result of slowing macroeconomic conditions. Although we forecast earnings to grow at only half the pace of consensus expectations, we do not expect negative earnings growth, even if U.S. GDP growth falls to 0%. Many S&P 500 companies derive substantial earnings outside the U.S., with a significant exposure to developing economies with strong growth expectations (*Figure 5 next page*).

Figure 4: S&P 500® Earnings Growth Forecast 12 Months Forward March 2011 to August 2011

Data Source: IBES, Thomson Reuters Datastream, Mellon Capital

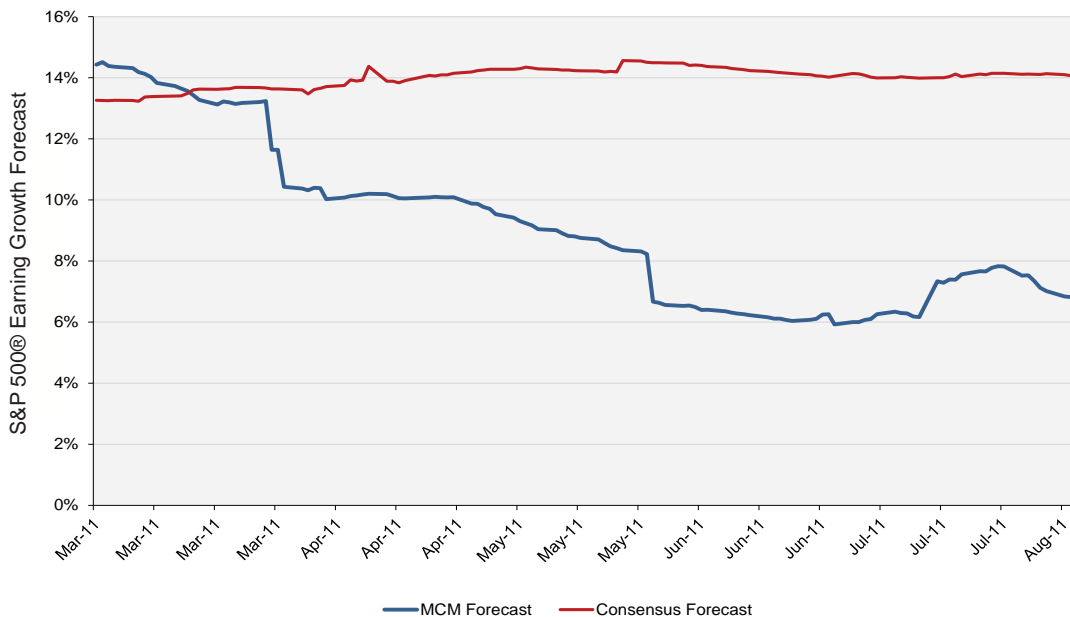
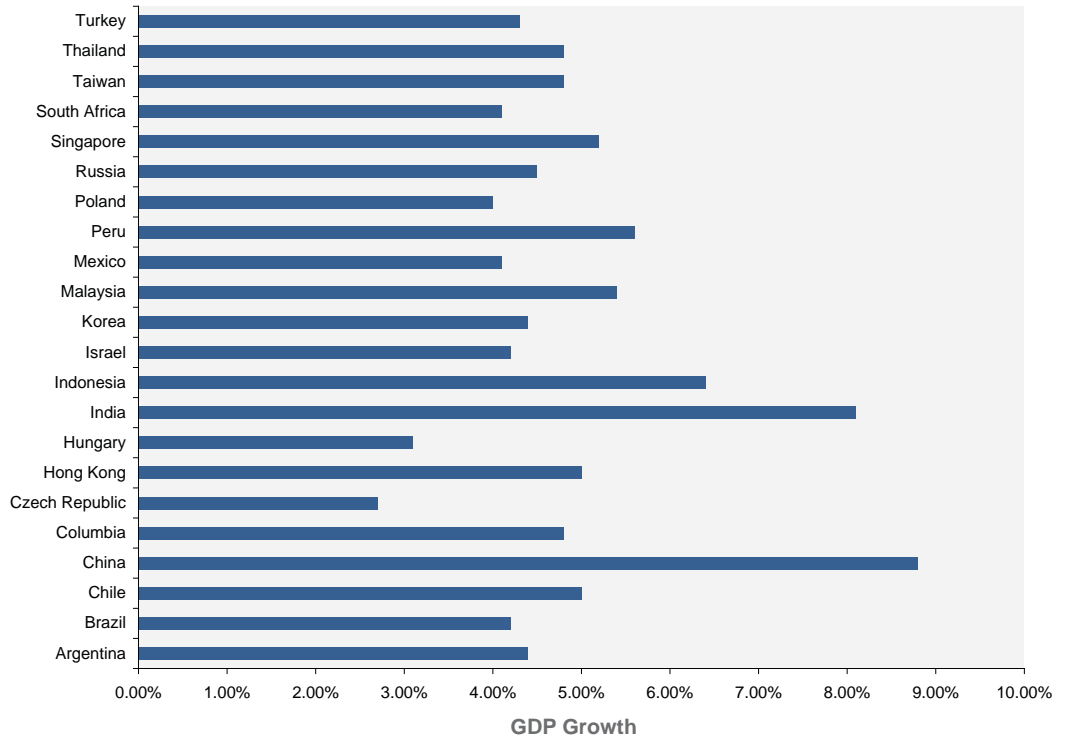


Figure 5: Emerging Economies' GDP Growth Forecast 12 Months Forward As of August 10, 2011

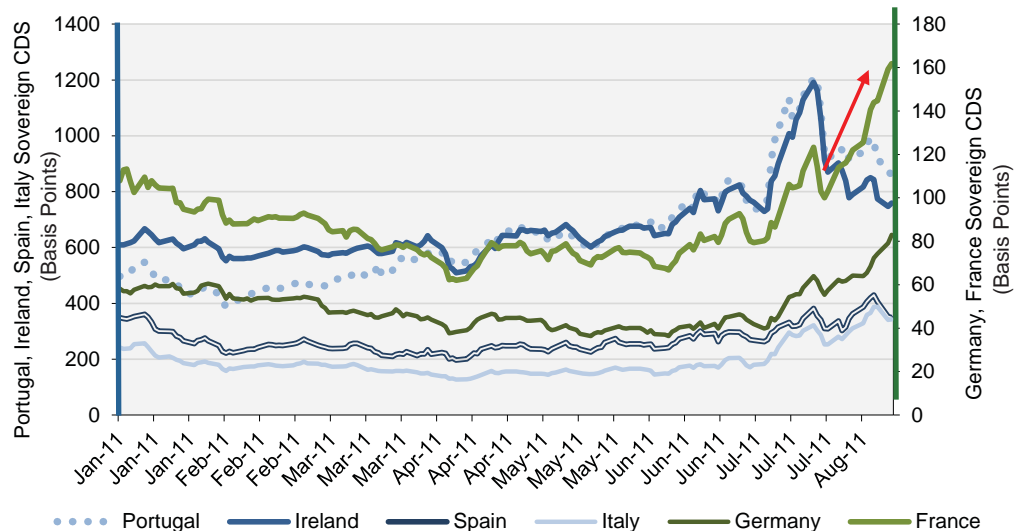
Data Source: Consensus Economics



Across the Atlantic, we believe the economic conditions are similar to the U.S., if not worse. As U.S. debt was being downgraded, the European Union was attempting to contain a debt problem that has spread from smaller EU countries to the larger economies of Italy and Spain. Sovereign credit default swap (CDS) spreads for both countries have widened significantly since June. As Germany is seen as the pillar of strength in the euro area, investors have piled into the country's sovereign debt as a safe haven from other euro area country's bonds. We believe the sovereign crisis in the euro area represents a much larger and more complicated structural issue than the U.S. debt downgrade or austerity plans. The underlying foundation of the European Union is coming under pressure as the European Central Bank (ECB), International Monetary Fund, and EU officials have so far failed to contain investors' pessimism. More troubling, there are indications that concerns have now spread to France and the health of its banks. As shown in *Figure 6* next page, credit default swap spreads in France have recently widened to 160 basis points from 100 basis points, whereas credit default swap spreads in Portugal, Ireland, Spain, and Italy have tightened.

Figure 6: Eurozone Sovereign CDS Spreads

Data Source: Bloomberg



The recent actions by ECB to purchase bonds in Italy and Spain seem to have eased short-term uncertainty. Similar to Greece in 2010, we do not believe this approach offers a long-term solution to resolving the sovereign debt issues in Europe. Even after nearly one year of dealing with Greece, European Union leaders have done little to resolve their constituents' debt problems. Markets recognize this, and will likely continue to put pressure on EU officials for a long-term solution. The austerity measures that the ECB and the EU have asked for in return for financial support for Portugal, Ireland, Greece, Spain and Italy will indeed, in our view, lower growth expectations for Europe. We believe much of this has been built into expectations. Our biggest worry continues to be the lack of a long-term solution, which may result in a prolonged period of uncertainty that ultimately ends with the restructuring of the sovereign debt in certain peripheral nations.

CONCLUSION

Macroeconomic conditions in the U.S. and Europe were deteriorating well before the debt ceiling or downgrade. In our opinion, the uncertainty surrounding government policies led to a further worsening of fundamentals. The slowdown in U.S. economic growth is less worrisome than the European sovereign debt crisis. We see little to no chance of negative growth in the next 12 months in the United States. However, the deteriorating conditions in the Eurozone, which most recently have spread to France and French banks, may ultimately create havoc in the financial markets. The ECB, IMF, and EU have yet to come to a long-term solution, opting only for short-term patches in hopes of austerity measures that would lessen pressure on their region's sovereign debt. In case of a full-fledged financial crisis in Europe, our forecast for the U.S. may be altered.

Index Definitions

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market-value-weighted index (stock price times number of shares outstanding), with each stock's weight in the index proportionate to its value. The index is one of the most widely used benchmarks of U.S. equity performance.

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