



Economic Update

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Our outlook is unchanged. We expect that (1) depression will be avoided, (2) the financial crisis will continue to ease, (3) America's longest and deepest Postwar recession will end near mid-2009, (4) the rate of growth in the subsequent expansion will be subpar, reflecting a mix of a strong inventory cycle and weak growth in final demand and (5) there will be a persistently high unemployment rate over the next several years.

There were some risks a few months ago that depression was a conceivable scenario, but we believe that is no longer true. We believe that the basic reason that the depression risk has passed is that policymakers, especially in the two key G2 countries (the U.S. and China), were quickly correct in diagnosing the debt deflation risks and prescribing and implementing monetary and fiscal policies to reduce these risks. In our view, the Great Recession will be the longest and deepest of the Postwar recessions, but not worse than that.

The financial crisis has begun to ease. The initial improvements were in markets benefiting directly from government or central bank support (bank funding markets, conventional mortgages, A1/P1 commercial paper). More recently, there have been substantial improvements in unsupported at-risk markets (investment grade corporate bonds, high yield bonds, jumbo mortgages, A2/P2 commercial paper, volatility). Risk spreads are off their peak levels in nearly all markets. We regard this broad pattern as providing clear evidence that risk aversion is easing. In our opinion, the financial panic has crested and the economy and markets have transitioned into a phase of orderly deleveraging.

We continue to expect the longest and deepest U.S. recession of the Postwar era to end near mid-2009 as inventory liquidation eases in the aftermath of the shutdown of many domestic auto plants. The inventory cycle is one key to our outlook. Inventory

liquidations tend to be unstoppable when they are underway but have always proved temporary. We believe that it is clear that the pace of intense inventory liquidation in the first half of 2009 is unsustainable. As usual in the early recovery, the large reduction in inventory liquidation should contribute to the transition from declining economic activity to rising economic activity. Already, purchasing manager indices (PMIs) are rising from their cyclical lows all across the world. We expect this pattern to persist, since the inventory liquidation has been excessive and final demand is beginning to stabilize.

In the U.S., front-end sectors as autos and residential construction have reached such depressed levels that some rise is likely from mid-2009 to year-end 2009 and continuing through 2010. However, late cycle sectors vulnerable to the large excesses in global and domestic productive capacity, such as private non-residential construction and capital spending, should remain weak.

There has been a clear historical pattern that the sharpest recessions have been followed by the strongest rebounds. The classic cyclical precedent after such a severe recession would call for an initial growth rate of 6% or more in the early recovery. However, we do not believe this will occur this cycle. Instead, we expect a rebound at roughly half that pace. We do expect a powerful V-shaped inventory cycle, but the recovery of final demand should be hesitant. Consumer net worth has been reduced by the reversion of house prices from the bubble highs to levels more consistent with normal house-price-to-income and house-price-to-rent ratios. The drag of a negative wealth effect and gradual deleveraging should persist during the economic expansion.

Some analysts argue that the savings rate will continue to shift dramatically higher. We think that further increases may be more muted than is currently

expected by many economic pessimists. We believe that (1) consumers will desire to raise their savings rates, (2) it is advisable that they succeed in doing so and (3) there are likely to be adverse long-term consequences if they don't. Nonetheless, we don't expect that much more of an increase. Income growth may prove so sluggish that they prove unable to achieve their savings objectives. Interest rates are low and many dividends have been cut or eliminated, creating an income challenge for many, especially those who are retired. In addition, wage inflation is on a decelerating trend, creating another challenge for income growth. The drop in consumer spending in the last two quarters of 2008 was extreme and we expect a gradual transition to expansion from the new depressed level. The reported savings rate has already increased about 400 basis points from about zero to about 4%. Since debt increases are a form of negative saving, the disruption of consumer and mortgage credit growth has contributed to this rise in the savings rate. We expect that the availability of auto credit and mortgage credit will gradually ease over the next year, permitting a moderate increase in credit growth. Current fiscal policy is using deficit financing to shift income to those consumers with a high propensity to consume all or most of their available income. American consumers do not always do what they should do. They should substantially raise their rate of savings out of current income, but we are skeptical whether they will actually increase it much more than they already have. We believe that a savings rate close to 5% or 6% is more likely than the 10% anticipated by some of the economic pessimists.

There has been some talk that after the benefits of current stimulus wear off, there could be a double-dip recession such as occurred in 1981-1982. We feel that this is unlikely. The context in the early 1980s was that the Fed was fighting a multi-decade trend of rising inflation. Credit card controls were imposed in early 1980. The economy contracted, the Fed eased and the economy recovered. Because inflation remained high and the Fed had not completed its struggle against inflation, the Federal Reserve aggressively tightened monetary policy in 1981 in order to drive the economy back into a disinflationary recession, which did occur. In contrast, the Fed today has a policy of fighting deflation risks and thus is likely to retain its easy policy for an extended period

of time. Since a major premature tightening from the Fed is unlikely, we expect no double dip.

In the great debate about deflation risk and inflation risk, we agree with the FOMC: "the Committee sees some risks that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term." Our expectation is that the massive global excess supply of labor and productive capacity will contribute to downward pressures on wage inflation and price inflation. The inflationist argument is that rapid money supply growth ensures a major upsurge in inflation. We are less convinced. There has been a downtrend in velocity (ratio of nominal GDP to money supply). As financial innovation has gone into reverse with the meltdown of the shadow banking system, strong money supply growth is not yet generating a quick rebound in nominal GDP growth. Whether today's monetary growth will generate a major acceleration of inflation in three or four years will depend on the independence and judgment of the central bank in the intervening years in withdrawing liquidity as the financial system normalizes. Over the next year or two, however, inflationary pressures should be negligible. In the early phases of demand reflation, productivity growth tends to be quite rapid as the production rebound can be accommodated more by mobilizing underutilized resources than by adding productive capacity or new workers. Inflation is almost always low in the early reflation phase of the cycle.

What is the outlook for interest rates? We expect that the Fed will hold the Federal funds rate near zero at least until mid-2010. Longer term Treasury rates have started to drift higher as the perceived risk of depression has dropped. We believe that this is appropriate. Taxable ten-year Treasury yields near 2% only make sense to us if there is a substantial risk of a deflationary depression. We believe that the drop of nearly 1400 basis points in the yield on ten-year Treasury bonds from the secular peak of 16% in 1981 to the recent low near 2% completes the 28-year secular bull market in Treasury bonds. For a number of recent years, ten-year Treasury yields have cycled around 4.25%, consistent with long-term inflation expectations in the 2% to 2.5% range. We would expect this to continue over the next ten years. In the

near term, however, the economy is depressed, inflation is negligible and the Fed funds rate is zero. In that context, the level of ten-year yields should remain cyclically depressed for the next year. But we believe that the cyclical and secular lows in Treasury yields have already been seen.

What about the outlook for the dollar? Many observers were shocked by the strong rally in the dollar as foreign economies and interest rates followed the U.S. economy and interest rates down. The financial crisis contributed to the dollar rally both

because of the repatriation of risky assets and because the world banking system funds in dollars and found itself effectively short dollars. The dollar has weakened somewhat as the financial crisis has eased, which we believe is appropriate. However, our longer term expectation for the dollar is more neutral. The current account deficit has been cut in half and the U.S. economy should be among the first of the industrial economies to come out of recession. We are not supportive of any extreme views on the dollar in the current context.



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