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Economic Update

Richard B. Hoey
Chief Economist, BNY Mellon



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We expect a sustained global expansion at a real GDP growth rate of 4% to 4.5% for both 2010 and 2011, with financially strong countries leading and “debt hangover” countries growing more tentatively. We continue to expect the U.S. economy to grow at about a 3% to 4% pace in 2010 and 2011. The financial crisis and recession generated a downside synchronization of the world’s economies and now the resulting policy stimulus has generated an upside synchronization of the world’s economies. The dramatic upward shift in the economic consensus over the last year is illustrated by the rise in IMF forecasts in its World Economic Outlook between the April 2009 issue and the April 2010 issue, with the estimates for real GDP growth in 2010 rising from 1.9% to 4.2% for the world economy, rising from 4.0% to 6.3% for the emerging and developing economies and rising from zero to 3.1% for the U.S. economy.

The strongest economies in 2010 and 2011 should be those with three characteristics: (1) public policy which places the highest priority on economic growth relative to other objectives, (2) no significant debt overhang and (3) rising productivity of the workforce due to the diffusion of modern technology and business practices. This would include some of the largest emerging market countries. Economic policy remains stimulative in most major

emerging market countries. We expect strong growth to persist in such large emerging market countries as China, India, Brazil and Indonesia.

We believe that there are five cyclical stages of monetary policy (aggressively stimulative, stimulative, neutral, restrictive, aggressively restrictive). The stages can be identified by reference to a variety of measures, such as the yield curve, money and credit growth, real interest rates (interest rates minus inflation), deviations from the natural rate of interest (interest rates minus the growth rate of current dollar GDP). We believe that nearly all countries in the world are currently in the first or second stages of monetary policy: aggressively stimulative or stimulative.

The normal cyclical sequence is (1) monetary stimulus, (2) deflation of demand, (3) consumer price inflation. This process takes some time. It is common for inflation to remain relatively low in the early phases of cyclical expansion in a lagged response to the excess capacity created in the prior recession. As a result, policy can remain accommodative, sustaining economic expansion. Currently, the accommodative stance of economic policy worldwide is providing powerful support for sustained global expansion.

However, there is a distinction between most of the developed world and the major emerging market economies. There was a severe recession in most developed countries, so they still have substantial excess capacity at such an early phase of the cycle. In contrast, many of the major emerging countries did not experience a major debt shock or a severe and prolonged recession. While relatively easy monetary policy is still appropriate in the developed economies, major emerging countries have a greater logic for substantially reducing the degree of their stimulus to prevent overheating and potential asset bubbles. This is especially true where their currencies are fundamentally undervalued. We expect most major emerging market countries to raise their interest rates more quickly, but not to a degree which would threaten their continued economic expansion.

We disagree with the pessimistic theses of both the inflationists and the deflationists. Six key aspects of the inflation outlook are (1) the commodity supercycle thesis, (2) the money growth perspective, (3) the output gap perspective, (4) the inflation expectations perspective, (5) the public opinion/political perspective, and (6) the currency perspective. Now that commodity prices have shifted substantially higher, we expect energy prices and other commodity prices to be in a neutral to slightly positive phase in the near term. The supply/demand balance appears adequate at this phase of the cycle, barring a major military incident in the Middle East. Inflation pessimists expect a major acceleration of inflation in future years in response to the rapid acceleration of reserve growth, which has occurred in response to the financial crisis. However, these large increases are not being mobilized quickly into debt-financed spending given the combination of a reluctance to borrow and a reluctance to lend. Supply/demand pressures for a major inflation acceleration are weak due to a major output gap with an excess supply of both productive capacity and labor. The supply of low-priced exports from emerging countries persists. Their government policies support further increases in productive capacity while their modern labor force

expands as low-skilled labor is upgraded and trained. This process should reinforce a low inflation outlook in the developed world. Long-term inflation expectations have only risen back into the normal range and we believe that a major upsurge is unlikely. Inflation concerns linked to fears of a weak dollar against other reserve currencies have calmed substantially. With the U.S. likely to have a stronger economic recovery than most other developed countries, the multiyear dollar downtrend against other reserve currencies is probably over. What about public opinion? A longer-term concern is that recent economic pain has come more from asset deflation than consumer price inflation. As a result, public support for anti-inflationary policies may not be that robust. Fortunately, the worst fears about threats to the Fed's quasi-independence have not come to pass, so the policy flexibility to shift in the future to an anti-inflationary policy is intact.

What about the fears of the debt deflationists? In our opinion, the U.S. has already moved into an orderly phase of deleveraging of private sector debt. Current dollar GDP growth (real growth plus inflation) should average near 5% per annum over a period of years. Ratios of private sector debt to GDP and consumer debt to net worth can gradually normalize over a period of years without disrupting the economic expansion as both current-dollar GDP and net worth continue to rise. Some of this deleveraging is automatic as scheduled debt amortization reduces debt in an orderly way.

China adopted a hyperstimulative policy more than a year ago. It worked. The Chinese boom over the last year helped pull the global economy out of the worst recession since the Great Depression. Policy in China is now becoming somewhat less stimulative but we still expect Chinese economic real growth to run at or near 10% in the near term. At some point over the coming months, the policy shift in China may include the onset of gradual revaluation of the RMB against the U.S. dollar as such a policy shift is likely to become increasingly appropriate in response to Chinese economic fundamentals.

We believe that pessimistic analogies of the current Chinese property boom to the recent housing bubble/bust pattern in the advanced countries are overstated. What is similar is the aggressively stimulative stance of macroeconomic policy in an expanding economy with sharply rising property prices. In the U.S., however, consumers who were already heavily indebted raised their spending despite weak income growth by borrowing against rises in the value of housing collateral. Some of the major fundamentals in China are quite different: the consumer debt burden is much lower, real incomes are rising rapidly and increased demand for residential square footage reflects a rapidly rising standard of living.

We believe that the key fundamental driver of the Chinese economic expansion is not rising leverage in a property boom, but rather the combination of stimulative macroeconomic policy and a powerful rise in the productivity of its labor force. We expect sustained expansion in the Chinese economy. Some year-over-year growth rates may drop as the surge of rapid growth in the spring of 2009 falls out of the calculation of reported growth rates. Neither a normalization of the stimulative monetary policy nor the onset of gradual upward revaluation of the RMB is likely to be big enough to stifle the expansion any time soon. Instead, the main risk is that policy tightening will occur too slowly, failing to cool the overheated economy soon enough to stabilize the long-term outlook. We believe that it is ambiguous whether or not some markets have overdiscounted the prospects of exceptional near-term growth in China, but we believe that the Chinese expansion will prove sustainable.

In Europe, the recent recession has surfaced underlying vulnerabilities. In the early years of the euro, countries in the periphery benefited from low interest rates due to a form of "borrowed credibility" from their association with core Europe, especially Germany. Periphery countries have tended to have somewhat higher inflation rates than Germany, so the real policy rate (short-term interest rate minus inflation) was lower in these countries. This

temporarily stimulated their growth, but there was a cumulative loss of competitiveness.

In recent years, these countries have been sovereign borrowers in the euro, not in their own historic currencies. As a result of the accumulated debt which is denominated in the euro, devaluing out of the euro would now be a very disruptive path, both for these countries and for the countries whose banks own a great deal of their debt. While it is conceivable that European rescue efforts could fail, we believe a more likely scenario is that the weaker countries will be forced to pursue a restrained fiscal policy in order to be eligible for financial support.

Europe should have somewhat slower growth than most other industrial countries for an extended period of time, although the weak euro should help support the export sector of the major exporters, notably Germany. Europe was expected to be a laggard in the global economic recovery in any case, even before the recent strains, so the negative impact on the global expansion should be limited unless financial contagion worsens substantially.

The U.S. should have the strongest recovery among the major industrial countries, leaving aside some of the commodity countries. The U.S. economic recovery should be "above-trend but below-normal." Relative to a normal recovery in the first four quarters after a severe recession, U.S. economic growth should be somewhat "subpar" at a real GDP growth rate of 3% to 4%, well below the growth rate of 8% or more which would be normal after such a severe recession. However, U.S. economic growth should also be "above trend," with growth higher than long-term trend growth near 2.5%. The U.S. economy bottomed in mid-2009. The labor market initially lagged the recovery, but we believe that U.S. employment has just bottomed and should now show sustainable positive growth, even excluding the coming surge of temporary Census jobs. We are convinced that the cyclical turn in the labor market has occurred.

Pessimistic forecasts of a dramatic rise in the personal savings rate in the U.S. have not proved correct. We continue to think that any upward shift in the personal savings rate may be much more muted than has been expected by many economic pessimists. We believe that (1) consumers will desire to raise their savings rate, (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 of an increase. Income growth is improving but growth should prove moderate enough that households may struggle 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. Wage inflation is on a decelerating trend, creating another challenge for income growth. The coming tax increases are focused on taxpayers who have a relatively high propensity to save, so some of the increased tax proceeds may reduce personal savings. Government income support, both direct and indirect, has tended to flow to those who spend all or nearly all of their income. Neither monetary policy nor fiscal policy is supportive of higher personal saving in the U.S.

The Great Recession occurred when private sector debt growth in the advanced economies became unsustainable following a property bubble and subsequent monetary tightening. Public sector debt growth in developed countries has replaced the excessive private sector debt growth. This has helped support the global recovery in this phase of the cycle. However, the government debt increase has largely gone to support income and consumption rather than to stimulate productive investment.

A growing number of countries are now on a long-term path to a very high ratio of sovereign government debt to GDP. The result of this anticipated upward trend in the sovereign debt to GDP ratio has been a growing debate about sovereign debt sustainability. Our view is that, despite stresses in some countries, including Greece, the long-term uptrend in sovereign debt ratios is unlikely to

disrupt the sustainability of the current global economic expansion. The cyclical expansion should prove sustainable over the next several years despite these longer-term issues. However, countries which do not shift onto a credible path to more moderate budget deficits and more sustainable sovereign debt ratios over the next several years run the risk of a downward shift in their long-term trend growth. In "The Future of Public Debt: Prospects and Implications" (BIS Working Papers No. 300, available at www.bis.org), the authors "note the risk that persistently high levels of public debt will drive down capital accumulation, productivity growth and long-term potential growth." We share this longer-term concern for trend growth in the developed countries, despite our confidence in a sustained cyclical expansion over the next several years. We believe that the U.S. outlook is more favorable than many other developed countries due to a more flexible economy, an expanding population and the benefits of reserve currency status.

The core of the fiscal debate in the U.S. is about the government share of GDP versus the private sector share of GDP. The potentially temporary cyclical rise in the Federal spending share of GDP is likely to be locked into a permanent increase in the Federal spending share as a result of recent legislation. In addition, well-known demographic pressures are likely to intensify as the years pass. Current economic policies have the effect of permanently lowering the private sector share of GDP, creating long-term risks of some slowdown in productivity growth and long-term trend economic growth. The potential magnitude of this risk to trend growth should not be overstated since the U.S. economy remains quite flexible relative to other developed economies. We do not believe that these long-term fiscal risks will generate a significant near-term cyclical risk to the U.S. economic recovery since there is ample excess productive capacity in the economy.

There are concerns that high budget deficits in the U.S. could generate an interest rate spike that will disrupt the economic expansion. On this issue, we have a more

positive view on the short-term outlook than on the long-term outlook. Private sector credit demands are unlikely to be strong enough to create a “crowding out” conflict with Treasury financing any time soon. We believe that near-term cyclical fundamentals imply that very high budget deficits can be financed in an orderly way over the next year or two. A very steep yield curve should be helpful in encouraging the purchase of Treasury securities by financial institutions and individuals who wish to restore their liquidity and financial flexibility. We anticipate that the cyclical budget deficit may decline faster in 2010 than many expect due to a reasonably strong economic rebound and temporary boost in tax revenues as high income taxpayers accelerate income recognition in anticipation of tax hikes. Any such cyclical improvement in the budget deficit may lower the odds of substantial actions to reduce the long-term structural deficit.

We are concerned about the long-term risks of persistently high structural budget deficits in the U.S. In early March 2010, the Congressional Budget Office reviewed the President’s budget proposals and raised its estimate of the national debt for 2020 to \$20.3 trillion, substantially above its January 2010 estimate. According to the CBO, “Under the President’s budget, debt held by the public would grow from \$7.5 trillion (53 percent of GDP) at the end of 2009 to \$20.3 trillion (90 percent of GDP) at the end of 2020. As a result, net interest would more than quadruple between 2010 and 2020 in nominal dollars (without an adjustment for inflation); it would expand from 1.4 percent of GDP in 2010 to 4.1 percent in 2020.” The CBO estimates Federal spending as a share of GDP to rise 3.4 percentage points to an average of 24.1% for 2011 to 2020, well above the historic 20.7% average. The budget deficit is forecast to fall to about 4% of GDP in 2014 and then rise steadily, reaching 5.6% of GDP in 2020. A further uptrend is likely thereafter, given demographic realities. For the year 2020, the CBO estimates a budget deficit of \$1.253 trillion, consisting of its March 2010 baseline estimate of \$683 billion plus the effects of the President’s proposed budget, namely Federal

revenues lower by \$150 billion and Federal spending higher by \$420 billion. Some of these increments represent adjustment of politically unrealistic assumptions traditional for baseline budget estimates and some reflect new initiatives. Investors may wish to review both the “Preliminary Analysis of the President’s Budget Request for 2011,” dated March 5, 2010, and “The Long-Term Budget Outlook,” dated June 2009, both available at www.cbo.gov.

What is needed is a *credible path to a balanced budget*. We are skeptical whether that will occur without a future fiscal crisis. The political left and political right fundamentally disagree about the most appropriate Federal spending share of GDP and private sector share of GDP over the coming years. We believe they are unlikely to modify their views. Political conditions do not appear favorable for a major compromise to deal with the structural budget deficit prior to a fiscal crisis. After Chairman Volcker made comments about a potential future value added tax, the Senate voted 84 to 13 for the following proposition: “It is the sense of the Senate that the Value Added Tax is a massive tax increase that will cripple families on fixed income and only further push back America’s economic recovery.” This political attitude may help explain why the tax report of the Volcker Commission, due December 4, 2009, was never released. The response of the latest fiscal commission, created by President Obama’s executive order, is scheduled to be released December 1, 2010. We believe that it is more likely to be an educational effort than a precursor to long-term structural reform.

The U.S. may be gradually drifting towards a “future fiscal train wreck,” perhaps four, five or six years down the road. The cyclical conditions under which this might occur would tend to be the opposite of today’s cyclical conditions: (1) high and rising inflation, (2) aggressively restrictive monetary policy and (3) “crowding out” stress as persistent demand for Treasury financing conflicts with strong corporate credit demand due to a financially illiquid corporate sector stressed by weakening profits.

We do not expect such cyclical conditions for a number of years, so any “future fiscal train wreck” is unlikely to occur soon. It is somewhat encouraging that public concern about excessive long-term budget deficits is rising, but the long-term fiscal outlook remains worrisome.

Overall, the good news about the U.S. budget deficit is cyclical. We expect no major fiscal tightening which might disrupt the cyclical expansion. In the short run, the cyclical deficit may fall faster than expected due to a combination of a reasonably strong cyclical recovery and a surge of tax revenues as high income taxpayers accelerate income prior to the tax hikes. The bad news about the U.S. budget deficit is structural--little or no progress is likely to be made on the long-term budget deficit under current political conditions.

What is the outlook for monetary policy? We believe that the most likely path is (1) the removal of the extended period language by mid-2010, (2) some gradual reduction in the Fed’s balance sheet in the next year or two and (3) the first overt move to raise the Federal funds rate and the IOR (interest on reserves) rate near the end of 2010. The three leading Fed officials (Federal Reserve Board Chairman Ben Bernanke, New York Federal Reserve President William Dudley and the presumptive future Federal Reserve Board Vice Chairman Janet Yellen) have expressed views implying a relatively tentative approach to future Federal Reserve tightening. We tend to agree with their expectation of relatively low inflation in the near term, but we believe that real economic growth could be

somewhat stronger than they appear to expect. Overall, we expect a prolonged period of relatively accommodative monetary policy.

The U.S. has benefited from declining interest rates for nearly three decades. Our view is that a 28-year secular decline of about 1400 basis points in yields on 10-year Treasury bonds has now ended. We believe that the decline from 16% on September 30, 1981 to near 2% at the end of 2008 has completed the secular decline in Treasury yields. The secular bull market in Treasury bonds lasted more than a quarter century, but we believe that it is now over. Some will label the next decade or two a secular bear market in Treasury bonds, since Treasury yields are unlikely to drop below their December 2008 lows. However, we believe the most likely bond market outlook is better described as a “secular neutral” trend in interest rates. Over the next decade, we would expect a “secular neutral” center of gravity for 10-year Treasury yields of around 4% to 5% with a normal range of about 100 basis points on either side of this center of gravity. We believe that the cyclical rise in long-term rates has begun but believe that it is premature to expect substantial further increases soon, even with the large Treasury calendar. We believe that the appetite for accumulating Treasury securities on the balance sheets of financial firms and intervening central banks abroad is not likely to ebb quickly. We expect a normal cyclical upward drift in interest rates due not to any major upsurge of inflation but rather to a rise in real yields (yields minus inflation) as the economic expansion persists.



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