



BNY MELLON

Economic Update

Richard B. Hoey
Chief Economist, BNY Mellon



November 8, 2010

bnymellon.com

We continue to expect a broad global economic expansion in 2011, with global economic growth running at about 4%. That expansion should be led by financially strong countries (mostly in emerging market countries), while “debt hangover” countries (mostly in the developed world) should grow more slowly. Policy is powerful and policy is stimulative in most parts of the world. Real interest rates (interest rates relative to inflation) are low in many parts of the world. The natural rates of interest (interest rates relative to current dollar GDP growth—including both real growth and inflation) are also low. The Fed’s stimulative monetary policy is increasing the availability of risk capital in many parts of the world, which should prove supportive of global expansion.

We expect continued strength in the export-driven German economy. Continued expansion is likely in the other countries of core Europe and in the U.K. The outlook for peripheral Europe is both challenging and uncertain. We expect a volatile pattern of alternating bouts of concern and hope with respect to the financial stresses in peripheral Europe. While membership in the euro by these stressed countries

has brought them official financial support, it has also made them competitively vulnerable when the euro rallies. Japan faces a payback for expiring stimulus programs in the near term, but moderate expansion should resume later in 2011.

Most parts of the emerging world are financially strong because they avoided the credit boom and bust experienced by many advanced countries. Many emerging countries have a stimulative combination of undervalued currencies, low real interest rates (interest rates relative to inflation) and low natural rates of interest (interest rates relative to nominal GDP growth—the sum of real growth and inflation). Many of these countries are now receiving an increased inflow of risk capital. As a result, we believe the emerging market countries should make a strong contribution to global economic growth in 2011. We expect China to lead the global economy, expanding at a high single-digit pace. The commodity exporting countries including OPEC, Australia and Canada and parts of Latin America and Africa should benefit from expanding world trade and high commodity prices.

The U.S. is currently in a subpar expansion, but we expect it to be a “sustained subpar expansion.” Following the “soft patch” in the middle of 2010, we expect somewhat above-trend real GDP growth in 2011 in the 2.5% to 3.5% range. The mid-2010 “soft patch” in the U.S. was due to (1) the exhaustion of the early inventory recovery from the phase of severe inventory liquidation, (2) a major surge in real imports, which generated weaker real net exports and (3) the expiration of the temporary homebuyers’ tax credit. The annualized growth rate of U.S. real GDP from the first quarter of 2010 to the third quarter of 2010 was 1.9%, but if real net exports had not deteriorated, the real GDP growth rate would have been 4.6% for that half-year period.

We believe that the erosion of real net exports is now over. We believe that the same is true of residential construction, which should recover somewhat in 2011 from an extraordinarily depressed level, led by multi-family housing. Private sector employment is growing at a gradually rising pace. While employment growth is not yet strong enough to reduce the U.S. unemployment rate, we believe that it has begun to expand enough to generate solid gains in wage and salary income. This should support real consumption growth. We would expect the unemployment rate to begin to decline by the spring of 2011.

We believe that the midterm elections in the U.S. have somewhat lowered the risk of a large tax hike on January 1, 2011. The magnitude of potential fiscal tightening in 2011 is likely to be substantially mitigated. Increased tax clarity should lift an uncertainty which we believe has been holding back spending decisions. In the September 2010 survey of the National Federation of Independent Business, the

main concerns of small business, in rank order, were (1) poor sales, (2) taxes and (3) government regulations and red tape. The results of the election are likely to lower but not eliminate the latter two concerns. One early indicator of improving sentiment among small businesses comes from the Office Depot Small Business Index: “...significantly more small businesses expect that their firms will be hiring new employees in the next six months (October 26% vs. September 19%). In fact, more respondents across both small- and medium-sized firms...indicate that they will be adding new employees in the near future compared to findings seen only one month ago. Moreover, when asked why they’ll be hiring, more respondents in the October Small Business Index indicated that their ‘business is improving’ (October 65% vs. September 48%) and that they feel that there is greater ‘economic certainty/stability’ (October 24% vs. September 19%).”

We regard the recent adoption of QE2 by the Federal Reserve as a form of “tail risk insurance,” designed to reduce the risk of a double-dip recession or a breakdown to deflationary expectations. We have believed that neither was likely, but the Fed’s decision to move aggressively to reduce these risks is understandable. We expect this incremental easing move by the Fed should somewhat improve the outlook for U.S. economic growth in 2011, but the reduction of tax and regulatory concerns is likely to be a bigger contributor to growth.

QE2 is strong medicine, but we expect it to have some severe side effects. Only some of the potential channels for transmission of the QE2 easing to stronger economic growth are likely to work well. Many large corporations have ample financial

resources. They can already finance any intended spending at very low interest rates and do not need even lower interest rates. Some consumers have the opposite problem. Many consumers have experienced a downgrading of their credit ratings or are underwater on their mortgages. They thus have little access to credit no matter how low interest rates may be. In addition, anticipation of QE2 has helped drive up energy prices, which should act as a drag on real incomes.

We believe a number of other transmission channels, however, should be effective in supporting economic expansion, including (1) a positive wealth effect from the recent rise in stock prices, (2) an improvement in export competitiveness due to a weaker dollar and (3) more stimulative global financial conditions, assuming many foreign countries do not fully offset the liquidity inflows triggered by easy U.S. monetary policy.

The effects of QE2 won't be limited to the U.S. Easy monetary policy is appropriate to U.S. economic conditions but it also is being exported to other countries which may not need and may not want such easy financial conditions. QE2 creates pressures for easy financial conditions elsewhere in the world as investors are driven to purchase higher risk assets which they perceive to offer higher potential returns. Ironically, this should reduce the cost of risk capital abroad for the expansion of productive capacity for future exports to the U.S. However, it should also lower the cost of risk capital abroad for purposes of domestic expansion.

Chairman Bernanke laid out the logic of further quantitative easing in his Jackson Hole speech on August 27, 2010. Since then, intermediate term

yields have dropped, the dollar has fallen and the stock market has risen. QE2 helped stabilize confidence even before it went into effect.

The context for the decision to adopt QE2 was the Fed's dual mandate of promoting maximum employment and price stability. We prefer to call it a "dual domestic mandate," since it focuses on domestic U.S. economic activity and domestic price stability, not on global economic activity or global inflation. Chairman Bernanke believes that both parts of the Fed's dual mandate support further ease: U.S. employment is too low and core inflation is below target. The Fed has an unofficial inflation target over the intermediate term of 1.70% to 2.00% for the core personal consumption deflator excluding food and energy. Core inflation is below that target and, in our view, is likely to stay below it for the next two years given excess capacity and weak wage inflation.

There are a number of impacts that QE2 could have in the U.S. and a number of impacts that QE2 could have internationally. We believe that Chairman Bernanke was concerned that excess capacity in the U.S. economy would drive down inflation and inflation expectations. One reason he did not wish a decline in inflation expectations to occur was that he feared that it would result in an unintended monetary tightening via a passive rise in expected real yields. An expected real yield is the actual yield minus the expected rate of inflation. With the Federal funds rate stuck near zero, a decline in inflation expectations would passively raise expected real yields, just as occurred in Japan during its deflation. When inflation expectations drop with the Fed funds rate at the "zero bound," real yields can rise. This can discourage borrowing and spending and

encourage the hoarding of liquidity. Our description of this risk would be that the monetary brakes from raising rates would still work, but the accelerator pedal would be broken.

We believe that Chairman Bernanke has succeeded in halting a downward drift in long-term inflation expectations and has driven them back up into the normal range. There are a variety of measures of expected inflation. One key measure is the “five-year five-year forward” inflation expectation (FED5YEAR Index on Bloomberg). This is a measure of what inflation rate the bond market expects for the period beginning five years from now and ending ten years from now. As of August 24, 2010, just before Chairman Bernanke’s speech, it had drifted down to 2.18%, approaching the lows of December 2008, in the midst of the financial crisis. Since then, it has rebounded to about 3%, about one-quarter of one percent above the 2.75% average over the last five years. The Fed would not want a major overshoot to the upside, but this normalization of inflation expectations should lower the odds of a liquidity trap.

Chairman Bernanke is a supporter of targeting domestic consumer price inflation. Targeting domestic consumer price inflation implies stability in the domestic store-of-value of the currency. Actual inflation is intended to be slightly positive over the intermediate term, accompanied by anchored public expectations that no major deviations from that path will persist for long. One implication of targeting domestic consumer price inflation is that the external store-of-value of the dollar is not a target. Rather, the view is that a weak dollar can help drive U.S. inflation back up when it is below target and a strong dollar can help drive U.S. inflation back down when inflation is too high. In the U.S. policymaking context, the

value of the dollar is not a target. The Fed targets domestic economic activity and domestic inflation, not the dollar. Some critics argue that this perspective is too narrow for a country whose currency is the primary reserve currency.

Given that easy Federal Reserve policy in prior cycles contributed first to the technology bubble and then to the U.S. housing bubble, worries that aggressively easy Fed policy might cause a bubble in some new location are hardly irrational. We believe that the history of Federal Reserve policy in recent years has been one of monetary policy oversteering, swinging from too easy to too tight and then back again. In part, this has reflected an attempt to mitigate policy mistakes in other areas. The U.S. needs to shift to more fundamental growth-supportive policies, which would reduce the pressures for monetary oversteering. As stated by Kevin M. Warsh, a Governor of the Federal Reserve, in his November 8, 2010 Wall Street Journal article, “...the Federal Reserve is not a repair shop for broken fiscal, trade or regulatory policies. Given what ails us, additional monetary policy measures are poor substitutes for more powerful pro-growth policies.”

What’s the outlook for QE2 and the Federal funds rate? Given our economic outlook, we believe that the most likely case might be that at the end of round one of QE2 in June 2011, the size of QE2 purchases might be downsized. In the rotation of Federal Reserve Presidents on the decision-making Federal Open Market Committee, one QE2 dissenter, Thomas Hoenig of the Kansas City Fed, will be rotating off at year-end. In 2011, two QE2 skeptics, Charles Plosser of Philadelphia and Richard Fisher of Dallas, plus an additional partial skeptic, Narayana Kocherlakota of Minneapolis, will join as voting

members of the FOMC. As fears of a double-dip recession and deflation ease further, the logic of QE2 is likely to fade. We would expect the first rise in the Federal funds rate to be postponed until 2012.

The nexus of the global economic system is the economic link between the U.S. and China. Global economic confidence is likely to prove highly sensitive to the success or failure of the U.S. and Chinese governments in managing their economic stresses, which have intensified recently. The objective cyclical circumstances have changed from what they were in past years. China has grown to be a more substantial share of global economic activity and especially of global economic growth. At the same time, the U.S. economy is currently in a subpar recovery in the aftermath of its housing bust. Given these contrasting cyclical conditions, very different policies are appropriate for the U.S. and for China. Because the currencies are linked, however, stresses have emerged from these contrasting cyclical fundamentals.

With respect to the global imbalance debate, we believe that what is needed is a shift towards (1) a more balanced mix of savings and investment appropriate to each country and (2) a more balanced mix of the sources of growth: domestic versus export (and export-oriented investment). We believe that large changes in nominal exchange rates may prove a much more disruptive path to achieving this rebalancing than proactive national policies. Given that a continuation of strong debt-financed growth in developed countries is neither likely nor desirable, we believe that the best policy shift for the global economy would be stimulation by developing countries of their own domestic demand. There are some indications that this may occur. At this stage of

the global expansion, the global economy needs to “rebalance up” via increased domestic demand in developing countries, rather than to “rebalance down” via rapid deleveraging in the developed countries.

On a multiyear perspective, we believe both the structural current account deficit in the U.S. and the structural current account surplus in China are likely to drift down, as both gradually adopt policies appropriate to their own internal realities. We believe that the shift in framing the discussion to current account surpluses and deficits rather than narrowly focusing on the bilateral exchange rate is a positive step. The focus has shifted to a broader multilateral and multi-factor perspective on global economic issues, away from a single bilateral exchange rate.

China is permitting a real exchange rate adjustment to occur gradually via a combination of faster wage inflation and slow currency appreciation rather than via rapid rises in its nominal exchange rate against other currencies. As a result, we expect some gradual shift in Chinese growth dynamics from external to internal sources. The opposite is likely to occur in the U.S., as the growth of consumption is restrained to a moderate growth rate in the aftermath of the housing bust.

Over the coming decades, we believe that U.S. and China will be “demographically congruent,” which is also likely to be true of the U.S. and many other Asian countries. Due to immigration, the population and work force of the U.S. will persistently expand at a faster pace than many other countries. Although U.S. economic growth is subpar during this cycle due to the housing bust, the long-term population growth

and economic growth rate of the U.S. economy is likely to be higher than many other countries at a similar stage of development. These demographic trends are not of much cyclical benefit, but the “demographic advantage” should prove a favorable long-term trend. In the context of the debate about current account surpluses and current account deficits, we expect that a rising external debt for the U.S. should prove sustainable, albeit at a lower pace of increase than has occurred in recent years.

There are two “missing links” in U.S. macroeconomic policy: (1) a credible “competitiveness agenda” and (2) a credible path to long-term government debt sustainability. Achievement of either would improve the U.S. economic outlook, but we are not optimistic about any quick improvement.

The U.S. faces huge budget deficits today (a minor problem) and huge budget deficits forecast for years

to come (a major problem). While the current budget deficits are cyclically appropriate, the persistent budget deficits are inappropriate. Some fear a future spike in inflation, some fear a future spike in real interest rates (interest rates minus inflation) and some fear a foreign exchange crisis. Our view is that the high budget deficits of today do not preclude a substantial cyclical economic recovery, at an above-trend but subpar pace. However, the unresolved structural deficits create substantial risks for future years, with the prospect of a fiscal train wreck in some future year when inflation is higher and the Fed needs to tighten aggressively. We regard the emerging public concern about the prospect of persistent deficits as the first stage of a multiyear process of gradually reducing the structural budget deficit over the coming decades.



BNY MELLON

BNY Mellon Asset Management is the umbrella organization for BNY Mellon's affiliated investment management firms and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. • The statements and opinions expressed in this article are those of the author as of the date of the article, and do not necessarily represent the views of BNY Mellon, BNY Mellon Asset Management International or any of their respective affiliates. This article does not constitute investment advice, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. BNY Mellon Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. • Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested. Portfolio holdings are subject to change at any time without notice, are for information purposes only and should not be construed as investment recommendations. • While the information in this document is not intended to be investment advice, it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors. • This material is not intended, and should not be construed, as an offer or solicitation of services or products or an endorsement thereof in any jurisdiction or in any circumstance that is otherwise unlawful or unauthorized. Any investment products or services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value. • This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited.

In Australia, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. • In Brazil, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. • In Canada, interests in any investment vehicles may be offered and sold through BNY Mellon Asset Management Canada, Ltd., a Portfolio Manager and an Exempt Market Dealer. • In Dubai, United Arab Emirates, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. • In Germany, this document is issued by WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. WestLB Mellon Asset Management Holdings Limited is a 50:50 joint venture between BNY Mellon and WestLB AG. WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH is a wholly owned subsidiary of this joint venture. • If this document is used or distributed in Hong Kong, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Unit 1501-1503, 15/F Vicwood Plaza, 199 Des Voeux Road, Central, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. • In Japan, this document is issued by BNY Mellon Asset Management Japan Limited, Meiji Seimei Kan 6F, 2-1-1 Marunouchi Chiyoda-ku, Tokyo 100-0005, Japan. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • In Singapore, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professional investors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. • This document is issued in the UK and in mainland Europe (excluding Germany), Taiwan and Korea by BNY Mellon Asset Management International Limited. BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority.

This document is issued in the United States by BNY Mellon Asset Management. • BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by BNY Mellon.

©2010 The Bank of New York Mellon Corporation.