

# Global Recovery Intact — Uncertainty Tempers Growth



The global economic recovery that began last year appears to be wavering as recent headwinds and disappointing economic data create uncertainty about its sustainability. We have clearly hit a soft patch in the recovery, but we do not think it is indicative of a double-dip recession. Although the recovery has been supported by stimulative monetary and fiscal policies, investors need to see greater evidence that improved consumer and business demand will help drive future growth. While we recognize that these headwinds will restrain growth, we expect the expansion to continue, albeit at a subpar pace.

## Eurozone Debt Crisis Unlikely to Derail Global Recovery

Investors became increasingly worried that the debt crisis that began in Greece earlier this year would negatively impact the global recovery. As a result, Greek bond prices plummeted, spreads on securities that insure against default widened, and investors began to fear contagion to other countries with high levels of public debt. As illustrated in Exhibit A, investors also began to abandon the euro in favor of the U.S. dollar. More recently, the euro has recovered as investors have become more constructive about the developments in Europe.

While the European Union and International Monetary Fund's \$1 trillion rescue package will help stem shorter-term liquidity concerns, attention has now turned toward solvency risk. A growing number of countries with a high ratio of sovereign government debt to GDP, as depicted in Exhibit B, are taking fiscal austerity measures. Although the combination of a weaker euro and spending cuts is likely to slow growth in Europe, we do not expect it to derail the global recovery.

Our forecast for 2010 world GDP is around 3%-4%, with growth shifting from developed to emerging markets, as depicted in Exhibit C. Many emerging market countries, including China and India, are benefiting from a rise in productivity, minimal levels of debt and supportive public policies. U.S. growth is expected to be the strongest among industrialized nations, but it likely will be subdued compared to similar points in prior recoveries due to high unemployment and weakened consumer spending. U.S. exports, which have been a bright spot, have become more competitive due to the depreciation of the dollar during the last few years. Also, demand from emerging markets is supporting U.S. exports, a trend we expect will help fuel future growth.

Exhibit A

## Euro Rebounds Against the Dollar



As of 7/22/10. Source: FactSet.

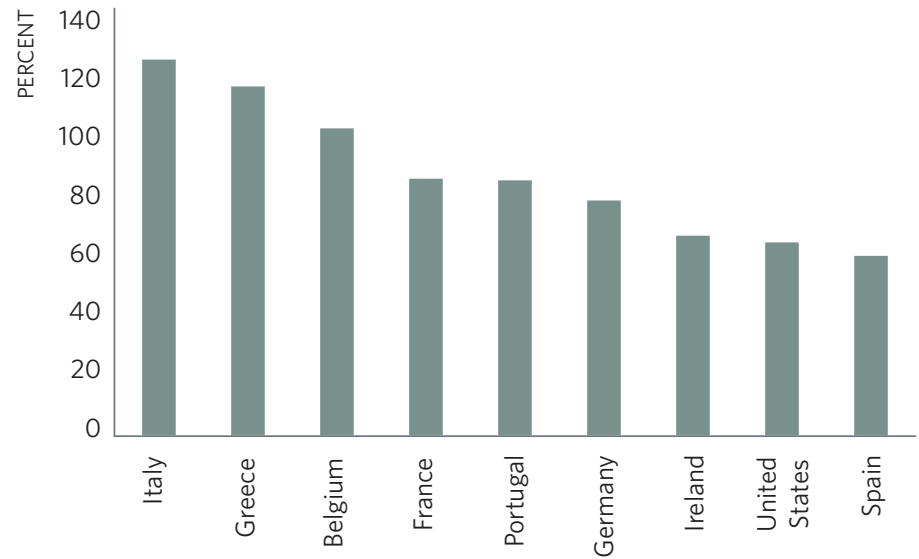
### Increased Recognition of Potential Challenges

Prior to the onset of the Greek crisis, investors had become perhaps overly focused on prospects for strong growth. Now it is increasingly recognized that economic growth will be choppy and asynchronous, as some areas grow much more strongly than others. In addition to recent economic and policy concerns, we have considered the elevated unemployment rate, fragile housing market and weak consumer sentiment in our forecast for modest domestic growth. Consumers now are focused on paying down debt and increasing savings, although trending retail sales suggest some increased spending. Ultimately, we expect consumers' confidence in their ability to find and keep a job will influence future spending. Although job creation has been anemic, we believe that the unemployment situation will improve slowly.

The housing market is in the midst of a bottoming process too, but data remains mixed. Existing home sales and year-over-year prices show signs of improving. However, many worry this trend was boosted by government incentives that expired at the end of April. The latest data on missed mortgage payments and foreclosures illustrates the financial strain still felt by many consumers. One positive impact from the debt crisis has been low mortgage rates. If rates hold, this could help stabilize prices and allow current owners to refinance and lower their monthly expenses.

Exhibit B

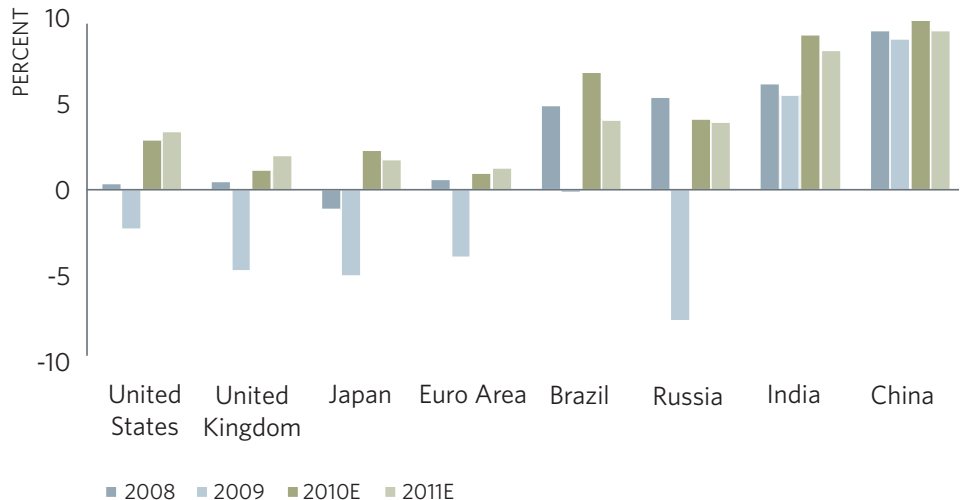
### Government Debt as Percentage of GDP



As of 5/7/10. Sources: Strategas and U.S. Office of Management Budget.

Exhibit C

### Double-Dip Recession Unlikely Real Gross Domestic Product (GDP)



As of 7/1/10. Sources: International Monetary Fund and BNY Mellon Wealth Management.

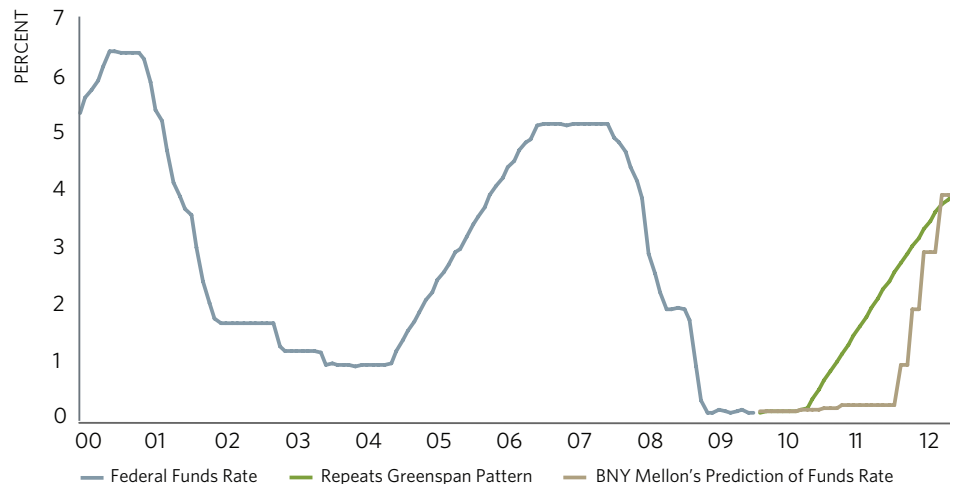
## Global Monetary Policy Largely Remains Supportive

Given the amount of global government spending and the aggressive central bank policies that were needed to avert a depression, inflation fears are understandable. However, we believe these fears have become largely overstated. Recently, the market view has moved closer to our own — that inflation does not appear to be a significant near-term concern but rather a considerable longer-term risk. While growing deficits do not pose an immediate threat to growth, ongoing developments in Europe should increase pressure on central banks to address their deficits. Despite this concern, we think it is still too early to position portfolios for a dramatic rise in inflation.

The fiscal tightening occurring in the Eurozone should encourage the European Central Bank to keep rates low in order to stimulate growth. We also expect the Fed to keep short-term interest rates close to zero for an extended period. As illustrated in Exhibit D, low inflation coupled with an unemployment rate that is expected to stay elevated until the end of 2011 suggests that higher interest rates are still a long way off. Although China has taken steps to ease bank lending, we expect that a balance between supporting growth and controlling inflation will be found.

Exhibit D

### A Patient Federal Reserve? Federal Funds Rate



As of 6/30/10. Sources: Bloomberg LP and BNY Mellon Wealth Management.

### The Road Ahead

Although clear challenges to growth exist around the world, the global recovery is under way. Recent events have reinforced our expectations of slower growth, low inflation and the need to address growing deficits. We expect that these conditions will continue. Although these challenges should resolve themselves over time, the road ahead likely will continue to exhibit uneven economic growth and high market volatility. In the end, higher corporate profits, contained inflation and supportive monetary policy should sustain the current global expansion.

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