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Economic Update

Richard B. Hoey
Chief Economist, BNY Mellon



July 27, 2010

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We continue to expect global GDP growth of about 4% to 4.5% for both 2010 and 2011. The global growth rate may be close to the upper part of that range in 2010 due to the strong growth which has already taken place during the first few months of 2010, while the global growth rate in 2011 may be close to the lower part of the range, given recent indications of a slower pace of expansion in many countries. We expect sustained expansion worldwide.

In China, policies to halt a property boom appear to have worked, weakening demand for materials used in that sector. Our most likely case is that the Chinese economy has made the transition from an unsustainably overheated economy to an economy growing at a somewhat lower but more sustainable pace.

In Europe, we expect that serious financial stresses on sovereign bonds and financial firms will gradually ease. We expect a multi-stage recuperation of the European financial sector over the course of the coming years.

Overall, Europe should have an economic expansion at a growth pace near its relatively low trend growth rate. We expect substantial regional differences, with strength in Germany (where exports should benefit both from global expansion and a more competitive euro) and reasonable growth in the other countries of core Europe. Most of the European weakness should be concentrated in the countries of peripheral Europe, which face both tight credit conditions and tight fiscal policy.

Our U.S. outlook has been for a sustained subpar expansion, with a pace of expansion well below a normal recovery from a severe recession. We believe that recent evidence of a slower growth rate is real and not a statistical aberration. We expect U.S. real GDP growth of 2.5% to 3% in 2010, which we would characterize as a "modest slowdown" rather than a "major slowdown" or a "double digit recession." Weaker real net exports due to a strong surge in imports should be a drain on growth in the second quarter of 2010, while some payback for the expired

homebuyer tax credit should weaken residential construction in the third quarter of 2010.

Our view is that the U.S. outlook for 2011 is uncertain and should prove sensitive to the quality of macroeconomic policy decisions. On balance, we expect a U.S. real GDP growth rate of 2.5% to 3.5% in 2011. However, there is the potential for a higher growth rate if growth-friendly policies are adopted. The adoption of a proactive "competitiveness agenda" could prove stimulative to growth, if it were to occur. We expect that the pressure for a shift to more growth-friendly policies should intensify as the slowdown persists.

There has been a clear slowing in U.S. economic indicators. A number of leading indicators have weakened, implying some degree of future economic slowdown. For example, the stock market had a substantial correction that began as European financial stresses intensified. There were sharp declines in stocks linked to materials used in the Chinese property sector. However, there was more muted weakness in other cyclical stocks. We regard this pattern as more consistent with a slowdown than with a double-dip recession. The yield curve became less steep, especially at the short end. Expectations for the timing of the first Federal Reserve rate hike have been pushed out. However, the yield curve between 10-year Treasuries and 30-year Treasuries remains steeper than it has been before prior recessions. That portion of the yield curve is less influenced by the Fed's current zero interest rate policy and more by longer-term growth and inflation expectations. Credit spreads in the bond market widened, but only to levels that were relatively normal. Credit spreads are nowhere near the extremes that were reached prior to the recent recession. The average workweek has just weakened

somewhat, even though it has strengthened substantially over the last year. Since the expiration of the homebuyer tax credit, there has been some weakness in the housing indicators. The OECD leading indicator indices for a variety of countries have also cooled somewhat in the last few months, although they remain well above the levels of a year ago.

We believe that there are three main scenarios for U.S. economic growth in the coming quarters: (1) modest slowdown, (2) major slowdown and (3) double-dip recession. Our most likely case is for a modest slowdown, with real GDP growth of 2.5% to 3% for 2010, followed by growth in the 2.5% to 3.5% range for 2011, resulting in a gradual improvement in the labor markets. There is some risk of a more major slowdown, with an average real GDP growth over the next several quarters which is positive but substantially below the long-term trend growth of about 2.5%. That would stall the improvement in the labor markets and probably trigger substantial new stimulus.

We believe that a double-dip recession is unlikely. Economic growth should be sustained due to the lagged benefit of monetary ease. We believe that the improved financial condition of large financial and non-financial companies limits the risk of a self-feeding economic decline. A global expansion is underway with substantial stress occurring in only a few areas. We believe that the balance sheet improvement has reduced the vulnerability of the expansion to shocks.

The recent recession was so severe that the amounts of capital goods and consumer durable goods in the current stock of assets are now very depressed. As a result, spending on capital goods and consumer durables such as automobiles should have a natural tendency to rise. Housing should eventually reach the

same stage, but has not yet done so due to large inventories of existing homes. However, we believe that the sharp drop in new home inventories is one of the precursors of an eventual improvement in trends in the housing sector.

Current policy and financial conditions are in sharp contrast to those that preceded the double-dip recession of 1981-1982. At that time, tightening by an anti-inflationary Federal Reserve generated a 17% yield on the 90-day Treasury bill, more than 100 times higher than the 0.15% yield on the 90-day Treasury bill today. Exceptionally low yields are reliquifying the economy through a variety of channels. The policy of the Bernanke Fed remains both anti-deflationary and stimulative.

Why has a slowdown begun in the U.S. economy? We believe that the main factors are (1) a slowing of the positive inventory swing both in the U.S. and abroad, (2) moderate renewed weakness in housing, reflecting both the continued overhang from the housing bubble and the onset of a payback period for the temporary homebuyer tax credit, (3) worries about renewed financial stress triggered by recent events in Europe, (4) a continued deleveraging drag in the aftermath of the housing bust and (5) uncertainties created by recent and prospective changes in economic and regulatory policy.

The major contribution to growth of the swing from severe inventory liquidation to an inventory growth rate in line with final sales has probably run its course in the U.S. and overseas. We believe that this is the main cause of the recent stall both in the U.S. ISM index and in some foreign purchasing manager surveys. So far, these indicators have been more consistent with some slowing of economic growth than with a double-dip

recession. We do not believe that significant inventory excess has been built up. We expect continued moderate inventory growth as final sales rise.

Residential construction in the U.S. has dropped to only about 2.5% of real GDP. This should limit the magnitude of any further weakness in residential construction and its impact on the overall economy. We expect a sawtooth pattern for residential construction at a depressed level for several quarters. We believe that residential construction is likely to decline in the third quarter of 2010 due a payback for the expiration of the temporary homebuyer tax credit. From a broader perspective, we believe that residential construction should bottom in 2010 but that the uptrend in 2011 and 2012 will be only moderate due to high inventories and the persistence of high unemployment. From a long-term perspective, however, residential construction is unsustainably depressed relative to U.S. household formation and should move into a rising trend over the next half decade. There is evidence that the supply/demand balance in the multifamily sector is already tightening. In addition, the commercial real estate price indices have begun to rise, which we regard as evidence that low interest rates are beginning to reliquify even those markets that became somewhat illiquid during the financial crisis.

We have been expecting an L-shaped pattern in house prices. In our view, we are now fluctuating around the flat part of this L-shaped pattern. Recent modest gains in the house price indices are statistically questionable and are likely to give way to modest price declines for some months within a broader back-and-forth neutral trend. We believe that the basic trend of house prices is now flat.

How growth-supportive are current U.S. fiscal, regulatory and monetary policies? There are some reasons to believe that policy is basically stimulative but somewhat less growth-friendly than might be appropriate at this phase of the economic cycle.

In the aftermath of the credit bubble and bust, debt deflation risks had emerged in some of the advanced economies, including the U.S. Our case has been that there would be a slow and gradual recuperation of the functioning of the financial system, helping to generate a sustained but subpar economic expansion. We are convinced that Chairman Bernanke has a clear understanding of these debt deflation risks and has effectively used monetary policy tools to lower them. We believe that Chairman Bernanke's strategy is to generate a growth rate of current dollar GDP of 4% to 5% over the coming years. This should permit a gradual normalization of a high private sector debt-to-GDP ratio and a high debt-service-to-income ratio, on the reasonable assumption that demand for new credit to finance current spending will be relatively restrained. In our opinion, the stagnation in the growth of nominal GDP (real growth plus inflation) is one factor which made the hangover from the Japanese financial crisis so prolonged. We expect that different policies should generate a different outcome in the U.S.

We have argued that consumer price inflation would stay low due to excess capacity and the inefficient transmission of monetary ease through the financial system. Fortunately, that low inflation has not triggered a sharp drop in the public's inflation expectations into a deflationary mode. We view that as an indication that the Fed's commitment to rising nominal GDP and a positive inflation rate is viewed as credible. While inflation should remain low over the next two years, we believe that it is unrealistic to expect any sustained

deflation of consumer prices. The most recent pace of U.S. wage and salary inflation was near 1.5%, wages are rising in foreign countries which export to the U.S. and rents in the U.S. should begin to rise. Inflation is a lagging indicator. We would regard inflation rates of 1% or below as the normal cyclical aftermath of a severe recession rather than as a precursor to any sustained consumer price deflation.

With respect to monetary policy, a near-zero interest rate and large excess reserves are indicative of an accommodative monetary policy. However, as inflation declines, the real Federal funds rate rises passively. In addition, the Fed has begun to allow "all maturing agency debt and all prepayments of agency MBS to be redeemed without replacement." This indicates that the Fed balance sheet has reached its high water mark, unless there is an active decision to expand it further. We do not regard this as likely if our forecast of "modest slowdown" is correct, but it could occur if the economy weakens more than we expect.

On a stand-alone basis, we regard monetary policy as accommodative. However, the balance sheets of many private sector financial institutions are not expanding. The collateral deflation in real estate has weakened the borrowing capacity of some borrowers. Portions of the private sector are actively trying to delever. Large corporations have had such a strong recovery in their balance sheets and profits that they have little demand for new loans. In addition, however, there has been a regulatory tightening of the financial system reflecting (1) the recently passed financial regulation bill, (2) proposals for large future increases in bank taxes, (3) probable increases in requirements for bank capital and bank liquidity due to Basel III and (4) a prospective shift by the Financial Accounting Standards Board away from amortized cost accounting for loans. While bank

capital is recovering, the speed of recovery is challenged by these new regulations and anticipated changes. Loose financial regulation helped create the severe recession and tighter financial regulation was both appropriate and inevitable. In the end, we expect a better capitalized financial system but uncertainties in the transition period may act as a drag on economic growth. The combination of voluntary deleveraging in the private sector and the regulatory tightening of the financial system means that the Fed's easy monetary policy is being somewhat diluted.

We believe that there is a compositional problem with current fiscal policy, which has been stimulating consumption rather than supporting the competitiveness of domestic production. We believe this is limiting its contribution to economic expansion. During the housing bubble, growth in private sector debt permitted housing and consumption to grow at an unsustainable pace. There has been a handoff from spending financed by increases in private sector debt to spending financed by increases in government debt. Federal debt is now rising rapidly to finance increased support for incomes and consumption. A portion of the consumption-oriented U.S. stimulus has benefited foreign rather than domestic producers of consumer goods and oil, diluting its stimulative effect on the domestic labor market. We believe that one implication of the consumption-oriented fiscal policy is that net exports are unlikely to contribute to U.S. economic expansion and may prove a drag on growth.

With respect to fiscal policy, there are concerns that U.S. fiscal policy is insufficiently growth-supportive, from three very different perspectives (1) Keynesian, (2) supply-side and (3) Ricardian. The Keynesians are concerned that as the stimulus bill runs off over the coming quarters, there will be a downward shift in

demand before private sector demand has accelerated substantially. Much of the political left would support incremental new domestic spending and much of the political right would support a reduction in the planned tax hikes, but no near-term compromise appears likely. We do believe that there is likely to be some erosion of demand resulting from the combination of expiring spending provisions and the planned tax hikes. In addition, there will be some contractionary effect of pressures on state and local budgets.

The supply-side economists argue that large increases in regulation plus large rises planned for January 1, 2011 in the top marginal tax rates on income, capital gains and dividends will have powerful disincentive effects on the economy. Supply-side economists tend to be more focused on the incentive effects of marginal tax rates than on the overall size of tax revenues received by the government. They tend to support low marginal tax rates on a broad tax base with few exemptions.

We believe that the prospects of a persistent uptrend in Federal debt as a share of GDP can create some growth-hostile effects. Without getting lost in the weeds of dueling economic theories about "Ricardian equivalence," we believe that there are some circumstances in which the lack of a credible path to Federal debt sustainability may influence economic decisions negatively. In the current context, we suspect that expectations of a persistent uptrend in U.S. Federal debt as a share of GDP may be acting as a damper on business and consumer confidence in U.S. economic growth. When confidence is sensitized to fears of long-term debt sustainability, stimulus via current spending increases or current tax cuts may have a diluted impact on overall demand in the economy. On balance, we believe that the absence of a credible path to debt sustainability is generating a drag

on consumer and business confidence in the domestic economic outlook which is contributing to the subpar nature of this economic expansion.

In summary, our cyclical outlook is for sustained subpar recovery in the U.S. If this expansion were to follow the usual U.S. pattern of strong rebounds from deep recessions, real GDP would probably grow 8% or more in the first four quarters of recovery. Instead, we expect a “half-a-thousand basis point shortfall,” with the U.S.

economic growth rate substantially slower than a normal recovery. On balance, our most likely expectation for U.S. economic growth in the next several quarters is not for a “major slowdown” or “double-dip recession,” but rather for a “modest slowdown.” We believe that the Federal Reserve’s policy of holding short-term rates near zero is gradually and persistently reliquifying the U.S. economy and implies that fears of a double-dip recession will prove to be unfounded.



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