



Market Insights



U.S. Economy Likely to Bounce Back in the Second Half of 2011

By Thomas D. Higgins, PhD,
Global Macro Strategist,
Standish Mellon Asset
Management Company LLC
("Standish")

Although risks remain,
we are squarely in the
sustainable economic
growth camp.

Executive Summary

Standish Global Macro Strategist Tom Higgins looks at the slowdown in the U.S. economy in the first quarter of 2011, but argues that was likely a soft patch due to oil price increases and manufacturing supply disruptions linked to Japan's disasters, not the first sign of a double-dip recession. While acknowledging risks to the economic outlook, he believes the recovery in the U.S. is sustainable, even as policy stimulus fades. Further, he rejects predictions of a great bear market in bonds as yields potentially drift higher and points to historical analysis Standish has done showing that corporate bonds posted positive total return over three of the last four Fed tightening cycles.

Soft Patch or Double Dip?

The U.S. economy slowed sharply in the first quarter of 2011. This resurrected debate between bulls and bears about whether the U.S. economy is in the midst of a sustainable expansion or a double-dip recession is lurking just around the corner. Although risks remain, we are squarely in the sustainable economic growth camp.

Real GDP growth moderated to an annual rate of 1.8% in the first quarter, down from 3.1% growth in the fourth quarter of 2010.¹ However, there were signs of strength beneath the surface, with consumer spending and business investment in equipment and software both increasing at a respectable pace. This suggests to us that we are undergoing a soft patch induced by temporary shocks. These shocks include the spike in energy prices that accompanied civil unrest in the Middle East and the manufacturing supply disruptions associated with the Japanese earthquake and tsunami.



¹ U.S. Bureau of Economic Analysis.

Despite our belief that the economic recovery is sustainable, we are not yet worried about a rapid acceleration in inflation due to the large amount of slack in U.S. product and labor markets.

We believe these factors will continue to weigh on growth through the early part of the summer before their effects begin to fade as we head into the fall. Jobless claims have already risen sharply, and we would not be surprised to see some softening in the manufacturing data over the next two months as a consequence of the production cutbacks by Japanese automakers. Beyond that, our view is the upside risks to growth still outweigh the downside risks. Indeed, there may even be a resurgence of economic activity later in the summer as Japanese automakers restore production back to pre-quake levels.

Therefore, unlike the soft patch that occurred in mid-2010, we believe the current environment does not warrant further policy intervention. In our view, the U.S. economic recovery was much more fragile when growth stumbled last year because government spending was behind much of the rise in output and employment. Today, by contrast, we see the economic expansion firmly in the hands of the private sector. Obviously risks remain, including a further surge in oil prices or a worsening of the European sovereign debt crisis. Yet, barring such a shock, we continue to believe the economic expansion will be sustained.

Economic Slack Should Limit the Short-Term Rise in Inflation

Despite our belief that the economic recovery is sustainable, we are not yet worried about a rapid acceleration in inflation due to the large amount of slack in U.S. product and labor markets. U.S. industrial capacity utilization remains well below the 83% level commonly associated with supply bottlenecks and cost-push inflation. At the same time, the unemployment rate is hovering at 9%, which is well above most economists' definition of full employment. Given that wages account for roughly two-thirds of the cost of producing most goods and services, it is difficult to imagine a scenario where inflation comes roaring back in the current environment.

Nevertheless, we anticipate that inflation will drift higher in the coming months as the rental component of the major prices indices continues to increase with more Americans choosing to rent rather than own. Rental vacancy rates have declined from 11.1% in the third quarter of 2009, to 9.7% in the first quarter of 2011.² The owners' equivalent rent (OER) is the single most important item in both the consumer price index (CPI) and the personal consumption (PCE) deflator, which is the Federal Reserve's preferred inflation gauge. After trending lower for much of the past two years, the OER has begun to move higher and brought the overall inflation rate with it. Rising rents are likely to push the core PCE, which excludes food and energy, back toward the Fed's implied target range of 1.5% to 2.0% later this year. This along with a reacceleration in economic growth and a drop in the unemployment rate will likely elevate discussions about the Fed's exit strategy later this year.

² U.S. Department of Commerce.

All other things equal, a higher rate of structural unemployment implies a smaller output gap. This has the potential to result in a policy mistake in which the Fed leaves rates too low for too long in hopes of achieving a level of unemployment that is inconsistent with the price stability component of its dual mandate.

Further down the road in 2012, the debate about the size of the output gap is likely to become more important to the inflation outlook. The Fed has argued that most of the job losses that occurred in the 2008-09 recession were cyclical in nature, which is why the central bank still believes a non-inflation accelerating rate of unemployment (NAIRU) of 5.0% to 5.5% is achievable in the longer-run.³

But we believe a case can be made that structural unemployment may be higher in the short term. The percentage of the unemployed who have been out of work for 27 weeks or longer remains near a record high at over 40%.⁴ This is nearly double the level of the early 1980s when the unemployment rate was at comparable levels to today. Unfortunately, the longer these workers remain unemployed, the higher the risk is they lose the skills necessary to compete in the current labor market, which suggests a higher rate of structural unemployment.

These were the findings of independent research from the International Monetary Fund, which estimates that structural unemployment may be about 1.5 percentage points higher than it was before the crisis.⁵ All other things equal, a higher rate of structural unemployment implies a smaller output gap. This has the potential to result in a policy mistake in which the Fed leaves rates too low for too long in hopes of achieving a level of unemployment that is inconsistent with the price stability component of its dual mandate. However, we believe that day of reckoning is still at least a couple years away.

³ Ben S. Bernanke, "Monetary Policy Objectives and Tools in a Low-Inflation Environment," Board of Governors of the Federal Reserve System, October 15, 2010.

⁴ U.S. Bureau of Labor Statistics.

⁵ Thomas Dowling, Marcello Esteveao, and Evridiki Tsounta, "The Great Recession and Structural Unemployment," IMF Country Report No. 10/248, International Monetary Fund, July 2010.

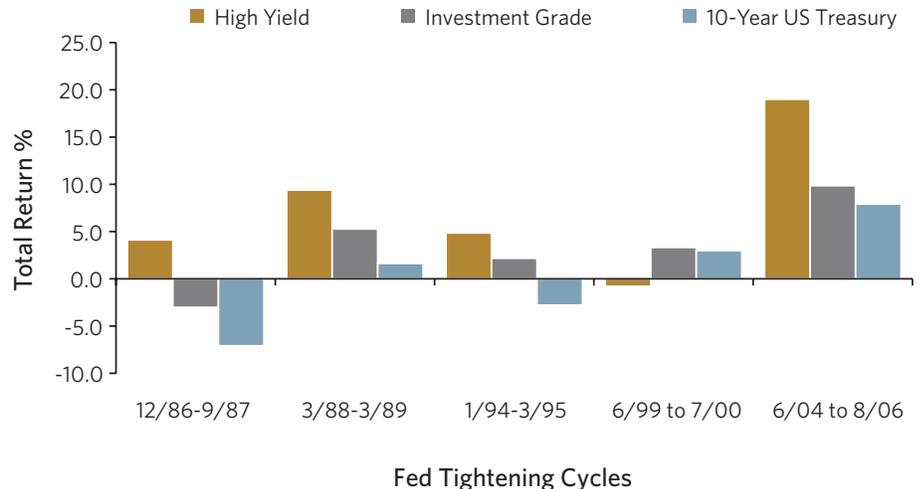
A more immediate concern for investors is what will happen when the Fed ends its second round of quantitative easing (QE2) in June. As we previously discussed, we believe the impact on U.S. Treasury yields will likely be relatively muted, given that the market is forward looking and has already priced in the end of QE2.

The End of Quantitative Easing and Risk Assets

A more immediate concern for investors is what will happen when the Fed ends its second round of quantitative easing (QE2) in June. As we previously discussed, we believe the impact on U.S. Treasury yields will likely be relatively muted, given that the market is forward looking and has already priced in the end of QE2. Moreover, neither the inflation nor growth outlook currently warrants sharply higher Treasury yields.

Yet, the impact on risk assets such as stocks or corporate bonds is less clear. This is particularly important since the Fed has cited the portfolio balance channel as one of the primary mechanisms through which QE has operated. According to the Fed, its purchases of Treasuries under QE2 affect financial conditions by changing the quantity and mix of financial assets held by the public.⁶ For instance, some investors who sold Treasury securities to the Fed may have replaced them in their portfolios with longer-term, high quality corporate bonds, lowering yields on those assets as well. Thus, when the Fed stops purchasing Treasuries, there is a risk that market volatility will rise, at least temporarily.

Performance of Investment Grade and High Yield Bonds During Fed Tightening Cycles*



* High Yield is represented by the Bank of America/Merrill Lynch U.S. High Yield Master II Index, Investment Grade by the Bank of America/Merrill Lynch U.S. Corporate Master Index. U.S. Treasury data based on the constant maturity 10-year total return captured by Bloomberg analytics.

Source: Standish, based on Bloomberg data.

⁶ Ben S. Bernanke, "The Economic Outlook and Monetary Policy," Federal Reserve of Kansas City Economic Symposium, August 27, 2010.

However, at the end of the day, we believe the performance of corporate stocks and bonds will be determined by the underlying fundamentals, including profitability and corporate default rates, rather than Fed policy. In fact, our analysis shows that corporate bonds from investment grade to high yield, actually posted positive total returns over three of the last four Fed tightening cycles. More important to the outlook for corporate credit is the performance of the economy. Given our expectation for sustainable economic growth, we believe corporate credit can continue to perform well in the medium term.

Thomas D. Higgins, PhD, Global Macro Strategist

Tom is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has eighteen years of experience analyzing financial markets. He is a member of both the American Economics Association and the National Association of Business Economics (NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. He is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. Tom was the 2010 Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics.

Index Definitions

The Bank of America/Merrill Lynch U.S. High Yield Master II Index captures the performance of below investment-grade debt issued by corporations domiciled in the United States or Canada. The Bank of America/Merrill Lynch U.S. Corporate Master Index is composed of U.S. Dollar-denominated investment-grade corporate public debt issued in the U.S. Domestic bond markets.

The indexes are trademarks of the foregoing licensors and are used herein solely for comparative purposes. The foregoing index licensors do not sponsor, endorse, sell or promote the investment strategies or products mentioned in this paper, and they make no representation regarding the advisability of investing in the products or strategies described herein.

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 authors as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon, BNY Mellon Asset Management International or any of their respective affiliates. This article is of general nature, does not constitute investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. 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. • 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. • Products or services described in this document are provided by BNY Mellon, its subsidiaries, affiliates or related companies and may be provided in various countries by one or more of these companies where authorized and regulated as required within each jurisdiction. However, 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. **The investment products and 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. • Investment vehicles may be offered and sold in Canada through BNY Mellon Asset Management Canada Ltd., a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager. • 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 Level 14, Three Pacific Place, 1 Queen's Road East, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities, 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 Korea, this document is issued by BNY Mellon AM Korea Limited for presentation to professional investors. BNY Mellon AM Korea Limited, 21/F Seoul Finance Center, 84 Taepyungro 1-ga, Jung-gu, Seoul, Korea. Regulated by the Financial Supervisory Service. • 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), by 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 holds over 90% of the parent holding company of The Alcentra Group. The Group refers to these affiliated companies: Alcentra, Ltd and Alcentra NY, LLC. Only Alcentra NY, LLC offers services in the U.S. • Ankura, Insight Investment and WestLB Mellon Asset Management do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon holds a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC). • BNY Mellon Beta Management is a division of The Bank of New York Mellon, a wholly-owned banking subsidiary of BNY Mellon. • BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • Hamon's services are offered in the U.S. by Hamon U.S. Investment Advisors Limited. BNY Mellon holds a 19.9% interest in Hamon Investment Group Pte Limited, which is the parent of Hamon U.S. Investment Advisors Limited. • The Newton Group refers to the following group of companies: Newton Investment Management Limited, Newton Capital Management Limited, Newton International Investment Management Limited, Newton Capital Management LLC, and Newton Fund Managers (CI) Limited. Except for Newton Capital Management LLC and Newton Capital Management Limited, none of the other Newton companies offers services in the U.S. • BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by BNY Mellon.



BNY MELLON ASSET MANAGEMENT

The Alcentra Group
Ankura Capital Pty Limited
Blackfriars Asset Management Limited
BNY Mellon ARX
BNY Mellon Beta Management
BNY Mellon Cash Investment Strategies
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
The Newton Group
Pareto Investment Management Limited
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management