STANDISH
A BNY MELLON ASSET MANAGEMENT COMPANY℠

Bond Market Observations

December 15, 2010

"The trouble with our times is that the future is not what it used to be."

– Paul Valery

Executive Summary

- We are cautiously optimistic about the economic outlook for 2011, but global growth is likely to be uneven and risks remain.
- Periodic bouts of volatility are likely until European leaders agree to a more permanent solution to the structural problems that plague the currency union.
- Our US economic outlook has improved with the adoption of further fiscal and monetary stimulus, but we do not believe we are on the precipice of the next secular bear market in bonds.
- Robust economic growth in emerging market economies should continue to attract strong foreign capital inflows and put upward pressure on these currencies.
- Looking into 2011, we believe higher yielding fixed income assets offer some protection against a future rise in interest rates. We continue to favor global credit and an overweight to emerging market currencies.

Cautious Optimism about the 2011 Global Economic Outlook

We are cautiously optimistic about the global economic outlook for 2011, but growth is likely to be uneven and risks remain. Chief among the risks is Europe's sovereign debt crisis. Government bonds in peripheral European economies—including Greece, Ireland, Portugal and Spain—have come under pressure as investors worry about the ability of these countries to repay their debts. The situation has been aggravated by discord among euro zone leaders about the best way to resolve matters. The European Central Bank's decision to resume buying the debt of the peripheral countries has temporarily halted the slide in these bonds. However, periodic bouts of volatility are likely until European leaders agree to a more permanent solution to the structural problems that plague the currency union.

In contrast to Europe, the US economic outlook has improved with the adoption of further fiscal and monetary stimulus. The Obama Administration and Congress agreed to extend the Bush tax cuts through 2012 as part of a deal allowing the unemployed to collect benefits for an additional 13 months. The fiscal package also includes a reduction in payroll taxes which should provide further impetus for consumer spending. Treasury yields have backed up sharply due to concerns that the new stimulus will add to future deficits. Yet, the weak US labor market and the Federal Reserve's commitment to purchase another $600 billion in Treasuries as part of its second round of quantitative easing suggest there is a limit to how high yields can rise at this stage. If these policies are successful at lowering unemployment and stabilizing inflation, a secular rise in interest rates could begin by the end of 2011.

Rising interest rates are already a fact of life in many emerging market economies. Robust economic growth has attracted strong foreign capital inflows, which is putting upward pressure on inflation in many of these countries. Indeed, inflation is running in excess of 5% in China, close to 6% in Brazil, and nearly 10% in India.[1] Central bankers have responded by tightening monetary policy, but this has done little to stem the flow of foreign capital. Some currency appreciation may be welcomed as these countries seek to contain domestic price pressures, though most have resisted a rapid strengthening of their exchange rates for fear it will choke off export growth. Below, we will delve a little deeper into these issues and discuss some of the investment themes for the beginning of the New Year.

European Volatility Is Likely to Persist

The epicenter of financial upheaval in the global economy has shifted from the United States to the euro zone. The region's problems are rooted in the fact it has a single currency and monetary policy, yet fiscal policy is divided among its 16 member governments. Consequently, overly indebted countries in peripheral Europe cannot devalue their exchange rates to bolster their competitiveness and grow their way out of their debt problems. Instead, they have been forced to raise taxes and cut spending at a time when their economies are already undergoing deep recessions.

Despite credible efforts to reduce deficits, borrowing costs remain elevated for the peripheral countries as investors begin to discount an eventual restructuring of their debt. The European Central Bank has responded by resuming its purchases of the debt of these countries and extending short-term liquidity to banks in the region. While this appears to have temporarily stabilized debt markets, it is not a long-term answer. Unfortunately, more permanent solutions such as moving toward greater fiscal integration or issuing jointly sponsored euro zone bonds, have been rejected by one or more members.

Greater fiscal union would force euro zone members to sacrifice their fiscal sovereignty for the sake of the currency union. It would require Europe to adopt a US-style system where countries pass constitutional amendments prohibiting borrowing for operating purposes similar to states in the US, which can issue debt to finance infrastructure but not salaries, services, transfer payments or other operating expenses. Theoretically, this would reduce the risk that euro zone governments would get into fiscal troubles in the future. Combining this with the issuance of a common euro zone bond could lower borrowing costs for peripheral economies. But, it could also raise borrowing costs for countries such as Germany and France since they would be liable for the spending by their more profligate neighbors.

Not surprisingly, German and French leaders have rejected proposals for a common euro zone bond arguing that it is not permitted under the Maastricht Treaty. Jean-Claude Juncker, the Prime Minister of Luxembourg, responded to their lack of enthusiasm by suggesting that, "This way of creating taboo areas in Europe and not dealing with others' ideas is a very un-European way of dealing with European matters."[2] Thus, the prospect for a speedy resolution to Europe's problems seems remote.

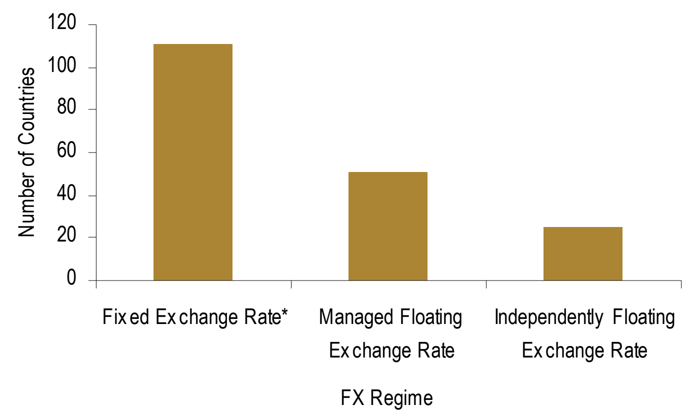
While sovereign debt woes in peripheral Europe may seem distant to investors in the United States or Asia, the situation could easily escalate into a global crisis should concerns about default spread from the smaller Greek, Irish and Portuguese markets to the much larger Spanish or Italian markets. In that scenario, the common currency would be at risk. We believe European leaders will take corrective action before that day arrives, but peripheral European debt markets are likely to remain volatile in the interim. We believe the safest way to play Europe in the current environment is probably through an overweight to German Bunds versus US Treasuries given the divergent fiscal paths in the two countries.

Premature to Call the Next Bear Market in US Treasuries

Despite our underweight to US Treasuries in global portfolios, we do not believe we are on the precipice of a bear market in bonds since the fundamental factors determining interest rates have yet to indicate a turning point in the Treasury market. According to the Standish econometric model, the primary drivers of bond yields on a six-month horizon are inflation, economic growth, Fed policy, and foreign purchases of US Treasuries. Although the fiscal stimulus is a positive for economic growth, it has not dramatically altered the outlook for most of the other variables in the model.

For example, inflation as measured by the consumer price index remains quite low at 1.2% year-to-year[3] and it has yet to bottom. The deleveraging of the household sector is likely to keep a cap on how fast the economy can grow and, therefore, how quickly we close the output gap and begin to see price pressure emerge. Inflation is seemingly uncomfortably low from the Fed's vantage point, which suggests the central bank will complete its $600 billion in US Treasury purchases through next June. Some of the more dovish Fed governors may even attempt to talk down rates in upcoming speeches to prevent the rise in rates from offsetting the benefit of looser fiscal policy.

Fixed Exchange Rate Regimes Still Dominate the Global Economy



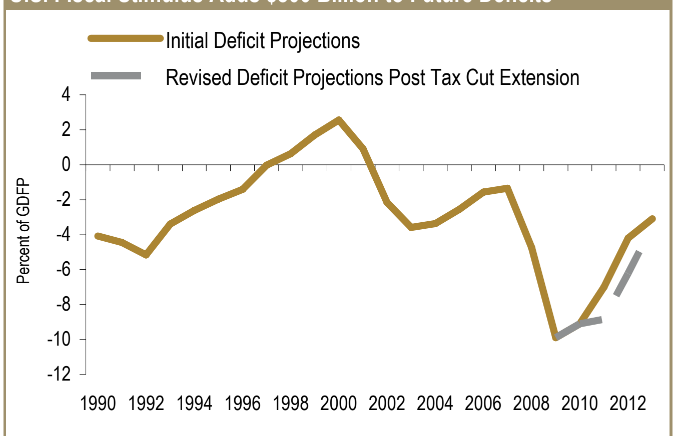
*Includes countries without separate legal tender, currency boards, and crawling pegs.
Source: International Monetary Fund

While foreign purchases have moderated from their pace earlier this year, they are still up 20.5% year over year to $4.3 trillion through October 2010[4]. Foreign demand for Treasuries is likely to continue to grow at a steady pace until more emerging markets adopt freely floating exchange rates. According to the International Monetary Fund, nearly 60% of emerging market currencies are still pegged or heavily managed and most of these target their exchange rate to the US dollar.[5] In order to maintain a fixed exchange rate, a country must hold reserves of the currency it is tied to. However, since there is only $829 billion in US currency in circulation globally, countries with fixed exchange rates will often hold the next best thing to a US dollar, which is a US Treasury.[6]

Demand for Treasuries from the Fed and overseas investors should be sufficient to absorb any new issuance during the first half of next year. Therefore, we believe it is premature to establish a strategic short duration position in US Treasuries at this stage. In fact, the 110 basis point rise in 10-year Treasury yields from 2.38% to 3.48% between early October and mid-December puts yields above the fair value estimate of our model and may present a buying opportunity for investors at some point.

Nevertheless, we are cognizant rates will rise eventually as the US economic recovery gathers momentum, the unemployment rate declines, and inflation stabilizes. Furthermore, according to academic research and our own internal studies, each percentage point increase in the structural budget deficit adds between 20 to 35 basis points to long-term interest rates in equilibrium. The fiscal stimulus will add approximately 2 percentage points to the structural deficit over the next two years and thus could add 40 to 70 basis points to 10-year Treasury yields over that time. Therefore, we are closely watching cyclical indicators and will advocate shortening duration if we see signs fiscal and monetary stimulus are beginning to gain traction. We do not anticipate a sustained rise in Treasury yields before the second half of 2011.

U.S. Fiscal Stimulus Adds $800 Billion to Future Deficits



Souce: Congressional Budget Office

Stronger Emerging Market Currencies to Aid Inflation Fight

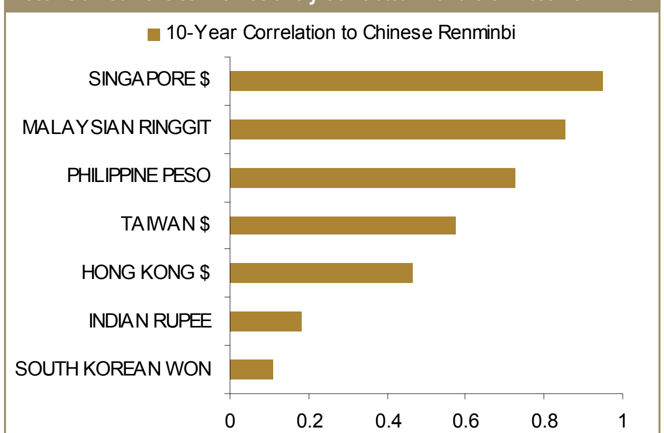
The economic cycles in emerging markets (EM) are far more advanced than they are in the United States and Europe. Indeed, output in many emerging market economies has already surpassed the levels that preceded the 2008-09 global financial crisis, while that in the developed economies is still well below pre-crisis levels.[7] As a result, inflationary pressures are building as some EM economies run up against capacity constraints.

We believe the situation has been aggravated by the massive influx of foreign capital into emerging markets. Net private capital flows to emerging markets will rise to $825 billion this year from $581 billion last year.[8] This a reflection of at least three factors: 1) sound fundamentals in emerging markets compared with developed markets; 2) the under-representation of EM assets in investor's portfolios; and 3) the Fed's quantitative easing encouraging investors to seek higher yields abroad.

In order to cope, EM policy makers have increased interest rates or imposed capital controls, but these strategies have limitations. For example, higher interest rates can attract even more foreign inflows as investors search for yield. An alternative approach is for more EM countries to adopt more flexible exchange rate regimes. An appreciation of the exchange rate can dampen foreign inflows and reduce price pressures by lowering the cost of imported inputs.

Some EM economies, particularly in Latin America, have moved in the direction of more freely floating exchange rates. However, the same is not true in parts of Asia, particularly China. After allowing a 17% appreciation of the renminbi between July 2005 and July 2008, China moved back toward a dollar-peg during the global financial crisis for fear an appreciating currency on top of collapsing global demand would completely shut down its export engine. But more recently, China has begun to allow the renminbi to appreciate anew. Since August, the Chinese currency has risen roughly 2.5% against the US dollar. What China does is critical since many of the region's currencies are closely correlated with the renminbi because these countries either compete to sell their goods into the Chinese market, or compete against China in third markets such as the United States. We expect a managed but continued appreciation in emerging market currencies, particularly in Asia, as these economies move to higher stages of development.

Most Asian Currencies Are Positively Correlated With the Chinese Renminbi



Souce: Thomson Financial

Investment Outlook for 2011

Our cautiously optimistic outlook for the global economy in 2011 plays into several investment themes. We believe higher yielding fixed income assets, including emerging market local currency debt and high yield corporate bonds, should continue to perform well as the global economic recovery gathers momentum.

Economic growth rates in EM economies are expected to average nearly 7% over the next five years compared to growth of just 2.5% in the developed world. [9] Meanwhile, EM local debt is still offering yields in excess of 6%. With currency appreciation, total returns in the high single digits to low double digits are still achievable. Coupons in the high yield market are a bit higher at over 7% and the fundamentals continue to improve with default rates expected to fall to 2.5% by mid-2011 from 3.5% currently.[10]

Although we are not in the camp of those who believe the great bear market in US Treasuries has arrived, we are aware that we may see increased pressure on interest rates if policy makers are successful in their efforts to kick start the economy. Both high yield and emerging market debt can offer some protection against a future rise in interest rates given the yield cushion they provide. That said, we do not expect to see a significant tightening in EM or high yield spreads over US Treasuries, rather we view this as an opportunity for investors to earn higher coupon income.

[1] National Bureau of Statistics of China, Ministry of Finance in India, Brazil Institute of Geography and Statistics

[2] Michael Slackman. "Europe Staggers as Critical Summit Looms." *The New York Times*. December 15, 2010.

[3] U.S. Department of Labor

[4] Source: U.S. Treasury TIC (Treasury International Capital) data

[5]The International Monetary Fund. "De Facto Classification of Exchange Rate Regimes and Monetary Policy Framework . July 31, 2006.

[6] Federal Reserve

[7] Standish

[8] Source: Institute for International Finance

[9] International Monetary Fund. "World Economic Outlook." October 2010

[10] Standish

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