



STANDISH



Bond Market Observations

May 2011

"The engine which drives enterprise is not thrift, but profit."

– John Maynard Keynes

Executive Summary

- Although there are risks to the outlook, we are squarely in the camp that believes in sustainable economic growth.
- We are not yet worried about a rapid acceleration in inflation due to the large amount of slack in US product and labor markets.
- Treasury yields may drift higher, but we do not believe we are on the precipice of the great bear market in bonds.
- Our analysis shows that corporate bonds from investment grade to high yield, actually posted positive total return over three of the last four Fed tightening cycles.

A Soft Patch or Double-Dip?

The US economy slowed sharply in the first quarter of 2011. This resurrected the debate between the bulls and bears about whether the US 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, 2010. 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, combined with private sector employment growth averaging more than 250,000 jobs over the three months to April, 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/tsunami.

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. The US 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, the economic expansion is 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 US product and labor markets. US 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. 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.

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-run¹.

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But 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%. 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.

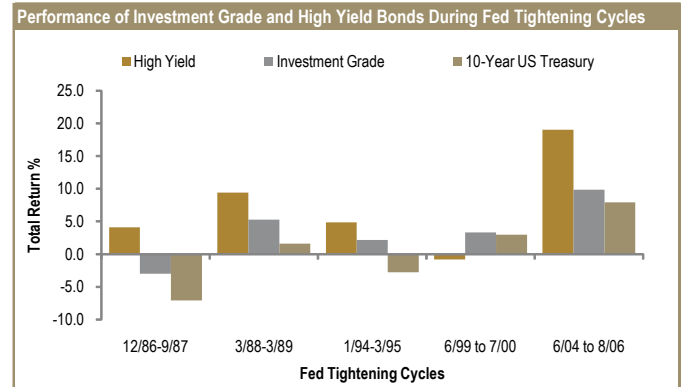
These were the findings of independent research from the International Monetary Fund which estimates that structural unemployment may be about 1.5 percentage points higher than it was before the crisis². All other things being equal, a higher rate of structural unemployment implies a smaller output gap. 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.

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 discussed last month, we believe the impact on US Treasury yields will likely be relatively muted given the market is forward-looking and has already priced in the end of QE2. Moreover, neither the inflation nor growth outlooks currently warrant 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 public³. 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.



However, at the end of the day, 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.

¹Ben S. Bernanke. "Monetary Policy Objectives and Tools in a Low-Inflation Environment." Board of Governors of the Federal Reserve System. October 15, 2010.

²Thomas Dowling, Marcello Esteveao, and Evridiki Tsounta. "The Great Recession and Structural Unemployment." IMF Country Report No. 10/248. The International Monetary Fund. July 2010.

³Ben S. Bernanke. "The Economic Outlook and Monetary Policy." Federal Reserve of Kansas City Economic Symposium. August 27, 2010.

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