# Global Market Outlook

Our specialist asset managers offer their views on the outlook for all major asset classes in 2011

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# Global Market Outlook 2011: Uncertainty Ahead

Investors face some tough decisions going into 2011, as they strive to decipher an abundance of mixed economic messages. With continued worries over the sustainability of the global recovery, deleveraging and sovereign debt concerns in the developed world, and contrasting deflationary/inflationary pressures in the developed and emerging worlds, respectively, it is likely that the year ahead will provide a challenging backdrop for investors.

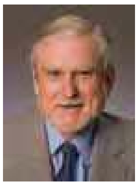
With the aim of providing some perspective in such an uncertain environment, BNY Mellon's Global Market Outlook 2011 incorporates forward-looking views from a number of asset managers within BNY Mellon Asset Management's multi-boutique model on a broad range of asset classes, including equities, fixed income, currencies, commodities, and property. It also includes the thoughts of our asset allocation experts.

Having earlier flooded their financial systems with money in an attempt to kick-start economic growth, policymakers in the developed world are entering 2011 faced with a delicate balancing act between supporting their ailing economies and cutting their growing fiscal deficits. In contrast to developed world governments, inflation, rather than growth, is once again the major concern for emerging economies.

"Volatility" looks set to be a buzzword for the year ahead as the world undergoes painful economic and market adjustments. Needless to say, investment opportunities will be plentiful, but navigating such conditions is likely to remain challenging.

We hope that you find this collection of perspectives thought provoking and informative.

All of these articles are also available at http://us.globaloutlook.bnymellonam.com along with some additional video material.



**Richard B. Hoey**
Chief Economist,
BNY Mellon

# Prospects from an Economist

We continue to expect a broad sustained global economic expansion over the next several years with the fastest growth in those countries in the strongest financial position – largely in the developing world – and the slowest growth likely in those countries with a debt hangover – largely in the developed world. We expect global real GDP growth to average 4% to 4.5% in 2011.

The fundamental trend of rising global productivity and incomes due to wider dispersion of modern technology should persist. Given that there is likely to only be a gradual decline in unemployment in those economies suffering from a debt hangover, we expect continuing trade tensions, but not a full-scale "jobs trade war." Consumers in the developed world overshot their debt capacity in the last cycle and the result should be relatively sluggish growth in developed world consumption. Slow growth in the incomes of the developed world and their debt-financed consumption is consistent with only moderate growth in exports to developed countries, now that the initial rebound from the recession lows has already occurred. Fortunately, many of the developing countries are in a strong financial position and have substantial policy flexibility. In addition, persistently low real interest rates (interest rates relative to inflation) in the U.S. and core Europe should underpin the deleveraging of those regions. Policy is powerful and cyclical policy is stimulative in most major countries.

"…the best policy shift for the global economy would be stimulation by developing countries of their own domestic demand."

With respect to the global imbalance debate, we believe that what is needed is a shift towards a more balanced mix of savings and investment appropriate to each country, and a more balanced mix of the sources of growth: domestic versus export (and export-oriented investment). We believe that large changes in nominal exchange rates may prove a much more disruptive path to achieving this rebalancing than proactive national policies. Given that a continuation of strong debt-financed growth in developed countries is neither likely nor desirable, we believe that the best policy shift for the global economy would be stimulation by developing countries of their own domestic demand. There are some indications that this may occur. At this stage of the global expansion, the global economy needs to "rebalance up" via increased domestic demand in developing countries, rather than to "rebalance down" via rapid deleveraging in the developed economies.

**Dual Mandate**

The context for the decision to adopt further quantitative easing (QE2) was the U.S. Federal Reserve's (Fed) dual mandate of promoting maximum employment and price stability. We prefer to call it a "dual domestic mandate," since it focuses on domestic U.S. economic activity and domestic price stability, not on global economic activity or global inflation. Ben Bernanke, the Fed Chairman, is a supporter of targeting domestic consumer price inflation. Focusing on domestic consumer price inflation targets the domestic store-of-value of the currency, but not the external store-of-value of the U.S. dollar. Some critics argue that this perspective is too narrow for a country whose currency is a primary reserve currency and we agree.

"The global cyclical outlook is favorable, but financial volatility is likely to persist."

We regard the adoption of QE2 by the Fed as a form of "tail risk insurance," designed to reduce the risk of a Japanese-style liquidity trap by preventing a passive rise in expected real yields due to falling inflation expectations. When inflation expectations drop, with the federal funds rate at close to zero, expected real yields rise. This can discourage borrowing and spending and encourage the hoarding of liquidity, just as occurred in Japan during its deflation. Our description of this risk would be that the monetary brakes from raising rates would still work, but the accelerator pedal would be broken. We believe that QE2 has succeeded in halting a downward drift in long-term inflation expectations and is driving them back up into the normal range. The risk of a U.S. liquidity trap, which we believed was low in any case, appears now negligible.

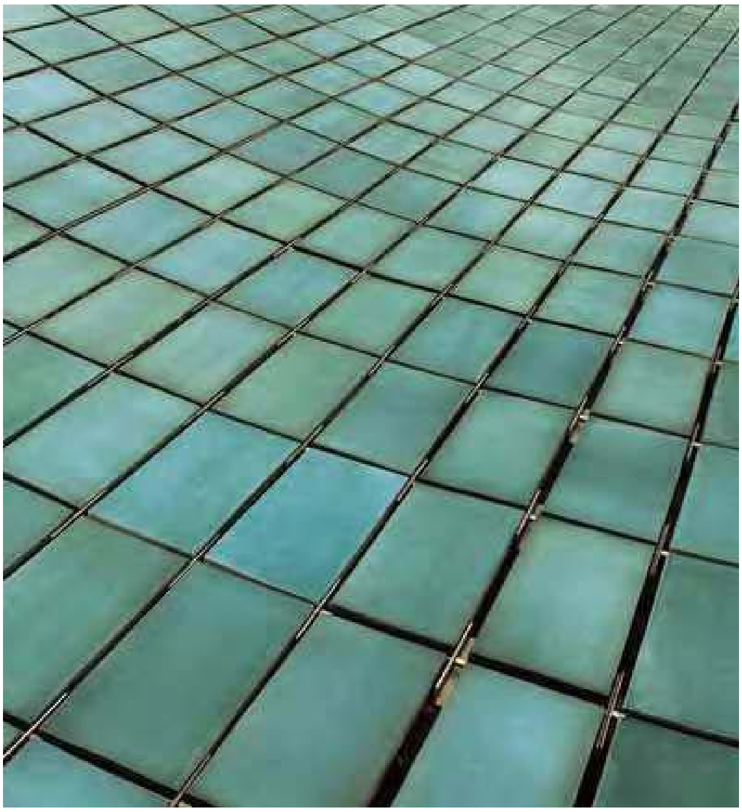
**Global Expansion**

Given that loose Fed policy in prior cycles contributed first to the technology bubble and then to the U.S. housing bubble, worries that aggressively loose policy might cause a bubble in some new location are hardly irrational. On the other hand, the Fed's stimulative monetary policy is increasing the availability of risk capital in many parts of the world, which should prove supportive for global expansion. The global cyclical outlook is favorable, but financial volatility is likely to persist.

There is so much focus on the various stresses in the global economy, domestic economies, currencies and markets that sometimes what we believe is the main story is not emphasized enough: the global economy should remain in a broad sustained expansion for the next several years.

“...the world is witnessing a reflationary impulse, the like of which has never been seen before. All sorts of market scenarios are possible, and continued volatility is all but guaranteed.”

**James Harries, Newton**



“While investment has been an important motor for Latin America’s growth, domestic consumption is also providing a ‘cushion’ against the global slowdown.”

**Alex Gorra, BNY Mellon ARX**

# Equities



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# Opportunities Abound in Global Equity Markets

**Francis Sempill**
Investment Manager
Walter Scott

Walter Scott & Partners Limited (Walter Scott) is a global equity investment manager serving institutional investors worldwide including pension plans, foundations, public funds and financial organizations. It sub-advises a number of mutual funds and equivalent vehicles in the USA, Canada, the UK, Europe and Australia. This manager is based in Edinburgh where it was established in 1983.

Walter Scott
Global Investment Management

In our view 2010 was characterized by seemingly indiscriminate investment across asset classes. With such exuberance has come a marked increase in volatility in equity markets, and we see no reason to expect this to change in 2011.

How does this affect the case for active management of global equities over a long time horizon? We believe continued uncertainty across markets only serves to reinforce the attraction of a bottom-up approach to seek companies with a credible strategy and a strong market position that may deliver sustainable growth through the economic cycle. Through the power of compound growth and dividend reinvestment, we believe real returns can be generated. We believe that stock-picking is the most demanding investment task.

**Quality Shines Through**
Growth has become a much scarcer commodity than it was over recent decades. The equity winners in the corporate world cannot be defined by sector or geography, or by their weighting in benchmarks. We believe imposing geographical constraints on equity selection reduces the opportunity set as well as downside protection through diversification.

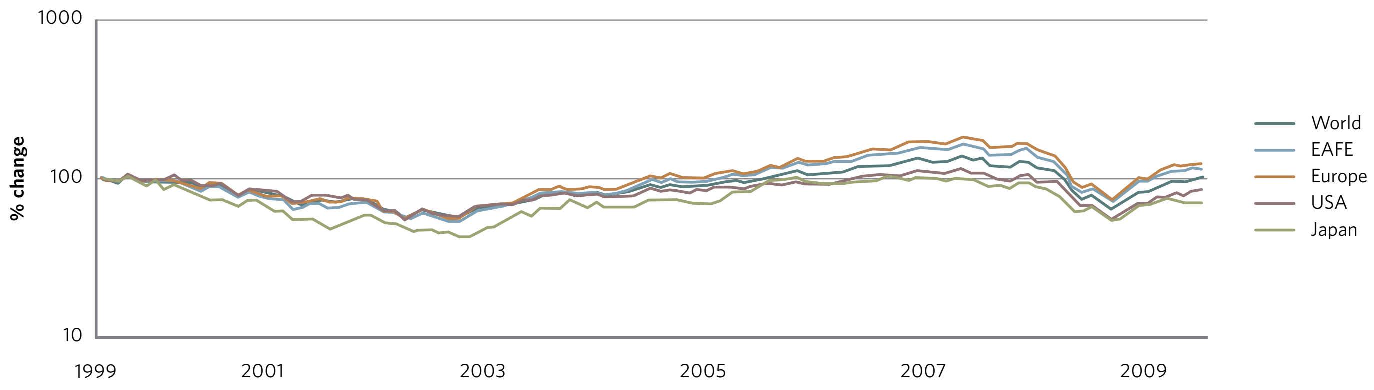
While we still may face uncertain economic conditions and unclear evidence of recovery, news from the corporate sector throughout the year has supported our belief that some great companies can prosper in almost any environment. The retail sector has faced a cautious consumer, with spending no longer fuelled by endless credit, but some individual retailers have continued to show impressive growth on the top and bottom line. For example, a Spanish retail group is continuing to execute an ambitious strategy to expand geographically, with plans to pursue meaningful opportunities across both Europe and Asia.

Volatility in equity markets has also brought investment opportunity. Valuations have come under pressure across the board, providing opportunities to invest in companies we regard highly but previously considered too expensive. For example, we believe technology companies with a global brand and growth opportunities far beyond the PC-based search engine could offer attractive opportunities. Companies providing operating systems for smart phones could be positioned for strong growth. Mobile search is expected to be a major driver of growth over the coming years and around 200,000 new androidbased phones are activated every day. We seek companies with a strong market position and a clear ability to generate cash, drive growth and create wealth over the long term. We believe 2011 may bring further opportunities to invest in great companies with all the attributes we look for at a reasonable price.

**Resilience Holds a Premium**
Leading global companies are by no means restricted to the developed world. The performance of many emerging market companies during 2010 supported our belief that the search for the world's best companies should not be constrained by geographical barriers or categories such as "developed" and "developing" markets. For example, there are a number of companies that are headquartered in emerging markets but are global leaders in their respective fields.

While emerging markets may be in vogue, Japan has fallen from favor with many investors as evidenced by declining exposure to Japanese equities. However, we believe there are still great companies in Japan. Some Japanese companies continue to produce consistently strong financial results. Market volatility is likely to continue and we may be entering a multi-year low growth environment. Still, we see no reason to change the way we seek to generate real returns over time. We believe that global equities remain a very attractive asset class for seeking to purchase growth and capturing return. We believe that will stay true in 2011 and beyond.

**GLOBAL MARKET PERFORMANCE OVER A 10 YEAR PERIOD**




Source: MSCI as at January 2010. MSCI Indices 1999 to 2009 US$ - Total return net dividends reinvested in US$.



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# All Change As Developing World Takes Up the Reins

**James Harries**
Head of Global Equity Income Strategy, Newton[1]

Newton is based in London and recognized as a top-tier U.K. investment house, renowned for its distinctive, proven global thematic investment approach, consistently applied across all strategies.

NEWTON The Power of Ideas

Global capital markets appear confused. Globally, government bond yields are matching Depression-era lows, while the gold price is at all-time highs and other industrial commodity prices are soaring. Less than two years after the biggest debt crisis in history, investors are showing interest in the return of 100-year corporate bonds. These anomalies result from the sheer scale of monetary and fiscal stimulus implemented in the world's major economies. The current economic and market backdrop must be viewed through the distorting lens of these policy settings.

**Rebalancing Act**

At Newton, we seek to understand important underlying trends, which we call themes. These highlight both the longer-term risks and opportunities that we see around the world. Our "all change" theme points to private (and public) sector debt reduction in Western economies. We believe that the credit crisis merely confirmed the transition from an unprecedented period of relatively low economic volatility and super-normal returns, to something more "normal" in a long-term historical context.

This theme is backed by substantial historical evidence that suggests that economic downturns precipitated by deflating credit bubbles and banking crises lead to extended periods of deleveraging and sluggish economic activity. Regardless of the improved backdrop since the worst of the credit crisis, we believe the underlying structural issues remain unaddressed.

The unfortunate reality is that the consumer in both the U.S. and elsewhere in the developed world remains under pressure despite the efforts of the authorities to stimulate demand. The "all change" theme captures the notion that U.S. Federal Reserve (Fed) policy is likely to stay "looser" for longer. As U.S. interest rates and bond yields provide a global benchmark for the cost of money, U.S. policy, and its distortions, are exported worldwide.

The potential distortions do not end there. With the arsenal of conventional monetary policy all but exhausted in many highly indebted developed countries such as the U.K. and the U.S., additional stimulus is likely to take the form of more unconventional policies, such as quantitative easing. This may have a direct impact upon financial asset prices as central banks buy government bonds from the private sector (in order to drive longer-term yields lower) using newly created money.

1. Please see disclosures in appendix

The likely outcome of such policies remains unclear given the structural headwinds that face economies. Unconventional policy is likely to further distort bond markets and capital allocation in economies far and wide. Such policy is likely also to boost investor interest in real assets (such as gold) and ultimately undermine the value of, and confidence in, the world's reserve currency, the U.S. dollar.

Developing world consumption is generally regarded as the world's most exciting longer-term growth opportunity, and we subscribe to that view. Capital has been channelled into these regions, causing their equity markets, real estate sectors and, in some cases, currencies to rise. This trend looks set to continue and, if more money is printed in the West, developing world assets, along with the commodities that fuel their growth, could likely be the epicenter of the world's next financial-market bubble.

The rebalancing of economic models is, however, a multi-year process, not least because, in both the developed and developing world, these adjustments – consuming less and saving more in deficit economies, and exporting less and consuming more in surplus economies – are likely to hamper short-term growth. We believe further bumps in the road are to be expected, perhaps imminently.

**Inflationary Pressures**

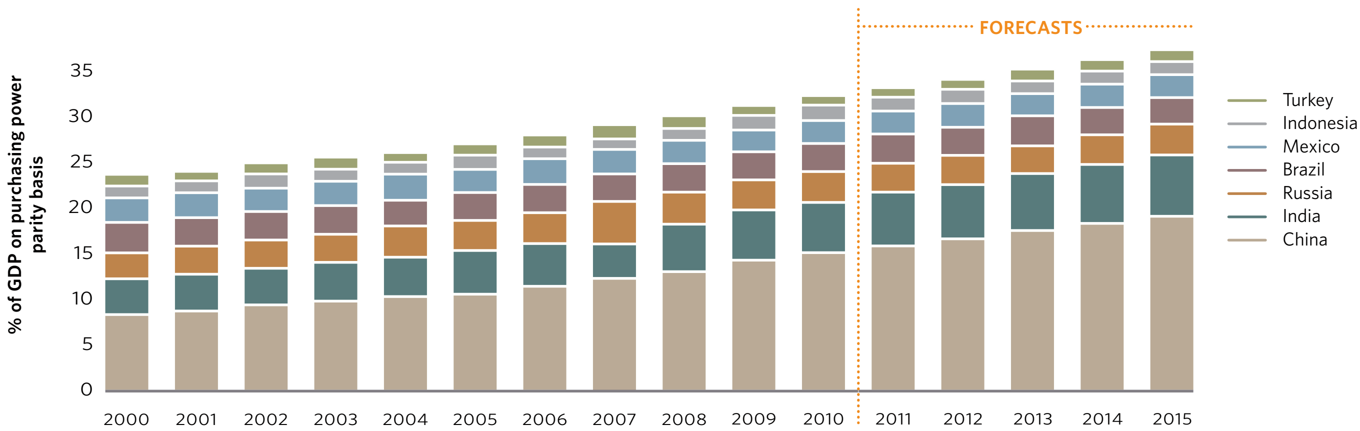
In our view, the most obvious risk facing investors is that overtly reflationary policies succeed in creating inflation. This is already the case in the developing world, where policymakers are often reluctant to raise interest rates, fearing further capital inflows and currency appreciation; something no economy seems to want in the current climate.

We believe post-crisis policies are likely to lead to isolated inflationary pressure– in the developing world and real assets – rather than generalized consumer price inflation. Meanwhile, we expect generalized inflation to be held back by weak domestic wage growth in the developed world, something we believe is already playing out. Ultimately, more widespread inflation is likely if policymakers feel compelled to support their flagging economies with newly printed money.

We believe all is not necessarily as it seems. Although there will be periods when the investment backdrop feels normal, in our opinion investors must remember that this can be far from the case. In the words of the Fed Chairman Ben Bernanke, an arch-proponent of money printing, the outlook is "unusually uncertain."[2] Deflating credit bubbles have a habit of resulting in deflating asset prices and economies, as Japan has discovered in recent years. In response, the world is witnessing a reflationary impulse, the like of which has rarely been seen before. All sorts of market scenarios are possible, and we believe continued volatility for the short term is all but guaranteed.

Against this uncertain backdrop, we continue to seek to invest in sound businesses with a good level of income yield. We think that in a low nominal growth environment income will be a key driver of returns. We also believe that prudently managed businesses, which often emphasize paying dividends, could attract a premium valuation as the current environment resolves its distortions.

**DEVELOPING ECONOMIES ARE INCREASING THEIR SHARE OF GLOBAL OUTPUT**




Source: IMF, July 2010.

2. Bernanke's semi-annual testimony to the U.S. Congress, July 21, 2010.

**EQUITIES** NORTH AMERICA

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# Volatility Marking the Start of a Slow and Steady Recovery

**Brian Ferguson**
Senior Portfolio Manager,
The Boston Company

The Boston Company Asset Management (The Boston Company), based in Boston, uses a bottom-up approach to stock selection, blending quantitative screening with fundamental research. The manager covers value, growth, core, and market neutral strategies.

THE BOSTON COMPANY
ASSET MANAGEMENT, LLC

A prolonged and hesitant economic recovery in the U.S. resulted in considerable market volatility for most of 2010. Equities weakened during the start of the year before an appreciable recovery during the latter half of the first quarter as investors were initially focused on a multitude of economic concerns. The S&P 500 Index, for example, ended the first three months of the year with its best quarterly returns in a decade. Markets were pressured during the second quarter of 2010 as investors became increasingly concerned about a slowdown in the rate of the recovery. A particularly significant sell-off occurred in May as domestic and overseas markets considered the sovereign debt situation in Greece and its impact on the global recovery.

Volatility moved sharply higher during the summer as investors were weighed down by disappointing unemployment figures and continuing problems in the U.S. housing market. As the collapse of the housing market was behind much of the decline into recession, a stabilization of the residential housing market is critical to supporting future growth. So far, however, few signs of stabilization have yet to be seen. That said, quarterly earnings in the U.S. largely delivered better-than-expected mid-year results, although those earnings were still recovering from depressed levels.

Equities rallied again during the latter half of the year as recent signs of economic improvement increased positive sentiment and overshadowed concerns regarding a potential double-dip recession. Despite another significant sell-off in August, as investors digested reports that signaled further weakness in the housing market, stocks surged again in September, overcoming prior month losses as markets responded favorably to new global banking rules, upbeat economic data from China and a pick-up in merger and acquisition (M&A) activity.

**Uncertainty Prevails**

Overall, concerns regarding a double-dip began to wane during the course of 2010; the gains in September – historically the worst month for the equity markets – were a welcome surprise and may have been a sign of higher confidence. Global expansion worries abated as economic reports reflected a rebound in China's manufacturing sector and better-than expected growth in the country's industrial segment. Investors also reacted positively to the stronger-than-expected report on orders for durable goods in the U.S.; solid rebounds in goods excluding transportation lessened the remote chance of a double-dip recession in the immediate future. Additionally, new global banking reform was positively received by investors as financial institutions will be required to more than double their capital reserves in an effort to mitigate the impact of future crises. But perhaps the most significant consequence of the market declines of 2008 is a strengthening of the balance sheets of both consumers and corporations alike as both sought to pay down debt and increase cash flow. By the end of the second quarter in 2010, consumer and corporate free cash flows rose to record levels (see chart).

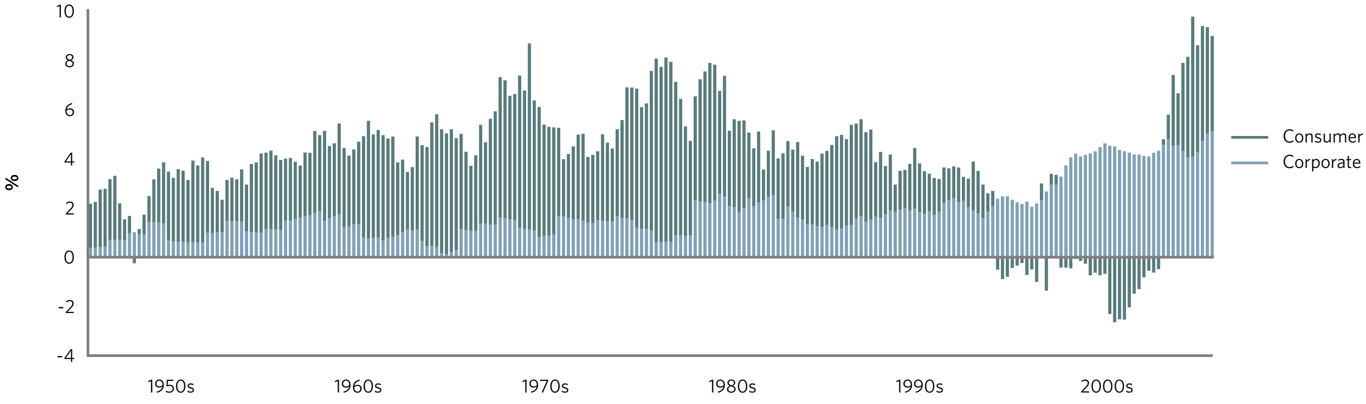
To us, it seems that corporate America's reluctance to spend the cash hoarded on balance sheets is due to the uncertainty over the implications of healthcare reform, financial reform, and tax increases; each of these raises meaningful questions for companies with many of the details of the various plans not yet finalized.

Nevertheless, we see compelling U.S. equity opportunities in some sectors. Within the consumer discretionary sector, and retail segment in particular, back-to-school shopping, albeit later than usual, helped position companies for stronger-than-expected operating results for 2010. Meanwhile, within the media segment, many content creators are boasting attractive free cash-flow yields, solid fundamentals, and both absolute and relative business improvement. Elsewhere, we believe there are many opportunities in the financial sector. We believe the short-term headwinds facing capital markets have been fully priced in, and record corporate cash balances present opportunities for future M&A activity. Regional banks should also benefit from improving credit costs and expectations of higher earnings.

**A Rocky Road Ahead**

Overall, we remain optimistic about the U.S. economic recovery, while at the same time acknowledging that the pace of recovery has slowed. Negative headlines have continued to pressure the market; but company management has generally not yet observed a slowdown in business. As a result, the greatest risk going forward is, in our opinion, a negative feedback loop whereby company management – who read the headlines like everyone else –slow spending and curtail growth initiatives, generating further negative headlines. As fundamentals continue to fluctuate, we expect the markets to remain erratic until the macroeconomic environment begins to stabilize. We believe that the economy remains in the middle of a slow recovery, but we are concerned that current expectations are too high. We continue to take a long-term view and seek to identify investment opportunities from short-term events and market overreactions.

**CONSUMER AND CORPORATE FREE CASHFLOWS RISE TO RECORD LEVELS (DEC 1950 - JUNE 2010)**




Source: US Department of Commerce, Corporate Reports, Empirical Research Partners Analysis. Corporate data for large-cap stocks, excluding financials and utilities.



# Resilient Latin America Plays to Its Strengths

**Alex Gorra**
Head of International Platform,
BNY Mellon ARX

BNY Mellon ARX is based in Rio de Janeiro and specializes in Brazilian multi-strategy, equity long short, equity long only and fixed income investment strategies. BNY Mellon ARX provides access to the expanding investment opportunities in the rapidly growing Brazilian marketplace.

Latin America entered the global recession in good shape, and has emerged relatively unscathed and rebounded strongly.

In particular, we believe Brazil, Latin America's biggest nation, looms large as an investment bright spot thanks to the successful economic policies of the hugely popular President Luiz Inacio Lula da Silva, who is stepping down after reaching his term limit. As Lula's hand-chosen candidate, Dilma Rousseff, the winner of October's presidential election, represents continuity, her campaign having been largely based on continuing his legacy. This has been underscored by Rousseff's market-friendly messages of prudent economic policies and respect for the independence of regulatory authorities, such as the central bank.

President-elect Rousseff aims to reduce net debt to 30% of GDP, from 40%, so that interest rates, which are the second-highest in the world after inflation, might fall. The Brazilian central bank's benchmark Selic rate[1] stands at 10.75%, which, with inflation running at 5.0%, translates into a real interest rate of approximately 5.8% per year. Brazil's high debt burden and government spending levels have helped keep real interest rates relatively high. In recent times, high interest rates in Brazil, combined with record low rates in the developed world, have led to concerns that speculative money is moving to Brazil to tap those higher returns, driving up the value of the Brazilian real and hurting Brazilian exporters.

We believe another market-friendly aspect of Rousseff's approach is her plan to spend more efficiently rather than to tighten the purse strings; were she to do the latter, it could choke off the rapid growth that has lifted millions of Brazilians out of poverty. Curbing inefficient spending is critical to safeguarding government funds that are needed for key infrastructure investment.

**Building for the Future**

There is a general recognition that the current state of Brazil's infrastructure has the potential to hold back the country's economic development, especially given the capacity shortfalls identified in the country's ports, railways, airports, roads and distribution centers. It is striking that Brazil lacks a national rail network. From 2010-2013, infrastructure investment is likely to represent 2.2% of GDP per year (see chart). High-profile elements of the infrastructure

1. Sistema Especial de Liquidação e Custodia. The Selic rate is the Brazilian central bank's overnight lending rate.
All data sourced from Bloomberg as at November 1, 2010.

spending plans include work for the upcoming World Cup and Olympic Games. Investment in infrastructure has a multiplier effect as it stimulates growth in the wider economy. Brazil has a potential GDP growth rate of approximately 5.5% in real terms. Any growth above this figure raises the risk of inflation.

While investment has been an important motor for Latin America's growth, domestic consumption is also providing a "cushion" against the global slowdown. Of particular note, Brazil has experienced a significant improvement in social mobility, a trend that favors domestic consumption. Rising disposable incomes make for more discretionary spending, while the pool of consumers will grow as the country's young (a large segment of the population) enters the workforce.

Brazil's boom has trickled down to benefit other countries, including neighboring Argentina. Although Argentina's recent history of political intervention in the economy has a made it a less attractive destination for global investment, Argentina could benefit from a move to a more centrist and market-friendly stance following the death of former president Nestor Kirchner, a strong behind-the-scenes interventionist influence on the current president, his widow Cristina Kirchner. (Nestor Kirchner had been expected to run for president in 2011.) Despite the twists and turns of domestic policy, low global interest rates have helped to mitigate capital flight from Argentina. Strong external demand and a large soya bean harvest have boosted Argentinean exports, while local producers have gained a temporary advantage from import barriers.

Chile's economy is growing strongly, with GDP growth expected to average 6.0% or more, in 2011. Domestic demand is booming, partly attributable to the temporary boost from post-earthquake spending. In February 2010, a massive earthquake hit central Chile. The country's electric power, telecommunications and transportation infrastructure were among the hardest hit segments of the Chilean economy and will require extensive rebuilding. The cost of repairing and rebuilding the infrastructure and housing damaged during the earthquake is put at around US$1.2 billion. While Chile's President Sebastian Pinera received a boost in his approval rating following the rescue of 33 trapped miners, we believe his management of the economy was also a factor in his high rating.

In Peru, we believe commodity prices remain supportive of growth – like its southern neighbor, 6.0% growth is expected in 2011. In addition, we expect a combination of high business confidence, low interest rates and continuing growth in investment to underpin economic expansion during 2011. In light of significant infrastructure quality gaps, there is an emphasis on infrastructure projects, in which the private sector is increasingly expected to play a leading role.

Mexico, Latin America's other main economy, can provide investors exposure to most of the region as its companies are often regional powerhouses operating throughout Latin America. Within its own borders, Mexico has its own substantial consumer market. A risk is Mexico's exposure to the U.S., the destination for the greater part of its exports, as sluggish recovery in the U.S. could dampen demand for Mexican goods.

We believe that while uncertainty is pervasive at the global level, Latin American countries may offer the prospect of solid growth.

*Unless otherwise noted, all data sourced is from Bloomberg as at November 1, 2010.*

**BRAZIL: INFRASTRUCTURE INVESTMENT PLANS (2010-2013)**

| Sectors | R$ billion | % of total | % of GDP per year |
|---|---|---|---|
| Electricity | 92 | 33.6 | 0.7 |
| Telecommunication | 67 | 24.5 | 0.5 |
| Sanitation | 39 | 14.2 | 0.3 |
| Railways | 29 | 10.6 | 0.2 |
| Highways | 33 | 12.0 | 0.3 |
| Ports | 14 | 5.1 | 0.1 |
| **Infrastructure** | **274** | **100** | **2.2** |

Source: World Bank and PPIAF, PPI Project Database (http://ppi.worldbank.org) as at March 25, 2010.



BNY MELLON
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# Volatility Is Here to Stay

**Simon Nichols**
Investment Manager,
U.K. Equities, Newton[1]

Newton is based in London and recognized as a top-tier U.K. investment house, renowned for its distinctive, proven global thematic investment approach, consistently applied across all strategies.

**NEWTON**
**The Power of Ideas**

The world is in the early stages of a transition that is likely to involve a multi-year rebalancing of the global economy. It requires deficit-running developed world countries like the U.K. to consume less and save, produce and export more; and surplus-running developing countries to save less and consume and import more. This rebalancing is likely to require changes in economic policies and potentially living standards as well as political involvement to smooth the transition. It seems inevitable that there will be pain for many.

Early skirmishes have already occurred in the currency markets. The U.S. and China have been in battle over the renminbi peg, and emerging market currencies have felt the strain. One of the risks to global growth is that domestically focused politicians might be tempted to erect trade barriers. Early examples of this have already been seen as Brazil, Thailand and Japan have taken action to weaken their currencies. Indeed, currency adjustments could play a major part in rebalancing; for example, the weakness of sterling should eventually aid the global competitiveness of U.K. companies.

We feel the U.K. is a good example of how unprecedented monetary and fiscal tools have been employed throughout the developed world. Interest rates are at all-time lows, and quantitative easing has been used to provide much-needed liquidity to financial markets. The economic downturn has seen the private sector shrink, and government has become a much larger part of the economy, with the budget deficit reaching what we consider to be uncomfortably high levels. However, we believe the new coalition government's comprehensive spending review has provided the U.K. with a credible plan to restore confidence in the country's finances. Large spending cuts and tax rises need to be implemented to achieve this aim, and such fiscal consolidation plans may carry further pain in the short term as the economy adjusts. With interest rates at close to zero, the Bank of England has very few weapons left in its armory to limit the negative impact of these austerity measures on consumers.

Against this uncertain macroeconomic backdrop, and with monetary and fiscal policy experiments under way in many countries, volatility is likely to remain a feature of markets over the near term.

1. Please see disclosures in appendix.

**Opportunities Abound**

As ever, we believe stock picking remains key in such an environment, as we continue to be guided by Newton's thematic investment process. We believe that bank stocks exposed to the developed world will struggle to grow as the deleveraging process continues, while stricter regulation will prohibit their short-term ability to provide investors with an attractive dividend yield, although they may be in a position to pay dividends in the future. Meanwhile, U.K. consumer finances remain under pressure as austerity plans take hold, and the lack of credit availability is likely to constrain house prices, having a negative effect on consumer wealth. As such, we expect a tough outlook for domestically focused, consumer-oriented stocks, although in some cases valuations will reflect this tough environment.

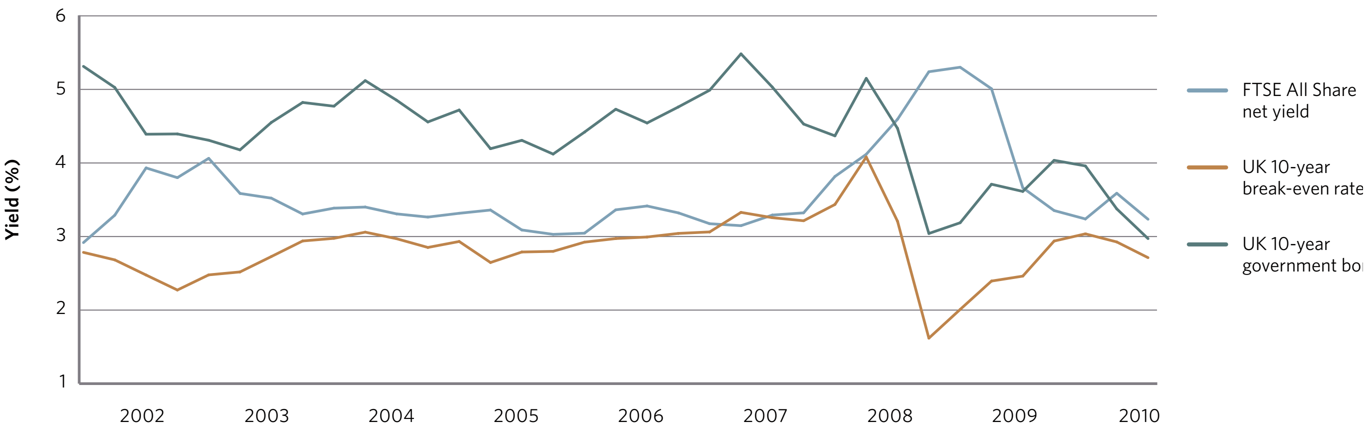
Importantly for U.K. equity investors, the U.K. stock market contains a diverse range of multi-national companies with exposure to those regions of the world where economies are growing. Many of these are some of the U.K.'s larger stocks, and can still be bought at what we believe to be relatively inexpensive valuations. In recent years, these stocks have underperformed mid and smaller capitalized companies, which have enjoyed much greater returns but whose valuations often rely heavily on sustained growth.

Meanwhile, we believe there continues to be good income opportunities within the U.K. market for investors to gain exposure to earnings streams that have not yet benefited from the yield compression that we have seen in fixed income markets. Bond yields have moved to very low levels, suggesting that fixed income investors expect a prolonged period of low growth, although quantitative easing is likely to add some uncertainty in this regard.

As the chart shows, inflation expectations have increased back to more moderate levels at the same time that nominal yields have compressed. We believe this suggests that bond market returns are set to be muted. Higher yielding equities, which have some element of protection should monetary policy experiments prove inflationary, should prove to be attractive investments in this environment.

The world is undergoing an unprecedented rebalancing process, and there is a heightened level of uncertainty at both a market and economic level. Despite this, we expect to find many opportunities within the U.K. equity market where attractive returns can be achieved.

**NOMINAL YIELDS HAVE COMPRESSED IN THE UK**




Source: Bloomberg, as at September 30, 2010.



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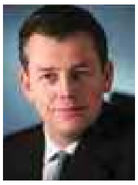
# Companies Rebound While Consumers and Governments Struggle



Andy Cawker
Head of Specialist Equities, Insight Investment

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Insight
INVESTMENT

Despite widespread concerns over the health of the British economy, we remain positive about the prospects for U.K. companies in 2011 and believe recent high correlations between share prices and market movements have created several potentially compelling opportunities for investors.

**Years of Volatility Have Left Parts of the Market Looking Undervalued**

Equity investors have had a rollercoaster ride in recent times; as a chart of the FTSE 100 shows, the U.K. equity market, for example, has effectively halved in value twice over the course of the past decade. 2010 was another highly volatile year – with risk appetite oscillating sharply – in which share prices have predominantly been driven by macroeconomic issues. Consequently, many asset allocators have favored bonds over equities, which we believe has left many parts of the equity market unloved and looking undervalued, particularly in the U.K. and Europe. The recent increase in merger and acquisition activity is evidence of this, and a strong signal that certain company valuations are not expensive. We expect this increase in merger and acquisition activity to continue in 2011.

**A Supportive Corporate Picture**

In 2011, we expect the balance of growth in the global economy to continue shifting from the Western world to emerging markets; developed world governments are likely to focus on deficit reduction and consumers will continue to pay down debts. While the headlines on the economy may make for grim reading, there are a number of reasons we believe the outlook for equities looks more positive.

First, in our view, companies have been conservatively managed through the recent recession and are well placed for the so-called "sober" decade, with healthy balance sheets and high cash levels. These businesses are likely to want to invest some of this cash to enhance profits organically, as well as returning some of it to shareholders by growing their dividends or buying back shares.

Secondly, we believe it is largely global growth that matters to equities, not the domestic outlook. For example, over 60% of the earnings of FTSE 100 companies comes from overseas, much of which is from countries with more robust rates of economic growth than that of the U.K.[1] This means that there are plenty of

1. Insight research.

companies with attractive growth prospects. A slowdown in the U.K.'s economy, therefore, need not necessarily lead to a fall in the shares of domestic companies if global growth remains strong.

Furthermore, significant inflows into fixed income assets have driven yields down to very low levels. Interest rates are at virtually zero and seem set to remain low. This environment has left many parts of the equity market looking attractive compared to other asset classes, especially given their decent yields and inexpensive valuations.

**Equities to Remain Volatile, But With Declining Correlations**

The combination of low growth and highly indebted consumers in developed economies has left little room for policy error, with too much tightening in fiscal policy risking a return to recession, but too loose monetary policy risking inflation further down the line. U.K. equity markets are likely remain volatile in 2011, as investors treat each negative piece of macroeconomic data as signs of a "double dip" and good news as the "all-clear" signal. We believe this is a fact of life in a low nominal growth world. The dominance of macroeconomic themes in investors' minds in 2010 led to high correlations between share prices as shares moved up and down largely with the market, often regardless of how well placed specific companies were to grow profits from a fundamental perspective. This has created a number of valuation anomalies in certain sectors and specific stocks. We believe company fundamentals are likely to become more important in 2011, with investors increasingly focusing on winners and losers in the "new normal" environment.

**Companies Demonstrating Good Growth Should Outperform**

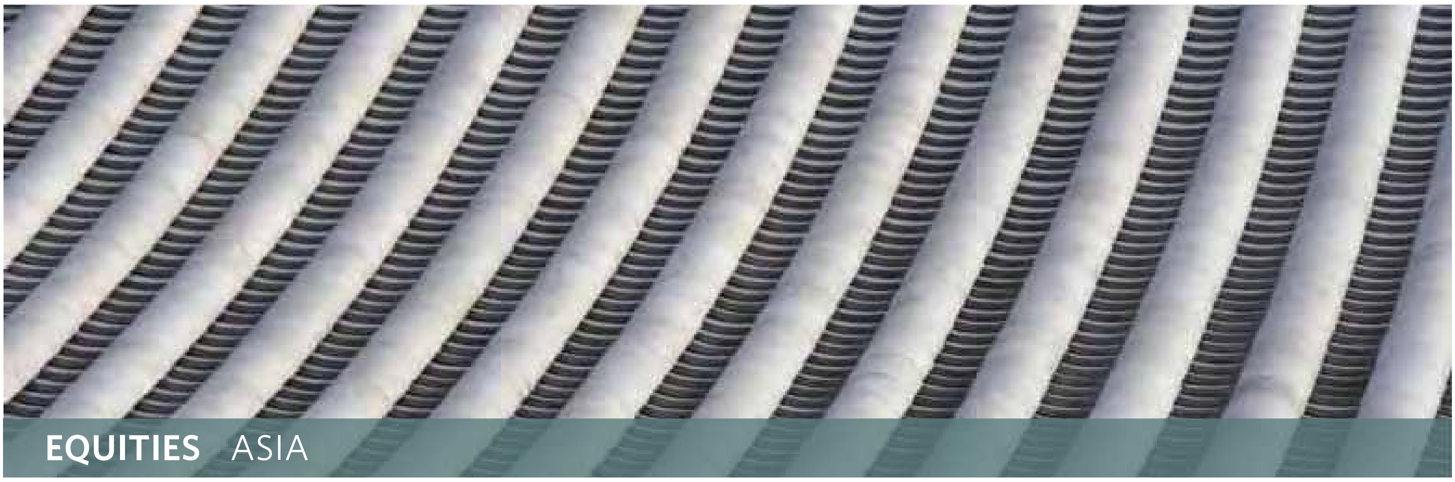
From a stock-picking perspective, we believe the "winners" will share certain characteristics. Stocks that generate above-average organic growth are likely to be rewarded with higher valuations given the low-growth environment. Businesses with these characteristics may include companies with a growing proportion of profits coming from emerging markets, companies in growing industries (for example, certain parts of the technology sector) and companies with good pricing power. Furthermore, with the corporate sector in better health than governments or the consumer, we think that investors will favor companies that sell all (or the majority) of their goods or services to other businesses.

Given global investors' relentless search for income, we expect high-quality, high-yielding blue chip stocks to be attractive, as they offer a compelling alternative to the very low yields and lack of inflation protection in what have generally been considered "safe" assets such as government bonds and cash.

On a less optimistic note, we are likely to continue to avoid or hedge exposure to companies exposed to overleveraged Western consumers who are likely to be weakened further by rising taxes and state spending cuts. Additional pressure on consumers' disposable income is emerging in the form of inflation from various input prices acting as a form of tax on the consumer, especially if wage inflation remains subdued.

**ROLLERCOASTER YEARS FOR THE U.K. EQUITY MARKET (FTSE 100 INDEX)**

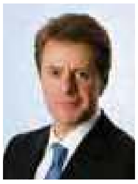

Source: Thomson Datastream from November 4, 1997 to November 4, 2010, price index in GBP





BNY MELLON
ASSET MANAGEMENT

# The Asian Consumer Picks Up the Pace



**Jason Pidcock**
Investment Leader,
Asian Equities,
Newton[1]

Newton is based in London and recognized as a top-tier U.K. investment house, renowned for its distinctive, proven global thematic investment approach, consistently applied across all strategies.

NEWTON
The Power of Ideas

In the midst of the economic doom and gloom overshadowing Western economies, it is easy to forget about the 500 million aspirants in Asia who, due to hard work and thrift, are rapidly moving up the income curve. Looking forward to 2011 and beyond, we believe that the scale and effect of changes in consumption patterns across Asia will surprise on the upside.

Taking a step back, we recognize that a host of meaningful changes have taken place over the past decade, unleashing the spending power of the Asian consumer. These have culminated to a point such that we are potentially on the brink of an unprecedented consumption boom in Asia.

At the heart of this change are the region's population dynamics. China, for example, is currently in a demographic sweet spot where its dependency ratio (defined as the ratio of the number of under-16s plus the number of over-60s, to the number of the working age population) has plummeted from 67% in 1980 to 39% today[2] – an all-time low. With a low dependency ratio, out of every additional dollar earned, a higher proportion can be spent on discretionary consumption.

Another important impact is the psychology of the consumer. Saving ratios have always been relatively high in Asia due to the absence of a meaningful social safety net. In China, this is slowly changing as the government embarks on implementing programs for healthcare and social housing. In addition, minimum wage increases, the young acquiring expensive and fashionable tastes, and the wealth effect from rising property prices have helped accelerate this trend of falling savings for the younger generation.

In China, the urban population is expected to increase by at least 200 million people by 2025 and importantly, the number of middle-class households could increase four-fold to 280 million, from 55 million today.[3] Crucially, as an increasing proportion of the population hits the middle class income level (earning the equivalent of around US$3,000 per annum), spending on low-end staples such as diapers, or food products such as processed meats, is likely to boom. At the higher end of the spectrum, the wealth effect driven by asset inflation can spur spending on luxury goods, including designer clothes and expensive cars.

1. Please see disclosures in appendix.
2. Observed patterns (NBS); Predicted trends (CCPDS), October 2010.
3. United Nations, CLSA Asia-Pacific Markets, August 2009.

One could worry that rising incomes caused by increases in the minimum wage will reduce corporate profitability. It is true that the government's recent mandate to increase the minimum wage by 20% will increase costs[4]; however, this needs to be coupled with increases in productivity as companies employ mechanization and increase production targets for their staff.

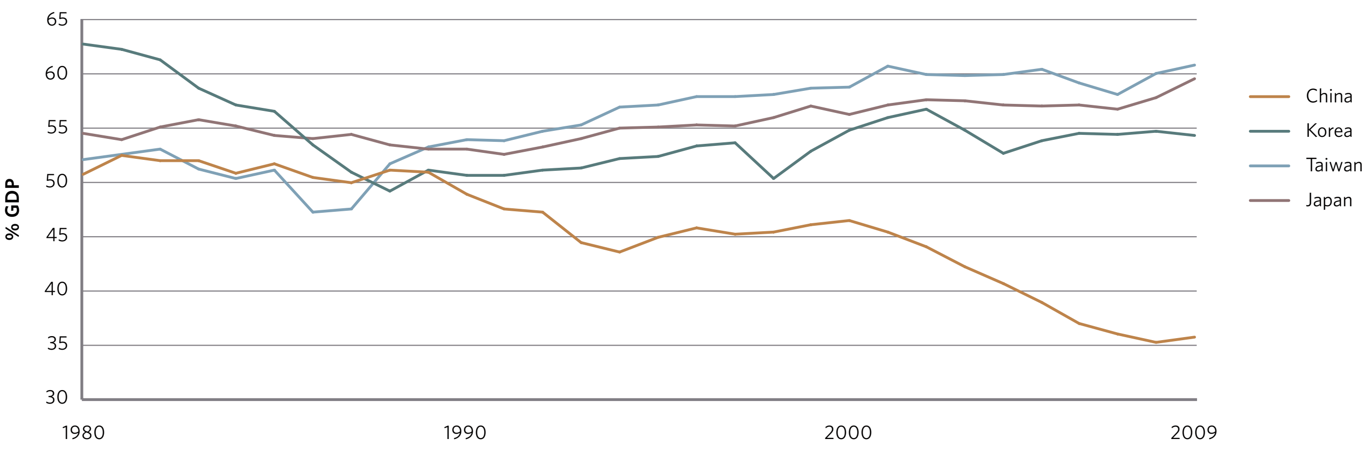
**Shifting Sands**

China is therefore experiencing a realignment. Not only is GDP transitioning from an investment-driven to consumption-driven model, China is also experiencing an economic shift from the coastal cities of the east to central and western provinces, as firms source cheaper labor and rural towns urbanize. The realignment trend is not distinct to China. In southeast Asia we are also seeing the demise of the export-led growth model in favor of a more domestic-focused one. This has proved to be a boon as many of the Western markets that usually receive a large proportion of their exports are still in the depths of a protracted recovery.

The risks to this bright picture for China, and Asia more generally, are that the Western economies buck the trend of recovery, and fall back into a recession. In this case, investors' risk appetite may be reduced and Asian companies' earnings temporarily hurt. Conversely, if there were a strong recovery in the West and central bankers were sufficiently concerned about inflationary risks to raise interest rates, the abundant liquidity that is currently inflating the Asian stock markets could disappear, fuelling a sell-off. However, we believe the likelihood of this scenario occurring, at least in the near term, is low as the likes of the U.S. Federal Reserve have committed to keep the interest rate environment favorable for some time. Another possibility would be that as hot money continues to surge into Asia, countries with pegged exchange rates may find it difficult to contain these inflows to stabilize the currency. This may cause them to introduce capital controls, which could further misallocate capital in the region, resulting in the classic "bridges to nowhere."

Despite this, we believe that globalization, which in our opinion has created a plutocracy in parts of the West, is increasingly working in China and other emerging Asian countries to create a large affluent class with significant buying power. In a post-global financial crisis world, these countries are embarking on the next stage of their economic growth and expansion. Having already reaped the rewards of China's productive power over the last decade, the world will now begin to feel the force of its consumptive power, especially as the vast population in the rest of the region increasingly follows China's lead up the income and consumption curve.

**GLOBAL REALIGNMENT – CHINESE CONSUMPTION SET TO RISE (CONSUMPTION/GDP)**




Source: CIEC, January 2010.

4. "China's Changing Workforce Creates Problems and Opportunities," BNY Mellon Asset Management/Hamon Investment Group, August 2010.



BNY MELLON
ASSET MANAGEMENT

# Asia's Rebalancing Act

**Hugh Simon**
Chief Executive Officer, Hamon[1]

Hamon Investment Group (Hamon) is based in Hong Kong and specializes in Asian equity investment. Hamon is led by an experienced management team that is drawn from a wide variety of disciplines and possesses solid and substantial fund management and research experience.

HAMON INVESTMENT GROUP

As the first year of a new decade draws to a close, Asia has taken an important step towards consolidating its international influence, as well as its political and economic clout. Despite concerns over austerity measures in Europe, a possible secondary economic contraction in the U.S., and earlier-than-expected policy tightening in China, Asian equity markets in general continued to outperform developed markets in 2010. Looking ahead, we believe the region offers compelling growth opportunities over the next decade, especially in the Association of Southeast Asian Nations (Asean) markets.

In order to provide continuing growth over the coming decade, we expect emerging Asian economies to further broaden their efforts to strengthen the purchasing power of domestic consumers, upgrade infrastructure and invest in improvements in advanced technology. While exports will remain a key driver of the region's economic growth, we believe domestic consumer sectors and industries will evolve towards higher-value services, in the process rebalancing Asia's economic engines, and creating a stable foundation for sustainable growth, as well as agricultural reform.

**Focus on Domestic Economies**

Favorable policies and natural demographic advantages are important drivers of growth in emerging Asian economies. Specifically, we expect the region's growth to come from a combination of urbanization and rural reforms, rising income levels, developing social programs, an expanding middle class and greater demand for higher living standards.

Amid the growth of emerging Asia's middle classes, particularly in China and India, domestic companies are seeking to increase their brand awareness, advertising and marketing activities to meet local demand for superior and more competitively priced goods. Meanwhile, China's recently announced five-year plan – the twelfth it has announced – incorporates policies that address the imbalance between coastal and inland provinces, as western China is expected to grow faster than the coastal areas, led by rising consumerism in rural and secondary cities.

Rising levels of income and improved social welfare should also lead to increased demand for higher end and large-ticket items. In India for example, we believe rapidly growing demand for automobiles will serve

1. BNY Mellon holds a 19.9% interest in Hamon Investment Group Pte Limited, which is the parent of Hamon U.S. Investment Advisors Limited. Hamon's services are offered in the U.S. by Hamon U.S. Investment Advisors Ltd.

as a multi-year catalyst for the economy, given comparatively low penetration levels and the fact that the Indian middle class is dramatically expanding.[2]

**Infrastructure: a Recognized Necessity**
Extensive industrialization and modernization programs are transforming underdeveloped areas and remain a long-term catalyst for economic growth in emerging Asia. Developments to construct or improve roads, railways and telecom networks aim not only to promote urbanization, but also secure better logistics to support economic growth in those areas. China's rising demand for railway electrification systems and high-speed railway networks remains a multi-year growth driver given the economy's migration to advanced engineering systems. As China moves in favor of structural industrial changes, we expect India to increasingly follow suit; the authorities there have recently proposed the country's first high-speed train project.

**Increased Demand for Soft and Hard Commodities**
Rising infrastructure developments, along with a weakening US dollar (and increasing questions about the greenback's status as the global reserve currency) are likely to fuel commodity price rises. Furthermore, demand for commodities may also be supported by economic growth in emerging Asia. Robust demand from the larger emerging economies of China and India also bodes well for Asean countries that export to these markets.

Against this backdrop, although inflation rates are expected to increase across the region, we expect higher consumer prices to remain manageable given the reflection of the economy's domestic demand.

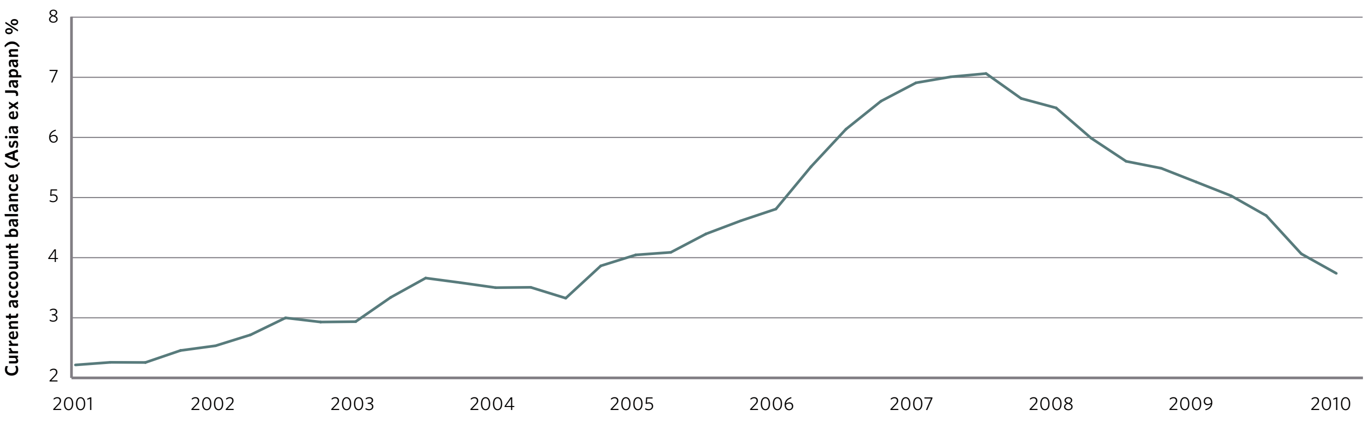
**Technology Drives Growth**
Weaknesses in orders and shipments from developed markets were unable to dampen Taiwanese and Korean production of advanced technology products in 2010, as inventory levels declined and new product launches continued to revitalize market interests. The better-than-expected consumer response to tablet computers and smart phones reflects underlying technology demand. Consumption patterns are migrating towards touch technology and related supply-chain components, including advanced and more sensitive glass screens. The release of new products should continue to support demand. We expect corporate PC replacement levels to pick up following the low levels of replacement seen in 2010.

We also believe China's IT servicing and internet sectors will continue to develop and flourish in the coming years. Furthermore, 2011 will represent the first full year of the Economic Co-operation Framework Agreement (ECFA) between China and Taiwan, where warming cross-strait relations look set to spur growth in the hospitality sector – to the benefit of both hotels and airlines – as well as the financial sector.

**Conclusion**
Opportunities in emerging Asia are growing at a rapid rate, and markets are outpacing their developed peers. We expect this trend to evolve into the new normal over the coming decade, driven by growing middle classes, infrastructure spending and urban modernization.

Among recent forecasts, it is notable that India's real GDP growth is expected to outpace that of China at some point over the next 10 years while China strives to reach its goal of sustainable growth. We believe the investment growth opportunities in Asia will be more compelling, particularly as the region's authorities strive to shift the emphasis of economic growth from exports to domestic consumption.

**DECREASED ACCOUNT BALANCES SUGGEST ASIAN COUNTRIES ARE SLOWLY REBALANCING THEIR ECONOMIES TO BECOME MORE DOMESTIC-DRIVEN.**




Source: CEIC, Morgan Stanley Research, from March 2001 to June 2010, % of GDP

2. "The Middle Class in India," Deutsche Bank Research, February 15, 2010.



BNY MELLON
ASSET MANAGEMENT

# Despite Near-Term Headwinds, Fundamentals Remain Intact

Kirk Henry
Senior Managing Director and Senior Portfolio Manager, The Boston Company

The Boston Company Asset Management (The Boston Company), based in Boston, uses a bottom-up approach to stock selection, blending quantitative screening with fundamental research. The manager covers value, growth, core, and market neutral strategies.

The Boston Company
Asset Management, LLC

After an exceptional 2009, emerging markets traded sideways early in 2010. After six to eight months of a choppy market within emerging market equities, the third quarter of 2010 delivered an exceptional return relative to other markets, moving the MSCI Emerging Market Index into positive territory for the year, as corporate earnings continued to exhibit solid recovery characteristics. China tightened lending policies just enough to moderate the pace of loan growth and remove some of the froth from the property market. While the Chinese government has indicated a willingness to remove the peg to the U.S. dollar and allow a strengthening of the Chinese currency, evidence points to a prolonged and moderate appreciation of the yuan.

We believe the next 6 to 12 months will be challenging for emerging market central banks as rising food inflation continues in emerging Asia. An effort to stem inflationary pressures with tightening monetary policy could spark continued foreign investment flows attracted to higher yields, denting export pricing competitiveness. In October the Brazilian government raised the tax on foreign investment inflows into Brazilian fixed-income securities to 6% to mitigate further currency appreciation from growing inflows.

We think an issue to be mindful of in such an environment is an outbreak of "competitive devaluation" in which multiple countries attempt to implement policies to ensure a relatively weak currency. Such moves towards inward thinking could prove problematic to a more robust global recovery. However, with a continuation of ultra low interest rates, and potential for further quantitative easing (QE) in the developed markets, and the U.S. in particular, we believe investors are likely to continue to favor allocating assets to the emerging markets.

We believe valuations are close to mid-cycle average multiples currently, providing the chance to purchase good quality franchises that exhibit continued earnings and margin recovery characteristics at a discount to the market. However, volatility has continued during the latter portion of the year, as weak economic data in developed countries and uncertainty regarding China's expansion has led investors to rotate back into perceived safe havens. The U.S. dollar has been a key currency trade, strong when the risk trade subsided, and weak following the U.S. Federal Reserve's announcement of further QE. Earnings support and more favorable economic conditions have allowed emerging markets to outperform developed markets during recent sell-offs. Meanwhile, China surpassed Japan to become the world's second largest economy, a reminder of the country's critical role to the global economic recovery.

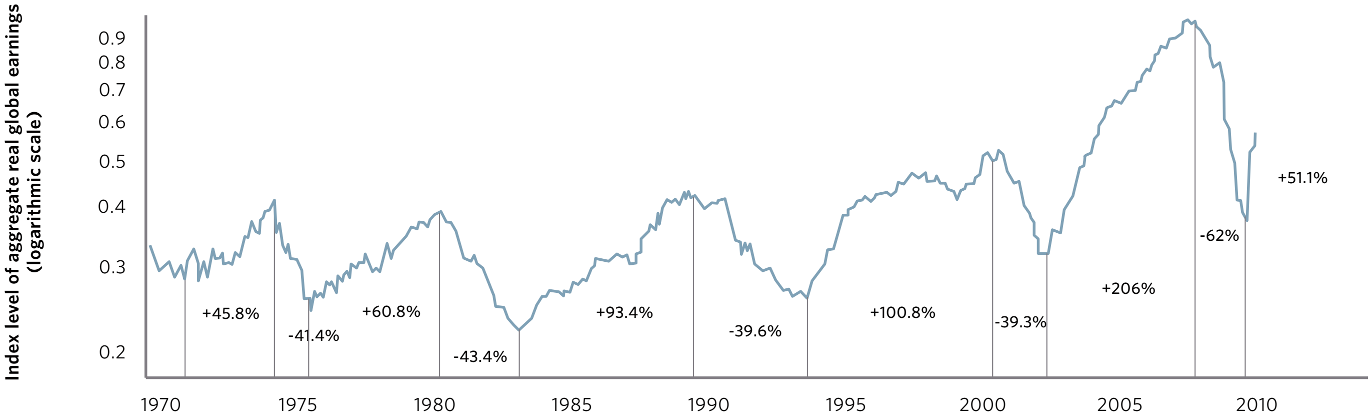
**Domestic Focus**

While 2010 saw emerging markets perform well relative to the G7, there has been a notable shift toward defensive sectors that are more exposed to trade as opposed to cyclical sectors. While we do not foresee a major contraction in developed economic growth in 2011, expansion will be below trend and arguably an obstacle to emerging market expansion, in our view. Cyclical industries compose 35% of the MSCI Emerging Market Index, and many of these companies, base metal producers for example, could be vulnerable to margin pressure if demand remains weak. China, a major growth driver, has curbed credit expansion to dampen speculative property investing. Lending has been robust, and many Chinese banks could be forced to raise capital to support future growth and protect balance sheets from loan losses. Uncertainty has already clouded the steel sector, which declined sharply in 2010.

Smaller markets, such as Thailand, Indonesia, Malaysia and Turkey, rely less on exports and should fare better, but much of this is reflected in recent performance. With valuation spreads at or above average, we remain cautious for the balance of the year. Emerging markets have been generating higher earnings growth and margins than developed markets, and should normally demand higher multiples. Near-term headwinds could cause margins to fall and multiples to contract. However, this scenario should favor companies with defensive market positions, stable top line growth, and the ability to grow margins.

Further on the horizon, our outlook for emerging markets remains positive. With burgeoning middle classes, pent-up consumer demand and young populations, emerging markets appear to us to be unmatched in their prospective return on investment. The staggering growth of emerging market economies has led to a new dynamic in global consumerism. Increasing wealth and modernization across these markets is creating a new global middle class, which is likely to become tomorrow's most important consumer base. Favorable long-term demographics, low product-penetration levels, and greater purchasing power all point to current and future growth in domestic demand. For example, real earnings, which are adjusted for inflation and therefore provide a measure of purchasing power, have begun to rise markedly on a global basis from previous lows at the beginning of 2010 (see chart). While emerging market equities are able to capture much of this economic expansion, traditional indexes have a bias towards the natural resources sector and global exporters. In order to access this new middle class, we believe investors may need to look beyond the more popular emerging market indexes or global multinational corporations and consider more domestic-driven companies.

**GLOBAL EARNINGS CYCLE: A HISTORICAL PERSPECTIVE**




Source: BCA Research 2010, as at 31 May 2010. Global real earnings deflated by consumer prices. Earnings are based on Morgan Stanley Capital International data.

“...other asset classes will need to stabilize before we see any material rise in bond yields; given the current economic backdrop, equities are set to remain volatile in the face of higher bond yields due to fears of higher rates quelling the recovery and crimping corporate profits.”

**Paul Brain, Newton**

“Concerns about public debt sustainability may spread to additional countries and drive developed market yields higher, slowing down global growth and potentially driving interest rates higher in emerging market countries as well.”

**Alex Kozhemiakin, Standish**

# Fixed Income



BNY MELLON ASSET MANAGEMENT

# V Needed for Victory

**Paul Brain**
Investment Leader,
Fixed Income,
Newton[1]

Newton is based in London and recognized as a top-tier U.K. investment house, renowned for its distinctive, proven global thematic investment approach, consistently applied across all strategies.

**NEWTON**
**The Power of Ideas**

In our opinion, the gradual recovery from the global financial meltdown is set to continue, but given the severity of the financial crisis, the extraordinary monetary policy measures put in place globally and the currency devaluations, making predictions for the coming 12 months is likely to be very difficult.

We believe the realignment of the world's major economies relies on economic growth and debt repayment in the West, coupled with economic growth and increased domestic demand in the East. To achieve the first part, monetary policy will need to remain stimulatory. With policy rates already at close to zero in much of the developed world, new untested stimulus measures – such as quantitative easing (QE) – are being implemented by Western policymakers, undermining the value of their currencies. To some, this is seen as a form of currency debasement and the response of authorities in other parts of the world is likely to be to resist the positive flows into their country by applying capital controls, and perhaps even currency controls. However, one could argue the West's unsustainable debt levels have already debased its currencies.

While the domestic banking systems of the West are slowly being repaired, the velocity of money (V) – the rate at which money is exchanged; in effect, a gauge of liquidity – is unlikely to rise sufficiently to enable the monetary stimulus-induced recovery to gain traction. If the V can be raised, then we believe the currency war could be won before it really starts.

In the years leading up to the credit crisis, the leverage in the system created by the banks was too high. Now leverage is coming down, as surplus funds are used to pay down debt. That reduction in debt – now a feature of the major Western economies (see chart) – is likely to take several years to achieve.

**Easing the Strain**

Debt reduction is not an inflationary pastime; it results in less consumer, corporate, bank and government spending and reduces the demand for goods and services. Furthermore, a focus on debt reduction may undermine the likelihood of a big pick-up in investment, despite a prolonged period of low capital costs.

QE helps offset this process in a number of ways. The fall in mortgage rates makes

1. Please see disclosures in appendix.

homes more affordable and frees up income. With interest rates at close to zero, sustained by QE, low consumer credit costs can also be a benefit, but only if there is the demand to borrow. On the other hand, the anemic recovery will add little to employment until there is a pick-up in investment. Equally valid is the point that liquidity created by QE is likely to only partially offset the money wiped out by the credit crisis, and the inflationary consequences could be minimal as a result. Effectively, the use of QE means that bond markets are being used as a monetary policy tool. We believe this is set to continue until economies are able to cope without unconventional monetary and fiscal support. There will be a time to be bearish, but we are not there yet.

At the same time, there are some liquidity leaks in the system, escaping externally to developing economies rather than internally within developed economies, prompting tightening responses from central bankers in many developing economies.

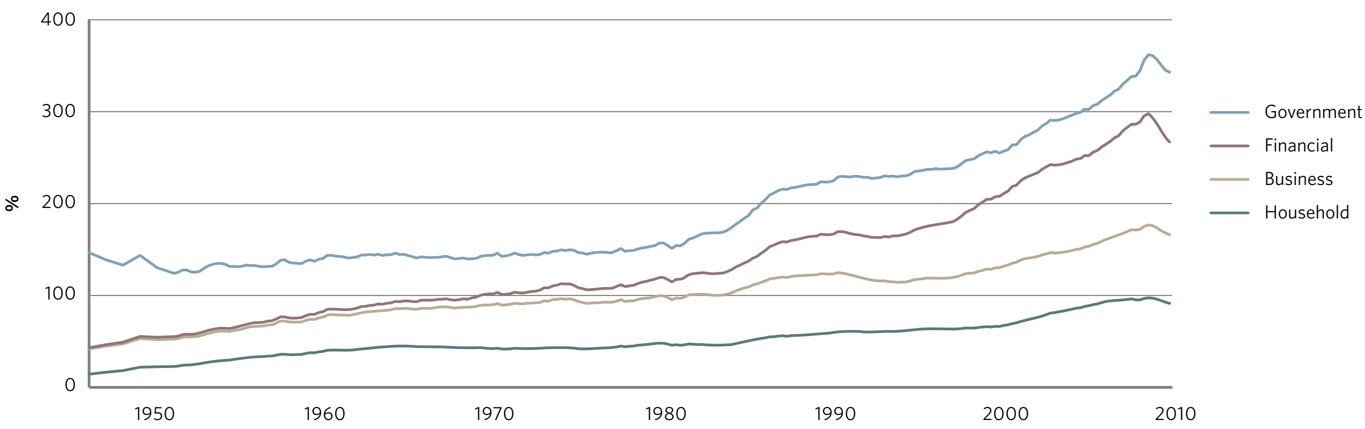
**History Lessons in the Making**

Ultimately, the success or failure of QE will be known only in years to come. If the economic recovery gains momentum and results in inflation, then QE can be considered a success, although this would leave an inflationary problem which would need to be addressed. However, a failure to offset the debt reduction process, coupled with further stutters in the economic recovery, would mean the need for more drastic measures.

We maintain a positive stance on government bond markets, but expect this to be severely challenged during 2011. With a steady developing markets-led economic recovery, a pick-up in investment could be possible, should equity markets stabilize. What will give us the signal that things are changing? Much rests on the velocity of money. Signs of a return to normal borrowing and lending conditions in the banking sector would suggest that the emergency funding measures are no longer required, and that the use of bond markets as a policy tool is at an end. However, with foreclosure problems and tighter balance sheet regulations, there are few signs that banking restructuring will end soon. Meanwhile, other asset classes will need to stabilize before we see any material rise in bond yields; given the current economic backdrop, equities are set to remain volatile in the face of higher bond yields due to fears of higher rates quelling the recovery and crimping corporate profits.

A period of sustained equity market strength and clear evidence of a fixed banking system are needed. If these conditions are met and they are confirmed by an increase in V, then victory can be declared over the forces of deflation. A prolonged period of low bond yields is required until central bankers are able to withdraw their unconventional monetary and fiscal support.

**DEBT REDUCTION IS NOW A FEATURE OF MAJOR WESTERN ECONOMIES - US DEBT AS A PERCENTAGE OF GDP (1946-2010)**




Source: US Federal Reserve, June 30, 2010, in US$.



BNY MELLON
ASSET MANAGEMENT

# Restoring Balance

**Thomas Higgins**
Global Macro Strategist,
Standish

Headquartered in Boston, Massachusetts, Standish Mellon Asset Management Company LLC (Standish) is a specialist active fixed-income manager investing in global fixed-income markets and across the full credit spectrum. The company is regarded as one of the world's premier fixed income managers.

STANDISH

Much of the euphoria that accompanied the initial rebound in global economic growth during 2009 has given way to resignation as we begin the long process of rebalancing the global economy.

There are at least two aspects to this rebalancing. First, several of the advanced economies need to consume less and export more as they rebuild savings and pay down debt in the aftermath of the global financial crisis. Second, many emerging markets, which already have excess savings, need to consume more and export less to offset the impact that deleveraging will have on global demand.

We believe the main risk for the advanced economies is that the lower level of growth associated with the rebalancing is making them vulnerable to shocks that could tip them back into recession. Central banks in the U.S., U.K., and Japan have responded by stating they are prepared to take additional action to drive down interest rates through quantitative easing (QE). In the short term, we believe this is constructive for fixed income markets from high yield to emerging market bonds, as investors search for yield.

However, the influx of money into emerging markets poses challenges, too. Specifically, large capital inflows are putting upward pressure on emerging market currencies. Countries such as China, and to a lesser extent Brazil, are resisting currency appreciation in order to keep their export machines churning. However, this increases the risk of overheating as foreign capital finds its way into their domestic economies. We believe policymakers in these countries will eventually come around to the fact that allowing their currencies to appreciate is in their long-term interest.

**Stuttering Recovery**

Any discussion of global rebalancing must begin with the U.S. since many of the worst excesses of the prior boom were centered there. A weaker U.S. dollar can aid in the rebalancing process, but much of the heavy lifting in our opinion needs to be done by the U.S. consumer through increasing savings and repaying debt.

Historically, the ratio of domestic credit to GDP falls significantly after a financial crisis. If the U.S. experience holds true to this pattern, then households are only about one-third of the way through the deleveraging process.[1] There is likely to be an ultimately long and painful road ahead. Meanwhile, slower economic growth carries its own risks, namely a greater vulnerability to economic shocks and further downward pressure on inflation. The U.S. Federal Reserve (Fed) has already announced that it is prepared to act in order to avoid these dire outcomes. With its policy rate already near zero, the Fed has announced an additional US$600 billion of QE, expanding its balance sheet to purchase Treasury securities in the primary hope of driving down bond yields and lowering private sector borrowing costs.

**Currency Wars?**

The prospect of further policy action has resulted in a drop in the U.S. dollar, and there has been speculation that the U.S. central bank may be using QE to devalue its currency and spark export growth. While possible, it seems more likely that U.S. dollar weakness is simply a side effect of the Fed's attempts to spark domestic demand and avoid deflation in the U.S.

Nevertheless, the Fed's announcement has not made it any friends in the international community. The European Central Bank objects to further QE on the grounds that it threatens long-term stability. The Japanese have no such qualms about intervening in the currency markets and have begun to do so, but with little success as the yen soared in 2010 to its highest levels against the U.S. dollar since the mid-1990s. Meanwhile, the U.S. Treasury has attempted to shift the spotlight to the Chinese yuan, which it says is overvalued due to its peg to the U.S. dollar.

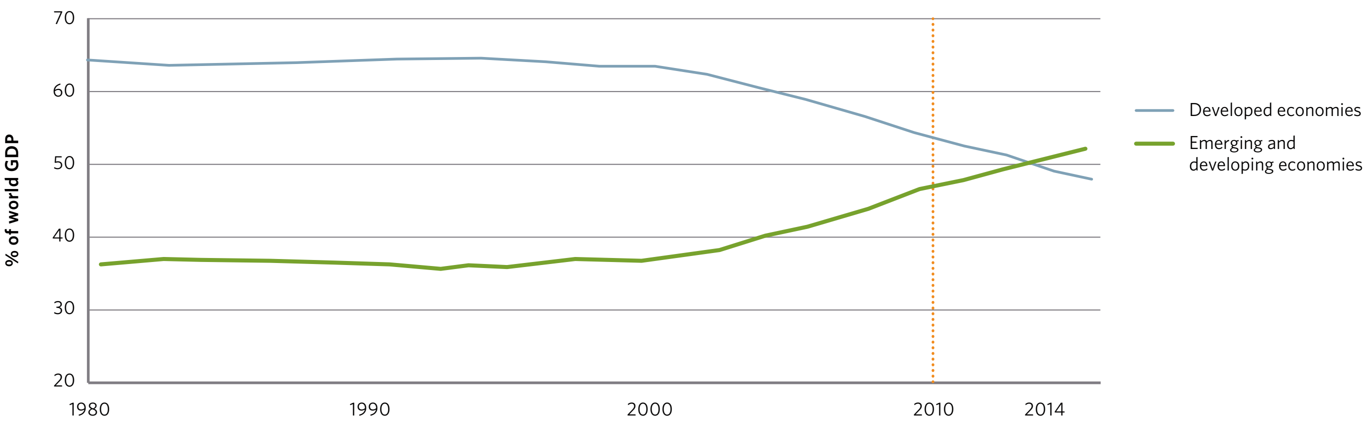
Despite the bickering, it does not appear that the U.S. dollar is unduly stretched. Even so, the speed of the U.S. dollar's recent fall against the euro and yen could prompt a reversal at some stage. As for emerging market currencies, including the yuan, the bias should be towards further appreciation over the long term as some of the larger emerging market countries develop further. A similar process occurred with the Japanese yen versus the U.S. dollar after World War II.

**Deleveraging, Decoupling and U.S. Dollar Weakness**

The ongoing deleveraging in the world's advanced economies suggests that economic growth is likely to remain subdued and unemployment high for an extended period of time. By contrast, according to the International Monetary Fund, healthy economic growth rates suggest emerging markets will surpass advanced economies as a share of world output by 2013.

Monetary policymakers in the West have committed to maintaining low interest rates in order to push investors out along the curve and down the risk ladder, and force liquidity into the financial system. This strategy is bullish for credit, from high yield to emerging market bonds, as investors reach for yield. The flip side will be a weaker U.S. dollar, versus emerging market currencies in particular, where the economic fundamentals appear more robust.

**EMERGING MARKETS ARE EXPECTED TO SURPASS DEVELOPED MARKETS AS A SHARE OF THE WORLD ECONOMY BY 2013**




Source: International Monetary Fund as at September 30, 2010.

1. Carmen and Vincent Reinhart, "After the Fall," http://www.kansascityfed.org/publicat/sympos/2010/2010-08-17-reinhart.pdf



BNY MELLON
ASSET MANAGEMENT

# Calmer Waters Ahead

**Dr. Walter Schepers**
Senior Fixed Income Specialist, WestLB Mellon Asset Management

WestLB Mellon Asset Management (WMAM) is a 50:50 joint venture between WestLB and the Bank of New York Mellon Corporation. Headquartered in Düsseldorf, WMAM offers clients both core and specialist products with the focus on European bonds and equities. It does not offer services in the U.S. This article does not constitute an offer of the firm's services to any U.S. investor or where otherwise unlawful.

WestLB Mellon
Asset Management

While the macroeconomic environment means little chance of a global boom, we expect a reasonable level of economic growth during 2011. In Europe, we believe this growth will be mainly driven by Germany and other core countries such as France. We believe that the situation in the U.S. looks somewhat less favorable, although the risk of a double-dip recession appears exaggerated in our view. Elsewhere, emerging economies remain a major growth engine for the global economy. With the authorities in both the U.S. and the Eurozone maintaining their accommodative monetary policy for an extended period, the general picture points to a moderately positive economic trend.

**Positive Outlook for Default Rates**

We believe it is worth remembering that corporate bonds do not necessarily need strong growth momentum – either in terms of GDP or earnings – to perform well. What is more important is that investors can rely on issuers' ability to easily service their debts. Company reports published in 2010 were generally in line with expectations or even surprising to the upside, in both the investment grade and the high yield segments. According to Moody's, default rates registered on the global high yield corporate bond market, which soared to 13% in 2009, steadily declined to a level of 3.7% globally or 2.8% in Europe in the 12 months to the end of October 2010.[1] Moody's forecasts that the global default rate will decrease further to 1.9% in the 12 months to the end of October 2011. Based on historical spreads (and assuming a recovery rate[2] of 40%), we estimate the "fair" spread to be at 320 basis points for a default rate of 2.0%. Against this background, we think spreads of about 500 basis points appear attractive, suggesting the potential for further tightening.

In the investment grade segment, defaults are not much of an issue, but the trend in the high yield sector can be used as an indicator of the general credit climate. It is also worthwhile taking a look at (implied) default rates on the investment grade market on a longer-term horizon, which – based on the spreads registered as per the end of October and assuming a recovery rate of 40% – stand at a cumulative 10% for the next five years. According to Moody's, the maximum value measured over rolling five-year periods was 2.4%, using the years since 1970 as a database. Seen from this angle, we believe the investment grade market offers a comfortable risk premium.

1. Source: Moody's.
2. A default does not mean that all money is lost in general. The recovery rate gives the proportion of a bad debt (in percentage of the nominal value) which can be recovered.

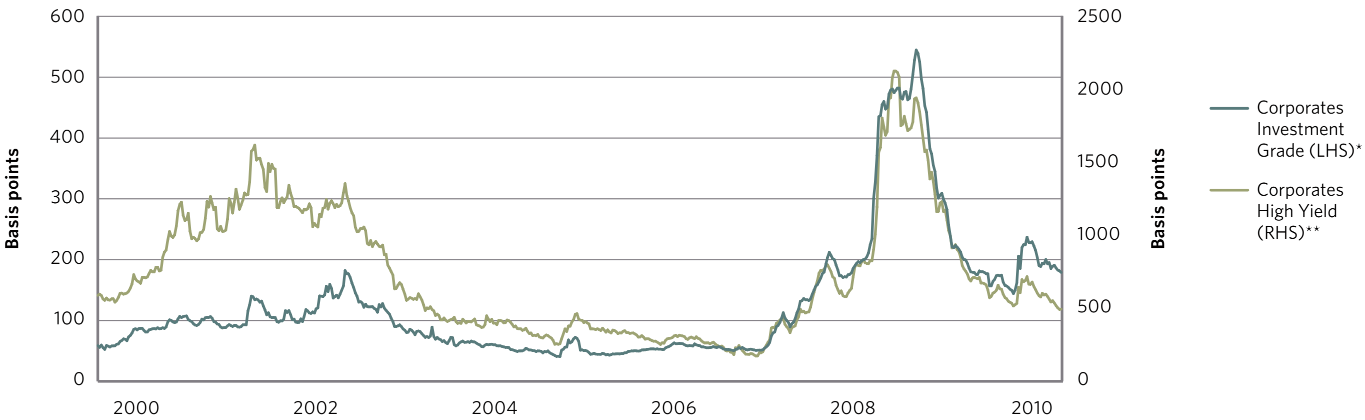
Bank bonds, in particular, have been keeping investors on edge since the onset of the financial crisis. We consider the regulatory changes adopted or under discussion to be mostly positive for bond investors, as higher capital and liquidity requirements and limits to riskier activities should add to security. A more negative element is the debate about impinging on bond creditors' rights in the event of default. Especially for subordinated bonds, we believe it will be paramount to study issue bond documents very carefully going forward.

**Volatility Is Here to Stay**

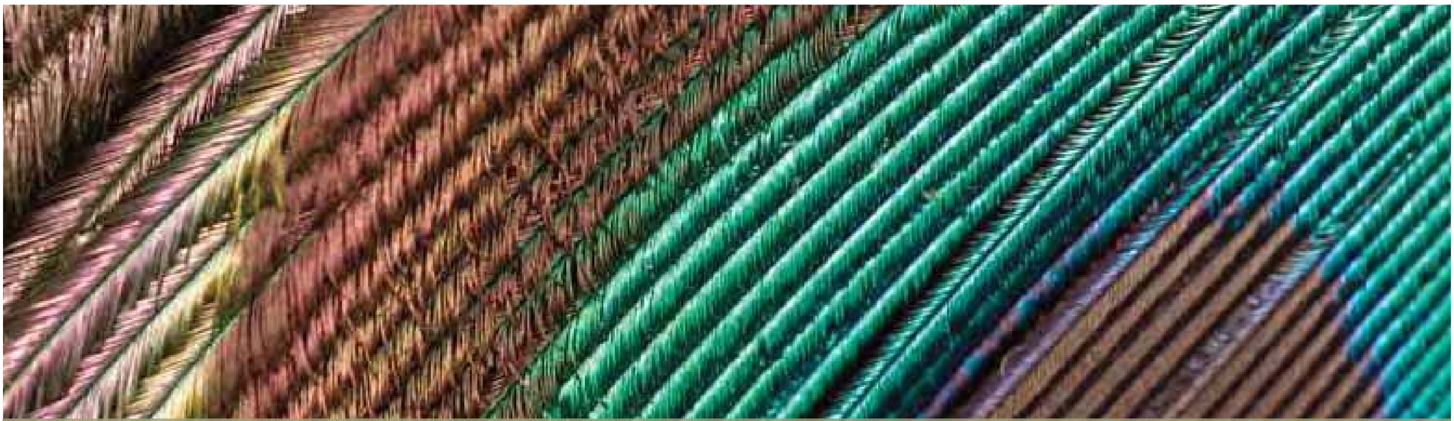
What other risks does the coming year hold for us? 2010 was characterized in no small measure by sovereign debt concerns, which – as was the case with other risky asset classes – also took its toll on the corporate bond markets. We expect similar periods of tension might be seen from time to time in 2011. We therefore expect volatility to continue to be a factor. However, we believe the combination of stricter fiscal discipline in some countries and the relief provided by tax earnings boosted by the economic recovery should help to mitigate budget problems. We also believe that the spectre of a double-dip recession is likely to be with us for quite some time, as there are concerns that insufficient (or in some countries even negative) fiscal stimulus cannot be compensated for by expansionary monetary measures. We consider this risk to be relatively low given a series of positive data especially from Europe and major emerging markets. However, in light of the scale of the "Great Recession" and the financial crisis, we believe markets will reconsider the possibility of this scenario every now and then.

As already pointed out, we believe spread levels of European investment grade and high yield corporate bonds are attractive both historically and relative to expected default rates. In our moderately positive scenario, corporate bonds should therefore benefit not only from higher yield levels, but also from a decline in risk premiums, which would also help compensate a potential moderate increase in the general yield level (government bonds), with high yield bonds offering an even more comfortable cushion than investment grade bonds. All in all, the outlook for European corporate bonds continues to be positive for 2011, the third year after the fall of Lehman Brothers.

**SPREADS ARE STILL WELL ABOVE THE LEVELS OBSERVED DURING 2004-2007, SUGGESTING THAT FROM A PURELY TECHNICAL PERSPECTIVE, THERE IS STILL FURTHER POTENTIAL FOR TIGHTENING**



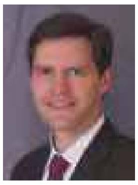

Source: Datastream, WMAM as at October 31, 2010.
*iBoxx € Corporate Bond Index, weekly data
**BofA Merrill Lynch High Yield Fixed Floating Rate Constrained Bond Index ex Financial; before 2007 the BofA Merrill Lynch High Yield Constrained Index; before the time of the switch the index included only a small quota of financials.





BNY MELLON
ASSET MANAGEMENT

# Bright Spot for Emerging Market Debt



**Alexander Kozhemiakin**
Head of Emerging Markets Strategy and Senior Portfolio Manager, Standish

Headquartered in Boston, Massachusetts, Standish Mellon Asset Management Company LLC (Standish) is a specialist active fixed-income manager investing in global fixed-income markets and across the full credit spectrum. The company is regarded as one of the world's premier fixed income managers.

STANDISH

We believe the outlook for emerging markets remains favorable. According to International Monetary Fund (IMF) forecasts, the cyclical rebound in global economic growth is set to continue in 2011, with expected real GDP growth of 4.2%. The IMF says growth in the developed world in 2011 should be relatively moderate, around 2.2%, but downside risks remain in those economies. In our view, this means that interest rates in advanced countries should stay low as inflation pressures remain subdued, given the still substantial negative output gaps.

**Growth in Emerging Economies Leads the Way**

For us, the major investment theme for emerging markets remains less pressing structural concerns and persistent growth differentials with the developed world. Emerging economies' growth is projected at around 6.4% in 2011 by the IMF. We believe these growth rates should continue to attract significant capital inflows into emerging economies and sustain appreciation pressures on their currencies.

These growth differentials reflect the structural improvements in the creditworthiness of emerging market countries. Supportive demographic factors, a competitive cost structure and a lower starting base have helped their relative performance and are likely to continue doing so for the foreseeable future. As such, we believe diversified exposure to currencies of the most advanced emerging market countries can provide an attractive way to capitalize on these continuing capital flows. Investors are increasingly discovering the diversification benefits as well as the attractive return potential of emerging market sovereign bonds denominated in local currency. These represent investments in both the currencies and local interest rates of the most advanced emerging market countries that have developed local fixed income markets. We believe the diversification benefits are further enhanced by the steady bid for local fixed-income instruments from rapidly growing pension plans and other financial institutions domiciled in emerging market countries.

**Leaning Against the Wind**

For us, recent interventions by emerging market central bankers against their own currencies were implemented as a way to smooth volatile capital flows. We believe that they are merely trying to lean against the wind. The important thing to keep in mind is that these interventions tend to slow the process of adjustment, rather than stop it, and we do not expect draconian measures that will significantly slow or halt these flows.

Furthermore, we believe the average core balance for emerging market countries – a conservative measure of the balance of payments outlook focusing on less volatile flows – is positive and will remain so for at least the next few years. The abundant supply of hard currency is reflected in the sizeable foreign exchange reserves of emerging market countries, which have continued to grow following their dip in the second half of 2008. Therefore, we believe there is still the potential for continuing appreciation in quite a few emerging market currencies.

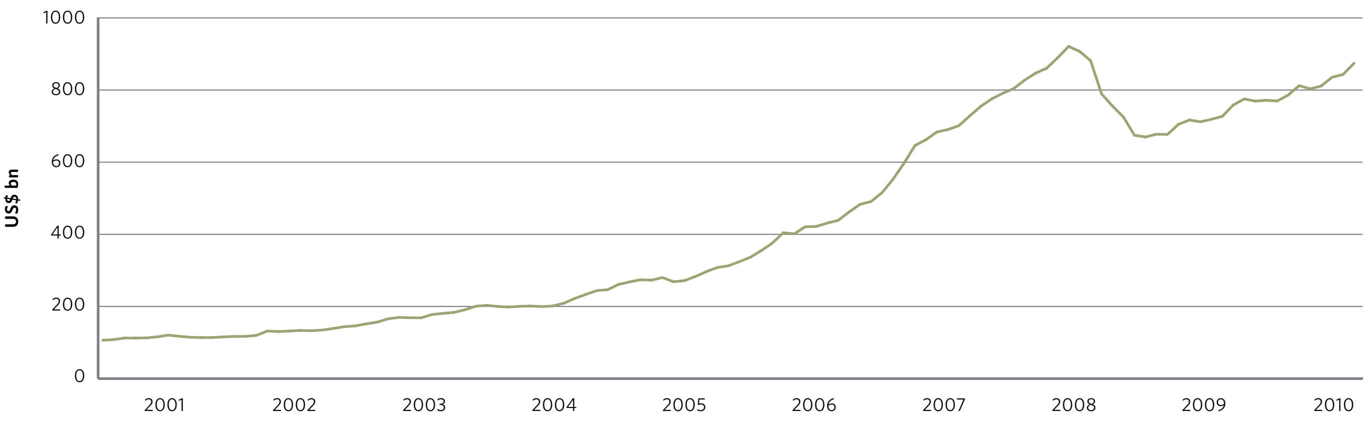
As we see signs of some central banks moving slowly towards the normalization of monetary policy, we expect that currencies will contribute more to performance than local bonds at this point. Having said this, we do not expect interest rates to move significantly higher in the short and medium term, as inflationary pressures in most emerging economies remain contained, despite the firmness in commodity markets. Importantly, appreciation of emerging market currencies helps to mitigate the local inflationary impact from higher commodity prices.

**Risks Ahead?**

Risks to the above outlook include the following: a deceleration of growth that would make us increasingly concerned about government deficits, especially in developed countries. Also, the recent global downturn has been accompanied in many countries by a de-leveraging by households; developed market consumers could continue to retrench in the face of high unemployment and growth disappointments once fiscal and monetary stimulus start to fade. Global growth rates below potential would also weaken commodity prices, which would hurt commodity exporters. Conversely, negative output gaps may not be as large as expected. In that case, upside inflation surprises could lead to early policy tightening and higher inflation expectations, especially in the emerging economies. Concerns about public debt sustainability may spread to additional countries and drive developed market yields higher, slowing down global growth and potentially driving interest rates higher in emerging market countries as well.

We believe emerging market local currency debt presents an attractive way to take advantage of the current global economic outlook and the appreciation potential of emerging market currencies via liquid sovereign bonds across the entire maturity spectrum. In our view, the asset class offers both the potential for relatively high returns and at least some diversification benefits due to the unique nature of its two main risks: local currencies and interest rates.

**COMBINED FOREIGN EXCHANGE RATE RESERVES OF BRAZIL, RUSSIA AND TURKEY**




Source: Thomson Datastream as at July 2010 (from December 31, 2000 to July 30, 2010).

"…we expect that the rebalancing of the global economy from the developed world to the developing world will gather pace, and that much of the heavy lifting will be done by the currency markets, with Western currencies broadly depreciating against emerging currencies."

Dale Thomas, Insight Investment

# Currencies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# U.S. Dollar Set for Further Blues

**Dale Thomas**
Head of Currency,
Insight Investment

Insight Investment Management (Global) Limited (Insight Investment) is a London-based asset manager specializing in fixed income, liability driven investment, cash management, multi-asset, absolute return and specialist equity strategies. It does not offer services in the U.S. This article does not constitute an offer of the firm's services to any U.S. investor or where otherwise unlawful.

Insight
INVESTMENT

In our view, the world is witnessing a large structural shift in purchasing power from the Western consumer to the emerging world consumer. During 2011, we believe that investors will come to further appreciate the strong underlying fundamentals of emerging economies, leading to significant inflows into emerging market assets. While several emerging market countries have already expressed concern about the impact of the appreciation of their local currencies, their economic strength is likely to continue to drive local currencies higher in the medium term, irrespective of attempts by governments to intervene.

The rise of the purchasing power of emerging currencies relative to that of Western currencies is all part of the rebalancing of demand, as emerging consumers run down their high savings levels and demand higher standards of living; while Western consumers look to pay down their debts. We believe currencies will do much of the work, with more favorable real exchange rates in emerging economies increasing their purchasing power in global terms, and weaker Western currencies reducing developed countries' debts in a relative sense. A move to stronger currencies in emerging economies is necessary to contain inflation given their high growth levels, and similarly weaker currencies in the West should help boost faltering long-term growth prospects and bring about the inflation necessary to erode the developed world's debt burden.

**Cyclical Factors: Global Cycle Upswing and Quantitative Easing**

In addition to the underlying structural movements, there are two main cyclical factors we believe are likely to influence the direction of currency markets.

In our view, it looks as though the economic downturn in the middle of this year has bottomed, and we believe that global economic activity will continue to increase from here. Market expectations for the global economy are now too pessimistic, which means if activity does pick up, risk assets should perform strongly. This is likely to create a positive environment for growth-sensitive currencies. An example is the Korean won, which typically performs well when global growth is accelerating. South Korea's economy is export-centric, meaning inflows into Korea tend to increase when aggregate demand is rising. By contrast, the U.S. dollar tends to lose ground as risk appetite strengthens. With their economies heavily weighted towards commodities, both the Canadian dollar and the Australian dollar would also be beneficiaries of a more constructive economic environment as demand for basic resources grows. Although historically sterling has often benefited from an improvement in risk appetite, we believe this is less likely to be the case this time around. The U.K. consumer is under severe pressure from the government's continued fiscal tightening and the domestic economy is likely to underperform as a result. Weakness in the U.K. housing market is also a matter of concern and is likely to weigh on consumers' desire to spend.

The new programs of quantitative easing in the U.S. and Japan will likely have considerable implications for the currencies in those countries. Furthermore, with the yen having risen to all-time highs against the U.S. dollar, the Japanese central bank decided in 2010 to intervene in the currency markets in an attempt to reduce potential adverse effects on its export-driven economy. We think the impact of U.S. Federal Reserve Chairman Ben Bernanke's printing presses should also be taken seriously, as should the knowledge that the US Federal Reserve (Fed) and the Bank of Japan are both keen to devalue their currency in favor of economic stability. In particular, we believe a weaker U.S. dollar is now on the Fed's agenda, which is likely to weigh on appetite for the U.S. dollar and encourage developing central banks to build up reserves in other major currencies. In the Eurozone, we consider there is a much reduced probability of fracture, as mechanisms are now in place to deal with insolvent nations. However, the euro is likely to lag somewhat, with intra-European politics likely to destabilize the currency.

During 2011 we expect the rebalancing of the global economy from the developed world to the developing world will gather pace, and that much of the heavy lifting will be done by the currency markets, with Western currencies broadly depreciating against emerging currencies. In addition, we expect an upswing in the global economy to be beneficial for commodity producers and growth-sensitive currencies, but lead to outflows from the U.S. dollar, especially given the very loose monetary policy in the U.S. The combination of large structural and cyclical forces is likely to lead to large moves in the foreign exchange markets, and correspondingly, a wealth of exciting opportunities for currency investors.

**Time for Asia to Take Its Turn**

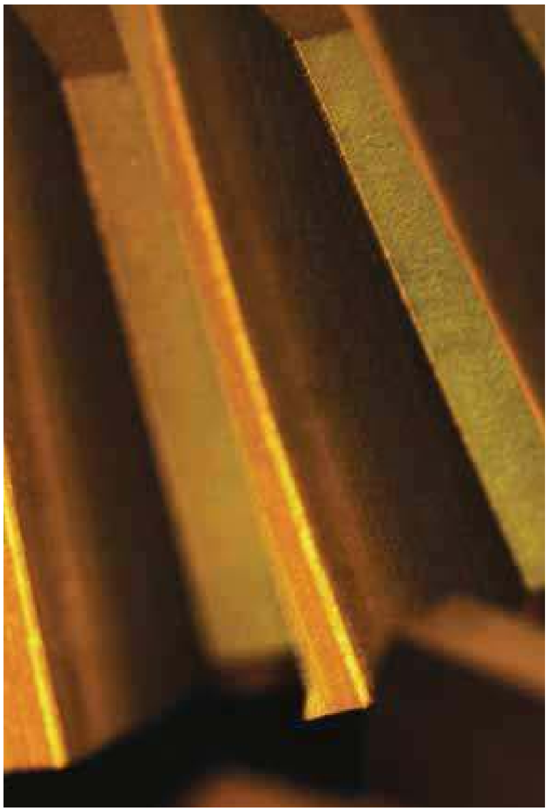
The chart shows the Asian currency index, which collapsed in the Asian currency crisis of 1997. Asian currencies have recovered a lot of ground over the past decade, but could have some way to go as they continue to strengthen relative to the U.S. dollar.

**ASIAN CURRENCIES HAVE ROOM TO APPRECIATE FURTHER: ASIAN DOLLAR INDEX (ADXY)**


Source: Thomson Datastream as at November 5, 2010 (from September 1994 to September 2010).

"With short-term interest rates on deposits remaining at near zero, dividend-paying investments, such as REITs, will likely continue to benefit from a thirst for yield until savings rates improve."

**Todd Briddell, Urdang**



# Property



BNY MELLON
ASSET MANAGEMENT

# Real Estate Markets: Local Strength, Global Uncertainty

**Todd Briddell**
Chief Investment Officer, Urdang[1]

Urdang Capital Management (Urdang) focuses exclusively on real estate, managing private equity investments, real estate debt investments and portfolios of real estate securities.

URDANG

We believe that in today's economy, investors are faced with a choice between two polar opposite economic outlooks. In one scenario, growing national deficits pose a risk of lower yields and a potentially higher risk of deflation. This economic situation generally calls for conservative risk-taking and disciplined spending. In another scenario, sluggish economies might be turned around by monetary and fiscal stimulus policies. The short-term boost to these economies, however, may come with a greater risk of future inflation and higher interest rates. Amid this uncertainty, we believe the easiest and possibly the best choice for many investors may be to diversify their investments globally. In our view, real estate securities, which we believe are well positioned and well capitalized, are gaining favor as a preferred vehicle for cross-border real estate ownership.

**Firmer Foundations**

The shape and magnitude of the recovery in the commercial real estate market have largely been dependent upon conditions in the broader global economy, which is showing some resilience amid significant gains since the downturn in 2009. The Eurozone is recovering from last summer's sovereign debt crisis, and local economies in mainland China, Hong Kong and Singapore have continued to grow rapidly. In the U.S., corporate profits rose sharply by 36% in 2010 through 30 September, and the equity market rallied.[2]

In addition, commercial real estate values are showing signs of recovery. Both leading and lagging real estate indexes (public and private) have indicated that prices have reached a bottom. Commercial real estate fundamentals are also improving. Apartment occupancy is rising, and office property rental rates are improving in the largest urban centers.

Following strong performance in late 2009 and 2010, we believe REITs remain compelling investments. The supply of new real estate is at historic lows, and as banks struggle with outstanding construction loans, the prospect for new building is dim. Meanwhile, demand for commercial space is improving in nearly all regions and sectors.

We expect REITs to continue to generate positive long-term total returns. With short-term interest rates on deposits remaining near zero, dividend-paying investments

1. Please see disclosures in appendix.
2. Bloomberg analytics, as of September 30, 2010.

such as REITs will likely continue to benefit from a thirst for yield until savings deposits rates improve. In addition, we believe the asset class's ability to capitalize on acquisition opportunities, with over US$70 billion in capital raised since 2009 through the end of October 2010[3] will continue to provide an advantage over other investments.

In our previous outlooks, we focused on the potential for an active market for acquisitions once banks abandoned their "pretend and extend" strategy. Today, we are much more focused on the macroeconomic events shaping economies worldwide and their effect on the state of the commercial real estate market. Through the ups and downs experienced in 2010, we have seen that property stocks are, and will likely continue to be, strongly influenced in the short term by public market sentiment. Public market sentiment, in turn, has taken, and will likely continue to take, its cues from the broader macroeconomic environment.

**Fundamental Concerns**

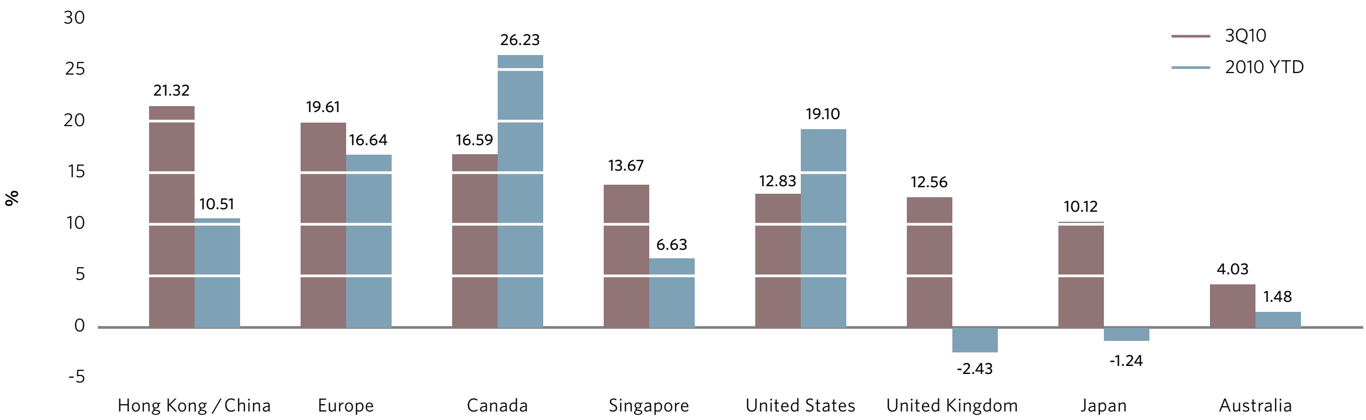
While markets across the globe are all showing the potential for a recovery, it is these macroeconomic factors that separate the strong from the weak economies. The United States economy is dealing with new financial regulations, healthcare reform, a weakening of the U.S. dollar and continued high unemployment rates, which are likely to shape investor sentiment in the coming quarters. Europe, although posting a large gain toward the end of 2010, is still clouded by doubt over its macroeconomic health. In general, we expect slower growth and little rent appreciation in continental Europe as well as other developed countries such as the U.K. and Japan.

However, we do expect continued growth in the Asian markets (ex-Japan). The Asia-Pacific region continues to lead the global recovery, with over half the markets in the region either at the bottom of the cycle or in the rental growth phase. Although policy risks still haunt the Hong Kong and mainland Chinese markets, listed property securities in the region are benefiting from strong economic growth. Meanwhile, in our view markets in Canada, Australia and South America seem to offer an interesting mix of higher-yield assets and growth assets. The growth in these regions is fueled largely by the strength of their commodities sectors.

Although risk aversion continues to fluctuate, we have seen an encouraging trend of positive absolute performance in global property securities, as well as the sector's outperformance relative to the broad equity markets.

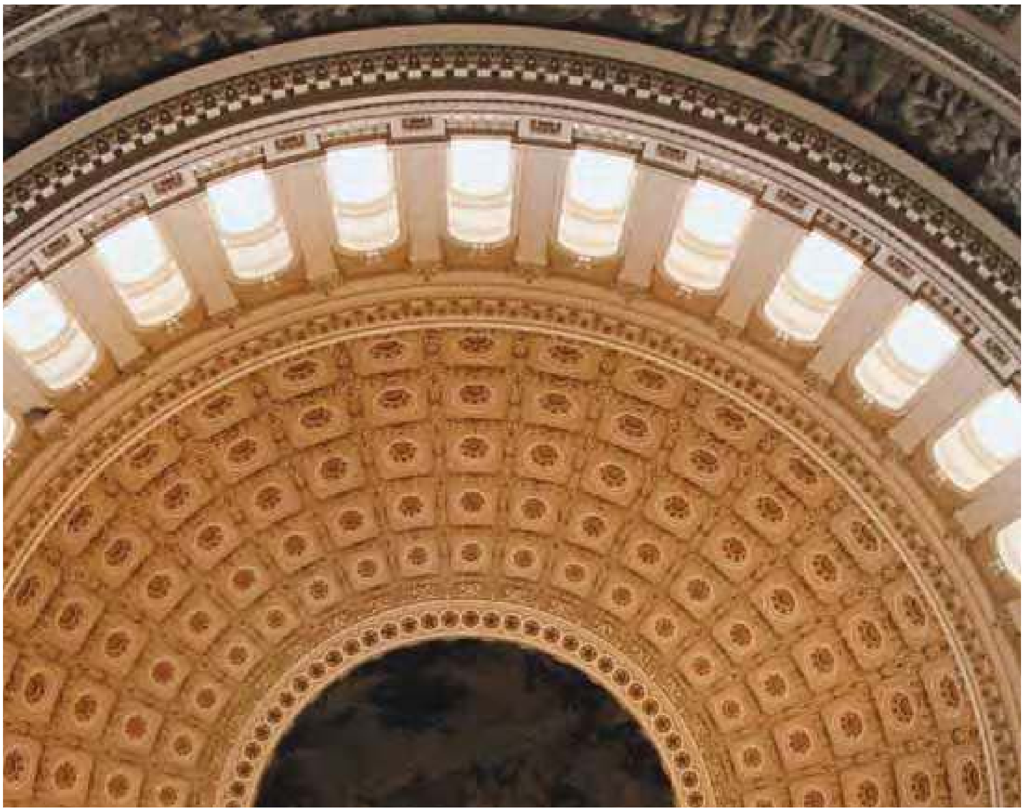
Our investment bias remains focused on quality companies, proven management teams, asset quality, and regions with better economic fundamentals. However, we are carefully monitoring weaker regions, looking to capitalize on recovery stories and value opportunities as well.

**GLOBAL PROPERTY MARKET IS GAINING STRENGTH**




Source: Bloomberg as at September 30, 2010. Returns based on region-specific indices.

3. Urdang research, as of October 2010.



"If gold's recent rise is due to the expansion of the world's monetary base, then perhaps we may be beginning to see gold as a shadow currency against which all other currencies are measured."

**Kenton Yee, Mellon Capital**

# Commodities



BNY MELLON
ASSET MANAGEMENT

# The Golden Age of Returns?

**Kenton Yee, PhD**
Senior Research Analyst,
Mellon Capital

Mellon Capital Management Corporation (Mellon Capital) is an innovative leader in the development of global investment solutions. It is known for its unique approach to asset allocation and robust, structural models based on financial economics. Mellon Capital is intellectual capital - applied.

MELLON CAPITAL®
MANAGEMENT

Perhaps now more than any other time in post World War II history, investors are looking for a safe harbor to store wealth and diversify against potential global inflation or other structural changes. Gold is, perhaps, the most accessible and liquid vehicle for providing this service. Gold carries no flag, no national agenda, and is about as global as an asset can be. Investors hailing from regions as diverse as China, the Middle East, and the developed markets generally believe that gold is a store of value. For this reason, gold is frequently referred to as a commodity currency in that it serves as a country-independent store of value in the face of idiosyncratic country risks, including currency and sovereign credit risks.

The events of the recent credit crisis and the aftermath that we are now calling the "Great Recession" have reduced the number of assets perceived as safe havens. In the last few years, sovereign bonds of various countries have served as temporary safe havens, but today sovereign bond yields have been driven down to very low levels, despite expectations of difficult government fiscal and monetary decisions in 2011.

Institutional investors have traditionally viewed stocks and bonds as the primary means for building and holding wealth. Caught up in the events of the recent credit crisis, investors view equity and credit risk as significant, and the potential for inflation, although in our view still two or more years away on the horizon, as growing. As a result, the real yields of inflation-protected bonds have become compressed to unprecedented levels since 2008 (see chart). With these current lower real yields, gold's value proposition has become enhanced in our view. In fact, we can see a much stronger relationship between lower real yields in the U.S. and higher gold prices since 2008 (see chart). Therefore, we believe that the way interest rates play out in 2011 will impact the price for gold.

Historically, gold's performance has been attributed to its role as a currency peg and inflation hedge. That gold can help against the loss of buying power during inflationary periods was never more evidenced than in the 1970s and early 1980s. In fact, the performance of gold – which rose 60% from 2008 to 2010 – has not tracked current inflation in the developed markets. Rather, government deficit spending worldwide has raised expectations about future inflation and gold prices have risen along with inflation fears. If gold's recent rise is due to the expansion of the world's monetary base, then perhaps we may be beginning to see gold as a shadow currency against which all other currencies are measured. Therefore, investors are likely to be faced with the choice of either buying lower and falling real yields in financial assets or buying real assets, like gold, that can potentially retain their buying power regardless of future inflation or other unexpected geopolitical events.

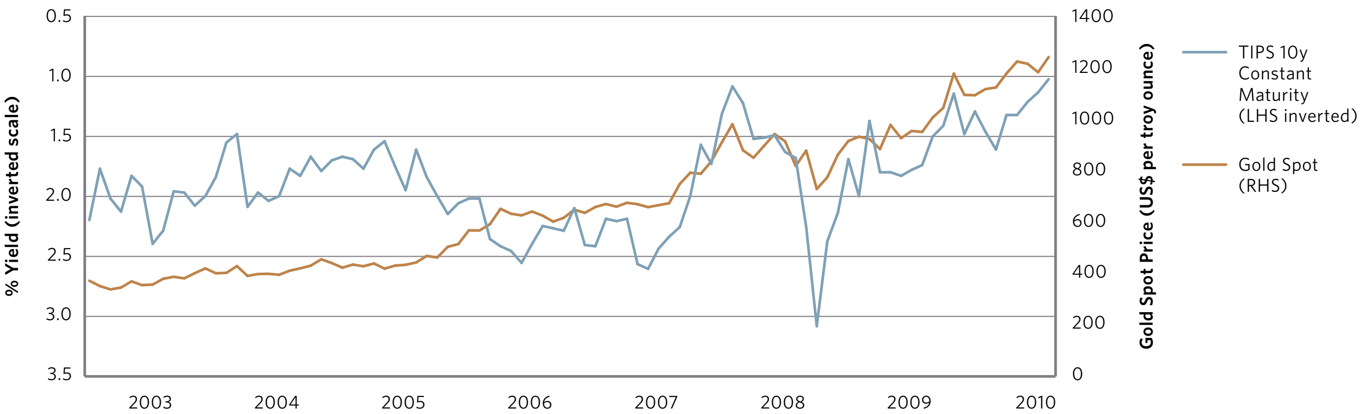
**Precious Little**

In November of 2010, the U.S. Federal Reserve announced a second round of quantitative easing (QE2) as a means of pushing down the longer end of the bond yield curve. The QE2 program is expected to continue well into the middle of 2011, and is expected to put pressure on real yields in 2011 and in our view provide support for gold throughout the tenure of this policy. Beyond QE2, we see gold as a beneficiary of the expanded monetary bases around the world, especially in the U.S.

In the face of increasing investment demand, the world's capacity to produce more gold is not keeping pace. In fact, gold mining activity has been flat or trending down for decades. 2009 saw a small uptick in mine production according to the World Gold Council's second quarter "2010 Gold Demand Trends" report. The bulk of this new supply is coming from new facilities in Australia. The same report mentioned higher recycling of gold in recent years, perhaps brought to market by higher prices. Still, according to the same source, most of what is currently produced annually finds its way into jewelry and not necessarily into the hands of physical gold buyers for investment. In essence, the supply of gold stored in vaults has not kept pace with appreciably higher gold prices over the last two years.

In conclusion, we see significant fundamental and structural factors supporting the price of gold through 2011 and beyond. This is despite the fact that gold has limited utility beyond acting as a safe-haven store of value or commodity currency. Warren Buffet was quoted recently in *The Wall Street Journal* as saying: "It doesn't do anything but cost you charges and stare at you."[1] Perhaps we will see a lot more investors staring back in the year ahead.

**RISING GOLD PRICES AND DECLINING US BOND YIELDS**

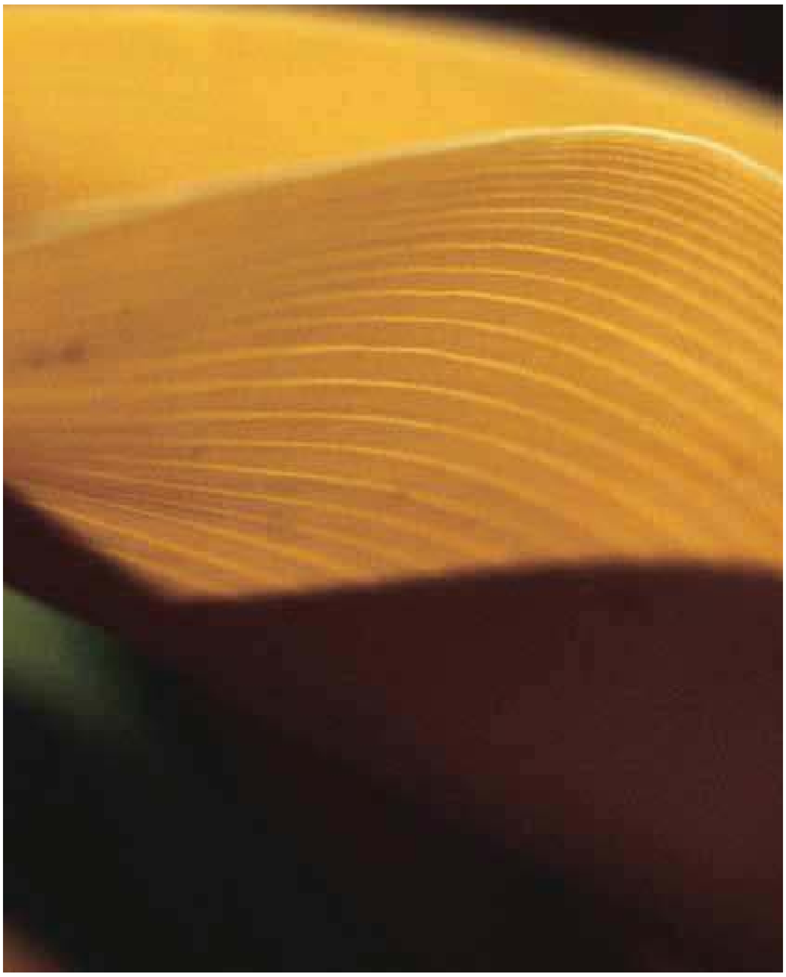


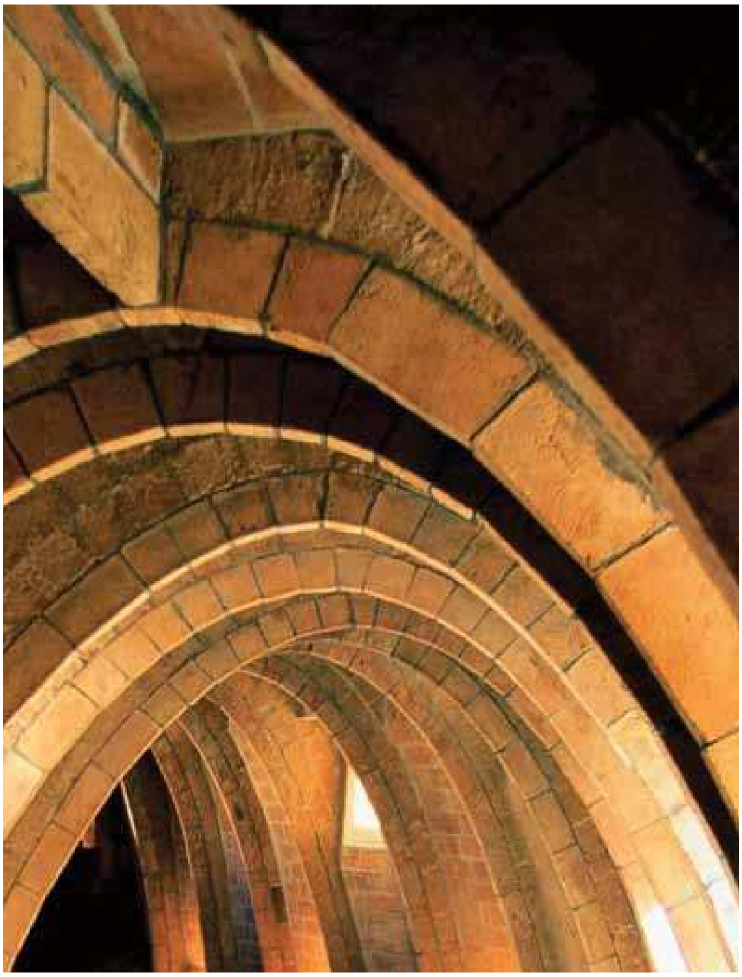

Source: Thomson Datastream as at September 15 2010

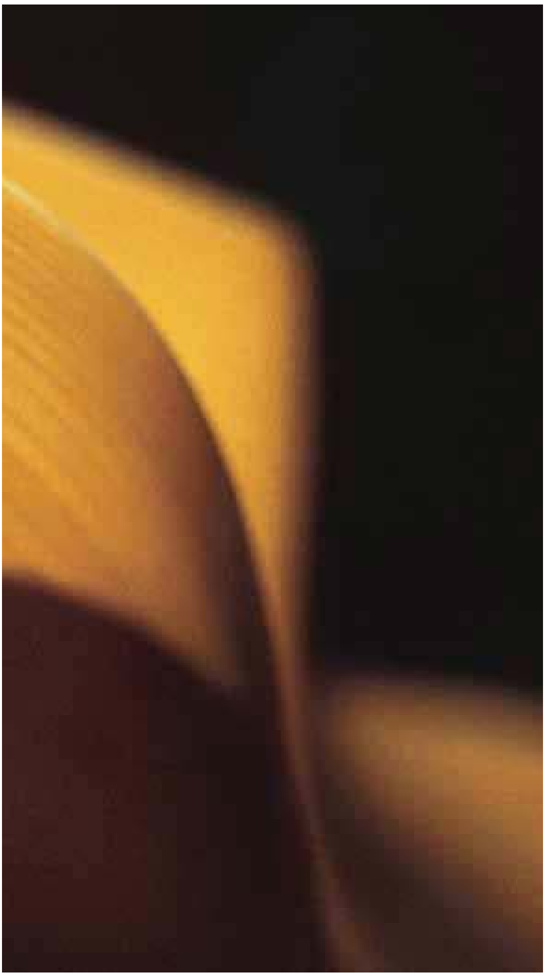
1. Susan Pulliam, "The World Does Not Need to End," The Wall Street Journal, October 30, 2010.

"Despite the current, volatile market scenario, there is already substantial evidence to suggest that a 'herd mentality' is developing, with fixed income assets attracting large inflows, while equities appear to be less favored."

Jamie Lewin, BNY Mellon Investment Strategy and Solutions Group







# Asset Allocation



BNY MELLON
ASSET MANAGEMENT

# Forget the Past – Invest for the Future

**Jamie Lewin**
Director, BNY Mellon Investment Strategy and Solutions Group[1]

BNY Mellon Investment Strategy and Solutions Group has access to a broad range of highly differential specialist asset management capabilities.
It offers tailored asset allocation, risk allocation and portfolio management advisory services, as well as multi-asset and single asset class strategies.

Hindsight, according to traditional wisdom, is a beneficial thing. On the face of it, it could be argued, there are few fields of endeavor in which the ability to learn from past experiences and errors could offer greater benefits than investment management.
Yet the principal problem with this line of thinking when applied to managing investments is that no two economic cycles are identical, meaning that lessons learned in one cycle can often be of limited use in a future cycle.

Furthermore, when looking at historic patterns of investor behavior, it quickly becomes apparent that investors have an uncanny ability to over compensate for their previous errors, rather than to adapt their investment strategies for uncertain future outcomes.
The danger of this retrospective approach is that it lacks the flexibility necessary to adapt to evolving capital market conditions. As a result, investors often fail to mitigate the adverse effects on wealth associated with volatile market environments. We think there are several asset allocation lessons investors can consider for 2011.

**Experiences from the Last Decade: "Chasing an Equity Risk Premium That Never Materialized"**
Superficially, the shape of the investment landscape in the first decade of the 21st century ended much as it began. It was a scene of widespread pension deficits – despite vast sums spent by plan sponsors – and general disillusionment with equities as an asset class. During this period, the key to a successful investment strategy was to make the right decisions on when to hold and when to avoid equity market risk. Alas, relatively few investors demonstrated the nimbleness necessary to limit the downside of exposure to equities.

**Lesson for the Next Decade: "Do Not Repeat a Costly Mistake"**
The risk now, perhaps, is that many investors are in danger of making a remarkably similar mistake again. In the scenario in which investors now find themselves, the effect of repeating earlier failures to allocate effectively between major asset classes could become particularly expensive, as the opportunity to recoup poor performance in the "lower return" world is likely to be severely restricted. Investors entered the last decade with a high exposure to equities, mainly because of the euphoria



1. Investment Strategy and Solutions Group ("ISSG") is part of The Bank of New York Mellon. Please see disclosures in appendix.

that had accompanied equity investments in the decade before that. However, following the bursting of the dotcom and credit bubbles, and the steep equity market declines that ensued, many investors ended the period feeling both bruised and highly sceptical about the presence of an equity risk premium.

Consequently, the next decade looks set to be the one in which investors, disillusioned with equities, eschew the asset class in favor of other asset classes where historic performance has been better. As equities fall out of favor, investors are shifting to fixed income securities, both as a way of managing liabilities, as well as to generate returns from income. However, with real interest rates at record lows in certain developed economies, investors are now likely to receive little or no compensation for holding developed government bonds. This, in turn, will of course constrain the potential of spread assets such as corporate bonds, whose performance is related to the performance of government bonds.

Despite the current, volatile market scenario, there is already substantial evidence to suggest that a "herd mentality" is developing, with fixed income assets attracting large inflows, while equities appear to be less favored. It is precisely this kind of collective behavior that can lead to asset bubbles. Bearing this in mind, it might be argued that "shutting the door" on equities at this stage may well be an error; hindsight will tell, but will be of little use to those investors who follow the herd.

**Alternatives Come to the Rescue... or Do They?**

Having earlier decided that the equity risk premium had proved itself too great a gamble, many investors have been quick to drop equity exposure in favor of alternative investments such as hedge funds, property, commodities and private equity. Many of these investments, too, have disappointed. The question remains, however: does the continuing promise of the bond markets and alternatives mean that investors will never again see any attraction in the equity risk premium?

If they are to avoid making the mistake of having an inappropriate asset allocation at different stages of the market cycle, investors must now pay greater attention to a range of considerations. Among the most notable of these is liquidity, or the lack of it, and the danger of purchasing overpriced exposure to market risk, masquerading as excess returns – a criticism that has been levelled at some types of hedge fund investments. Of greater importance still, however, is the risk that investors continue to apply an allocation that is too static, or inert. In the current environment, the danger for many portfolios appears to be that investors will maintain too large an exposure to bond markets for too long.

Self evidently, significant returns can be made by "timing" markets correctly. In reality, however, timing markets consistently and accurately is widely considered to be an impossible task. As we know from market measures of volatility, there is usually little warning before a significant change in investor sentiment. Nevertheless, we believe investors need to be nimble and willing, even radical, when they reassess their investments, just as fundamentals can change radically over the course of a market cycle.

**THE VIX VOLATILITY INDEX - MARKET VOLATILITY CAN RISE WITH VIRTUALLY NO WARNING**


Source: Bloomberg (from May 10, 2005 to October 29, 2010)



# Maximizing Sharpe Ratios with Dynamic Asset Allocation Strategies

**Joseph Miletich**
Managing Director,
Global Investment Strategist,
Mellon Capital

Mellon Capital Management Corporation (Mellon Capital) is an innovative leader in the development of global investment solutions. It is known for its unique approach to asset allocation and robust, structural models based on financial economics. Mellon Capital is intellectual capital - applied.

We believe institutional investors will continue to rethink their asset allocation approaches in 2011 and are likely to move away from static allocations that are dominated by far more equity risk than the traditional 60/40 equity/fixed income mix would suggest on the surface. At Mellon Capital, we believe that modern portfolio theory's lessons about tangent portfolios have the potential to create more efficient asset allocation structures with better Sharpe ratios than traditional portfolios.

During the "Great Moderation" of the 1980s and 1990s, we believe investors grew complacent about the macroeconomic background. Asset allocation strategies were generally formulated on the assumption of a seemingly permanent, positive economic climate. This bull market extrapolation led to several investment theses that would later be a problem. First, investors moved up the efficient frontier to ever larger and riskier allocations to equities. Second, asset allocation was a slow, deliberative process that resulted in fairly static structures that were revisited only every few years. Third, investors did not consider how these structures would behave during periods of market stress. One financial crisis, two recessions, and many stressful decisions later, many investors are now reconsidering their entire approach to asset allocation and risk management.

With so much uncertainty and volatility currently, investors appear to be fleeing equities for the apparent safety of bonds, even though, in our experience, their investment return demands remain unchanged at around 8%. As investors retrench down the efficient frontier, the question of how to structure an allocation program that can earn sufficient returns with reasonable risk will become more important.

At Mellon Capital, we believe that asset allocation structures need to move beyond the efficient frontier (see chart, yellow line) to construct portfolios with higher return potential and better diversification. For example, starting from an all-bond portfolio, as increments of stocks are added at the expense of bonds, the expected return continues to increase in linear proportion to the asset-class weights. However, the risk-adjusted efficiency of each portfolio, as measured by the Sharpe ratio, varies in a non-linear manner all along the efficient frontier.

In order to find the portfolio allocation with potentially the highest Sharpe ratio, one needs to determine the capital market line (CML). With one end anchored at cash, the CML is determined at the single point of intersection with the efficient frontier. Portfolio 'M' as depicted in the chart is the asset mix that is likely to produce the highest return per unit of risk. The CML can also be referred to as the "tangent" line.

In today's environment, portfolio M is generally viewed to be a low-risk portfolio with return expectations of less than 7%. If leverage is not permitted, the investor can potentially increase the expected return only by moving out the efficient frontier (the 1990s solution). The resulting portfolios at those higher return levels have lower Sharpe ratios. By relaxing the leverage constraint, it is our view that tangent portfolios have the potential to produce very favorable risk-adjusted returns as compared with portfolios restricted to the efficient frontier.

While tangent theory informs us of how to take risk, is does not address the question of when to take risk. This dovetails with the other principal concern of investors in uncertain and volatile macro environments. Specifically, investors are generally too slow in their decision processes and can make poor decisions at exactly the wrong moment. We require two important criteria for the tangent portfolios we structure:

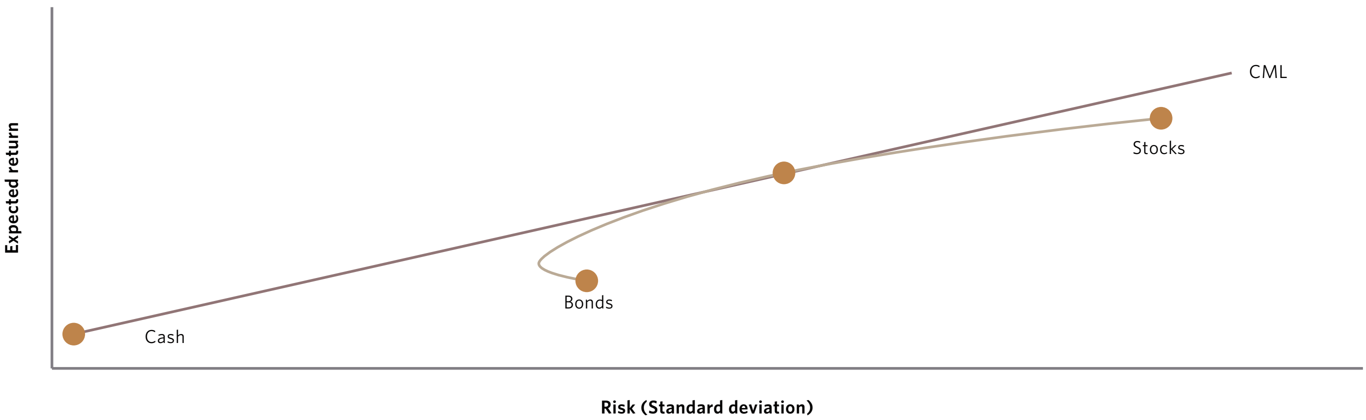
- They must be dynamic. Because asset-class expectations vary through time, the slopes of the efficient frontier and tangent line will vary as well. Optimal portfolio construction should respond appropriately.

- They must allow for deleveraging as market conditions change. For example, if cash is expected to be a better investment, exposure to riskier asset classes should be reduced.

There are several ways for investors to use tangent strategies. One is to use them as a complementary source of alpha to return-seeking mandates such as equities. Whereas stock and sector selection are the primary alpha sources in active equity strategies, tangent strategies can offer a distinctive source of potential excess return from tactical allocation decisions.

A second approach is to use tangent principles in strategic beta mandates such as risk-premium-capture portfolios (commonly referred to as "risk parity"), real-asset mandates, liability and deflation hedging strategies. When investors try to balance return and risk, they can be forced into sub-optimal choices, sacrificing one objective to improve the second. We believe tangent strategies mitigate the "either-or" conundrum as investors are not required to reduce return-seeking assets when adding risk-mitigating assets, and vice versa. Given this flexibility and efficiency, we believe tangent portfolios can offer distinct benefits and may present an attractive option for investors looking to restructure their asset allocation in 2011.

**EFFICIENT FRONTIER AND CAPITAL MARKET LINE (CML)**




Data source: Mellon Capital.

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1. AUM as of September 30, 2010

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The Markit iBoxx Euro Corporate Bond Index represents the investment grade fixed-income universe for Euro-denominated corporate bonds.

The BofA Merrill Lynch Global High Yield Constrained Index tracks the performance of below investment grade bonds of corporate issuers domiciled in countries having an investment grade foreign currency long-term debt rating (based on a composite of Moody's and S&P). The Index is weighted by outstanding issuance, but constrained such that the percentage of any one issuer may not represent more than 3% of the Index.

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FTSE EPRA/NAREIT Hong Kong Index

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