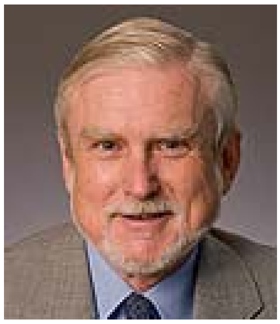
ECONOMIC UPDATE



Richard B. Hoey
Chief Economist, BNY Mellon

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We continue to expect global GDP growth to be somewhat stronger in 2013 than in 2012, with a slower pace of growth in early 2013 and a faster pace of growth in late 2013 and in 2014. While global growth was sluggish last year, a number of extreme negative scenarios were avoided. China avoided a hard landing. The European financial crisis and recession did not deteriorate into a full-scale financial meltdown or a breakup of the euro. The threat of a huge year-end fiscal tightening in the U.S. was reduced as last-minute legislation mitigated the magnitude of the scheduled tax increases. As the fears of disastrous outcomes have ebbed, financial conditions have eased. The global economy has still needed aggressive monetary ease to sustain expansion, but that has been forthcoming in the near term and promised for the intermediate term. We believe that the slow pace of global expansion in 2012 and 2013 implies that new imbalances are not emerging quickly and therefore prospects are favorable for sustained economic expansion for a number of years.

The dominant characteristic of the current global economic expansion has been a broad and persistent pattern of global monetary ease in response to restrained private sector demand. While private sector participants have feared a repetition of the shocks experienced during the global financial crisis, so have the central bankers. Their policy ease has supported a moderate but sustained pace of global economic expansion.

The shift in Japanese policy is reinforcing this global monetary ease. While rebuilding drove a sharp rise in Japanese economic activity in the first quarter of 2012, the Japanese economy fell into recession later last year. Now, however, the shift to a more stimulative set of policies should be effective in supporting Japanese economic expansion, aiding the sustainability of global expansion. The lower yen should improve the outlook for Japanese exporters and for capital spending. We regard the decline in the yen so far as a shift closer to fair value, correcting a prior overvaluation. Increased competitive pressures from Japan are likely to encourage other countries, especially in North Asia, to maintain easy monetary policies.

Many Western companies active in China have recently reported improved business conditions there, a trend confirmed by a variety of economic data. Average economic growth is likely to be more moderate in the coming years. One reason is that China has passed a demographic inflection point, with the growth of its workforce now slowing. However, the cyclical risk of a hard landing in China has dropped sharply. We believe that economic policy has been consistent with the new economic realities. By tolerating a wage inflation faster than in the developed countries, China has supported consumption spending and contributed to an adjustment in its real exchange rate.

We believe that core Europe is near a transition from full-scale recession to a hesitant economic recovery at a very subdued pace. The peripheral countries are likely to remain in recession throughout 2013. Financial conditions impact economic activity with a lag. The European financial crisis in 2012 was extremely severe for peripheral countries and they are still undergoing fiscal tightening in an ongoing recession. Europe has been healing financially, but intermediate-term economic growth prospects are poor.

Over the last several years, the U.S. economic expansion has persisted at a sluggish average growth rate

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somewhat above 2%, with alternating subcycles of slower and faster growth. The U.S. economy has benefited from easy monetary policy but fiscal policy has been gradually tightening.

The near-flat U.S. real GDP in the fourth quarter of 2012 (likely to be revised somewhat higher) reflected substantial weakness in both Federal spending and inventory growth combined with positive growth in key domestic demand sectors, including housing, consumption and capital spending. While it is favorable that private sector final demand was sustained in late 2012, two government policy changes should be a drag on the economy in the first half of 2013: the tax hikes and the spending cuts due to the sequester or its replacement.

We expect 2013 to be another year of expansion at a sluggish average real GDP growth rate somewhat above 2%, with growth likely to be slower earlier in the year and faster later in the year. Assuming fiscal policy is finally stabilized and clarified enough by midyear to encourage a rebound in capital spending later this year, a 3% growth rate in the U.S. in both late 2013 and in 2014 is plausible.

The constant struggle over Federal tax policy and Federal spending policy occurs in the context of a persistent political conflict about what should be the appropriate Federal spending share of GDP and what should be the appropriate Federal tax share of GDP. Each individual budget battle occurs within the context of this multiyear struggle over budget priorities. This fundamental political disagreement about budget priorities helps explain why each round of negotiations is so difficult. We expect a succession of budget “mini-bargains” over the coming years rather than a single “grand bargain.”

We believe that the bulk of individual tax provisions are now set for a number of years following the decisions at the beginning of 2013 to make most of the Bush tax cuts permanent while raising the tax rates and restricting deductions for high income taxpayers. We believe that the opportunity for a major growth-oriented individual tax reform or for tax simplification has passed. Tax reform proposals for individuals are now likely to come in the form of closing relatively minor loopholes in the tax code. Because of the complexities of the linkage between corporate income taxes and taxes on pass-through entities (where the profits of enterprises are taxed at individual tax rates), we believe that the prospects for a major growth-oriented comprehensive corporate tax reform have been somewhat reduced by the recent increase in the top individual tax rates.

The current budget deficits are not a major financial problem in the short run because they are easy to finance in a context of limited private sector credit demand and aggressively easy monetary policy. However, the long-term budget outlook is more worrisome. In terms of Federal spending, the major long-term problem is the projected rise in health care costs, despite some recent slowing in health care inflation. It is notable that the sequester legislation requires only limited cuts to entitlement programs but very large cuts to non-entitlement programs in both the defense and non-defense sectors. For discretionary spending, the multiyear sequester cuts would be in addition to the multiyear “discretionary caps.” We believe that most of the projected cuts in discretionary (non-entitlement) spending may occur for the first few years, but are likely to prove too large to be credible over the next decade. However, it is possible that this year, dissatisfaction with the badly-designed sequester may be used to help motivate a “mini-bargain” compromise to replace the initial year of the sequester, a compromise which may retroactively reduce the size of the planned fiscal drag.

While the risk of a large year-end fiscal tightening of 4% to 5% of GDP has passed, there remains the risk of an incremental tightening due to the sequester or substitute legislation. The sequester was intentionally designed to be bad economic policy in order to motivate a political compromise on a better substitute. The adoption of a fiscal policy intentionally designed to be dysfunctional in its impact appears to be a unique American policy innovation, one unlikely to be copied by other countries. If the sequester goes into effect, it could be followed by a compromise on a better-designed substitute within a few weeks. We would expect that a sequester substitute would be only a minor drag on U.S. economic expansion, especially if its short-term fiscal drag is revised down to 0.5% of GDP or less. We believe that a clarification of fiscal policy could contribute to a recovery of business confidence and capital spending in late 2013 and in 2014.

The Federal Reserve is likely to continue with an easy monetary policy in a context of persistent fiscal tightening. We classify monetary policy into five phases: (1) aggressively stimulative, (2) stimulative, (3) neutral, (4) restrictive, and (5) aggressively restrictive. We would describe the current monetary policy setting as aggressively stimulative. We expect that it will take two or three years for the Fed to complete a shift to neutral. We do not expect the early emergence of major inflationary pressures any time soon, so a shift to truly restrictive monetary policy is likely to be many years in the future.

However, we believe that the cyclical and secular low in Treasury bond yields was reached in the summer of 2012 at slightly below 1.4% for 10-year Treasury bonds, down from a secular peak of 16% on September 30, 1981. We do not expect the Federal Reserve to raise the Federal funds rate until 2015, but once the U.S. starts growing faster than trend, the bond market is likely to anticipate that the Fed will taper off the pace of its purchases of Treasury bonds.

We expect U.S. economic weakness in early 2013 due to the tax hikes, higher energy costs and disruption from the sequester battle. However, once past the economic risk of a severe sequester shock, we expect a "bear steepener" in the bond market, with short rates locked near zero, but longer term yields likely to drift higher in late 2013 and in 2014.

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BNY Mellon Asset Management Japan Limited

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