

# STANDISH



## Economic Observations & Outlook

Second Quarter 2010

## Consensus Economic Forecasts

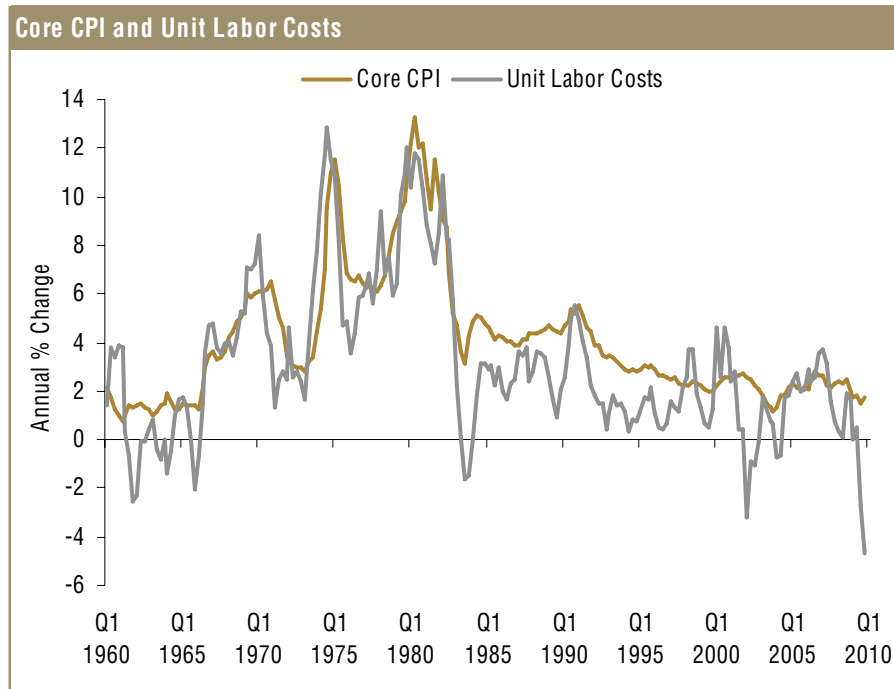
March 8, 2010 Survey	Real GDP			Consumer Prices		
	2009	2010	2011 <sup>F</sup>	2009	2010	2011 <sup>F</sup>
United States	-2.4	3.1	3.0	-0.3	2.2	1.9
Japan	-5.1	1.9	1.6	-1.4	-1.1	-0.3
United Kingdom	-5.0	1.4	2.3	2.2	2.6	1.7
Euro Zone	-4.0	1.1	1.5	0.3	1.1	1.4
Asia Pacific	1.5	5.5	5.1	0.8	2.1	2.3
Eastern Europe	-5.6	3.0	4.1	6.6	5.9	5.5
Latin America	-2.3	3.9	3.8	5.6	7.4	6.9
<b>Global</b>	<b>-2.1</b>	<b>3.2</b>	<b>3.3</b>	<b>1.4</b>	<b>2.7</b>	<b>2.7</b>

Source: Consensus Forecasts as of March 8, 2010  
F = Forecast

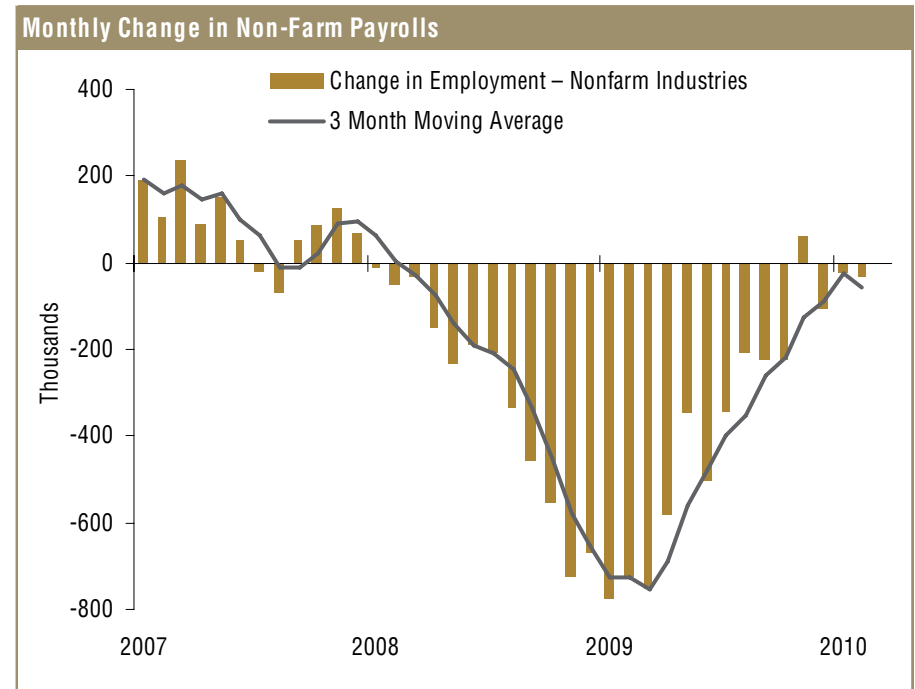
- We finally have a first look at growth expectations for 2011.
- A few issues to note:
  1. First, the emerging market outperformance compared to developed markets continues in 2011.
  2. Second, the 2011 growth expectation for the US at 3% seems ambitious.
  3. Third, Japan is expected to be in deflation for three straight years.
  4. Finally, Europe is expected to be the global growth pariah as Japanese growth is expected to exceed Europe in 2010 and 2011.

Please see important disclosures at the end of this presentation.

## Inflation to Decelerate Further



Source: Thomson Reuters Datastream as of December 31, 2009



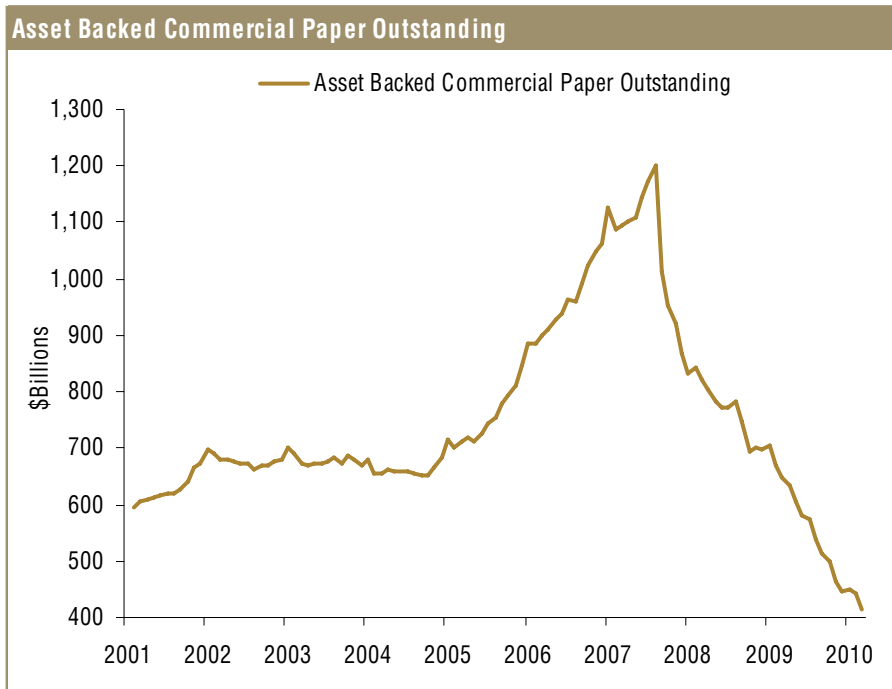
Source: Thomson Reuters Datastream as of February 15, 2010

- Unit labor costs are falling at record levels. This can help companies stay competitive and puts downward pressure on prices.
- A highly competitive business can compete on price aggressively if its cost base is low, as in the US market.

- Falling unit labor costs are usually good for companies because it helps rebuild profitability.
- The next step is for profits to drive job growth.
- Finally job growth needs to help raise incomes.
- Three critical steps for a sustainable expansion: profits, jobs, and income. Need all three kicking in late 2010, or else growth will be sub-par.

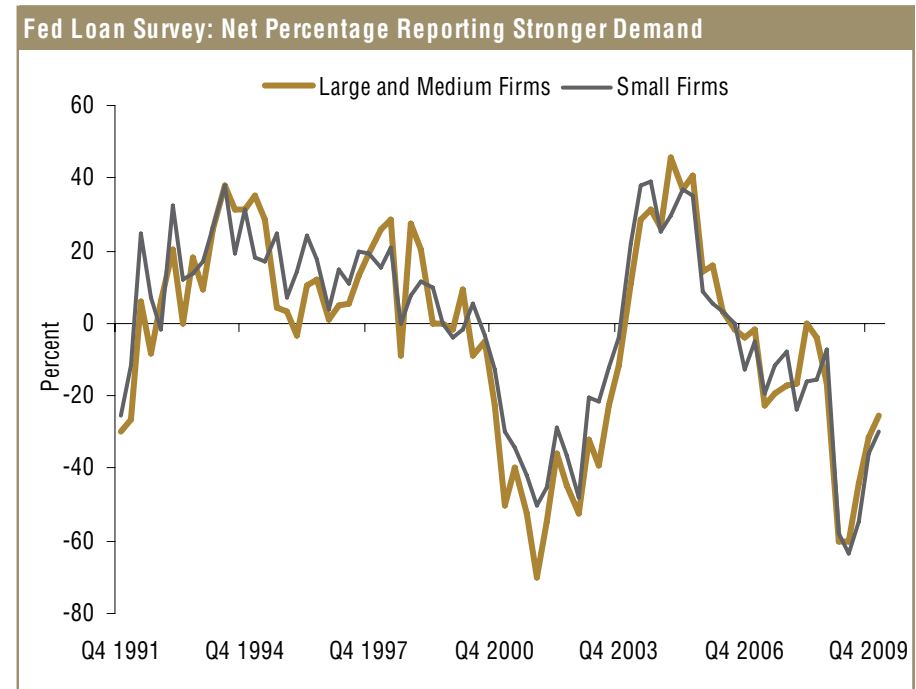
Please see important disclosures at the end of this presentation.

## Demand For Credit is Key Variable



Source: Thomson Reuters Datastream as of March 1, 2010

- ABCP was the conduit that financed the “shadow” banking system. Entities like Countrywide Financial borrowed in the ABCP market and lent long.
- As the ABCP market shut down in 2007, the debt superstructure of the entities in the shadow banking system collapsed because firms could not roll over their funding.

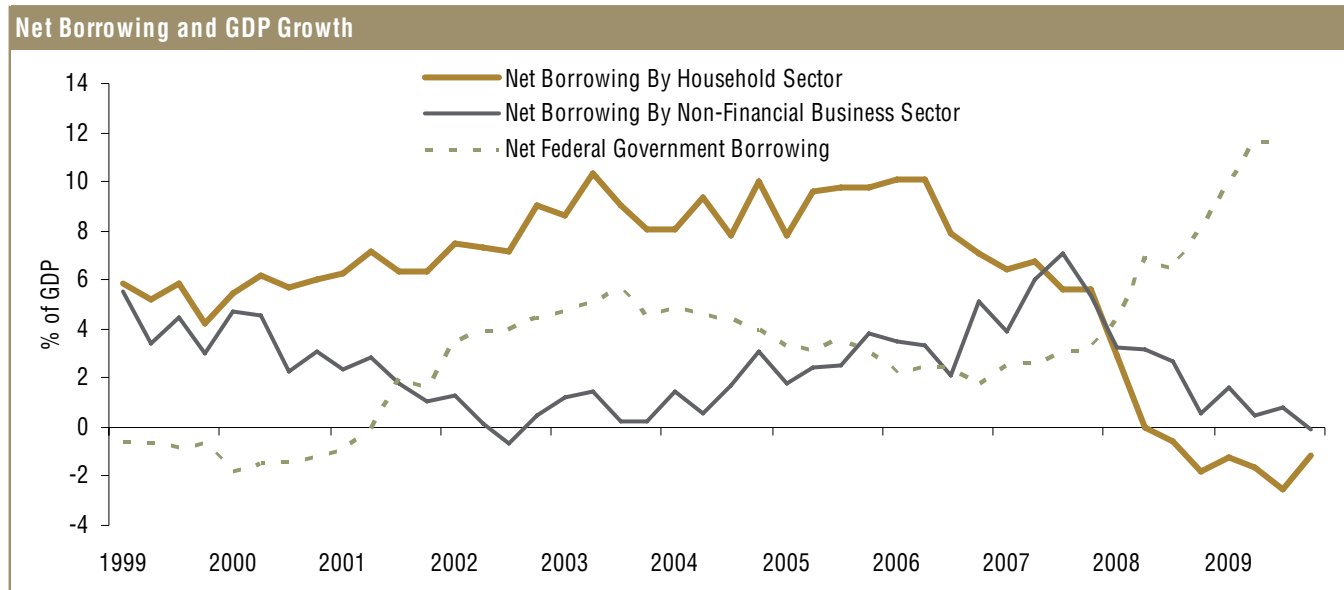


Source: Thomson Reuters Datastream as of March 1, 2010

- The most critical variable to watch is Japan since the peak of their bubble in 1990 was loan demand.
- Despite zero interest rates in Japan, firms focused on paying back debt and loan demand was consistently negative.
- Japan’s recession is known as a “balance sheet” recession because asset values were less than liabilities so firms needed to cut liabilities in order to get back to solvency.

Please see important disclosures at the end of this presentation.

## Borrower Of Last Resort

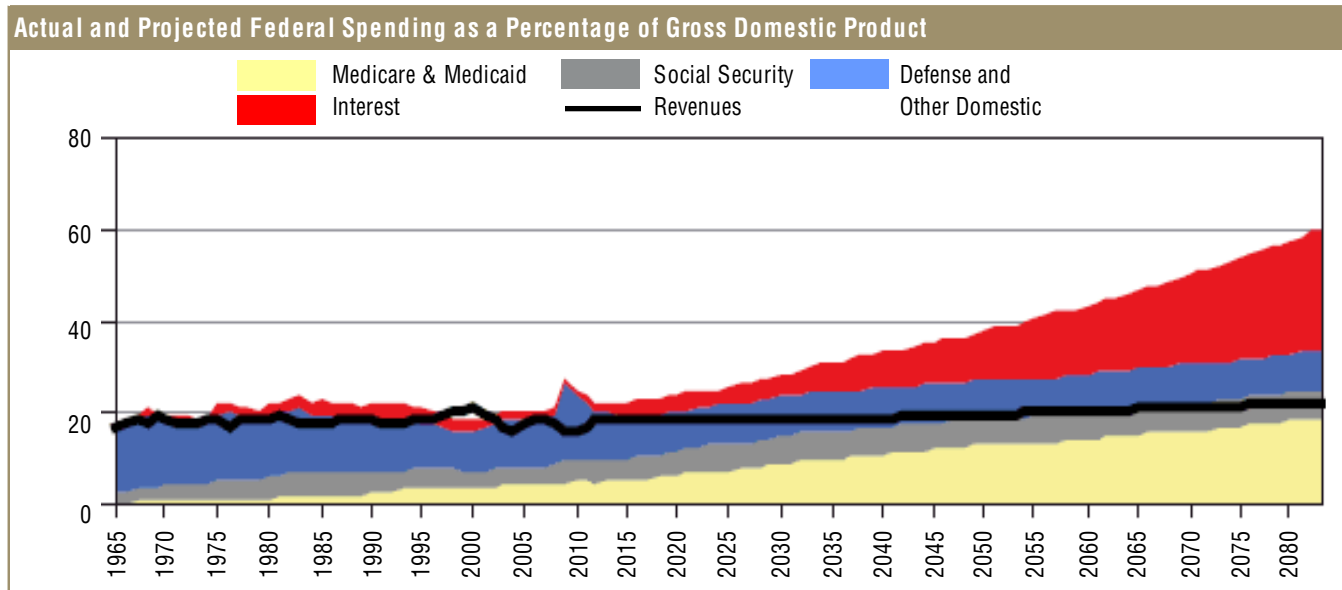


Source: Thomson Reuters Datastream as of December 31, 2009

- Without government borrowing we believe the economy would be in dire straits.
- The household sector and non-financial business sector have shifted from borrowing 16% of GDP to paying back 1% of GDP in debt, i.e., a 17% of GDP swing. The government has stepped in to borrow 12% of GDP.
- Remember, the US is a borrow and spend economy. If a sector stops borrowing and starts saving, it can lead to leakage of demand in the economy.

Please see important disclosures at the end of this presentation.

## Health Reform is Critical

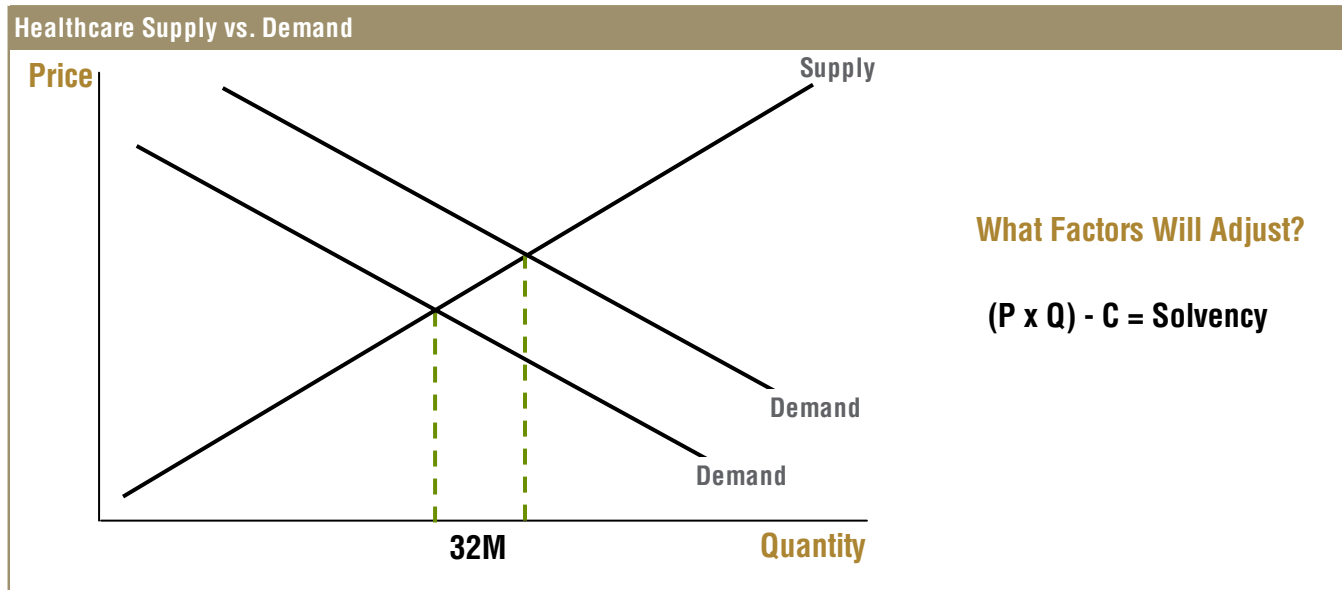


Source: National Research Council, *Choosing the Nation's Fiscal Future*, 2010

- Medicare and Medicaid are projected to become the biggest contributor to increased government spending over the next 50 years.
- The reason is that healthcare costs are rising much faster than GDP growth, as demographics – such as the retirement of the Baby Boomers – kick in to raise demand.
- Capping the rise in health care costs should be a budget priority.

Please see important disclosures at the end of this presentation.

## A Simple Economic Observation of Current Healthcare Reform

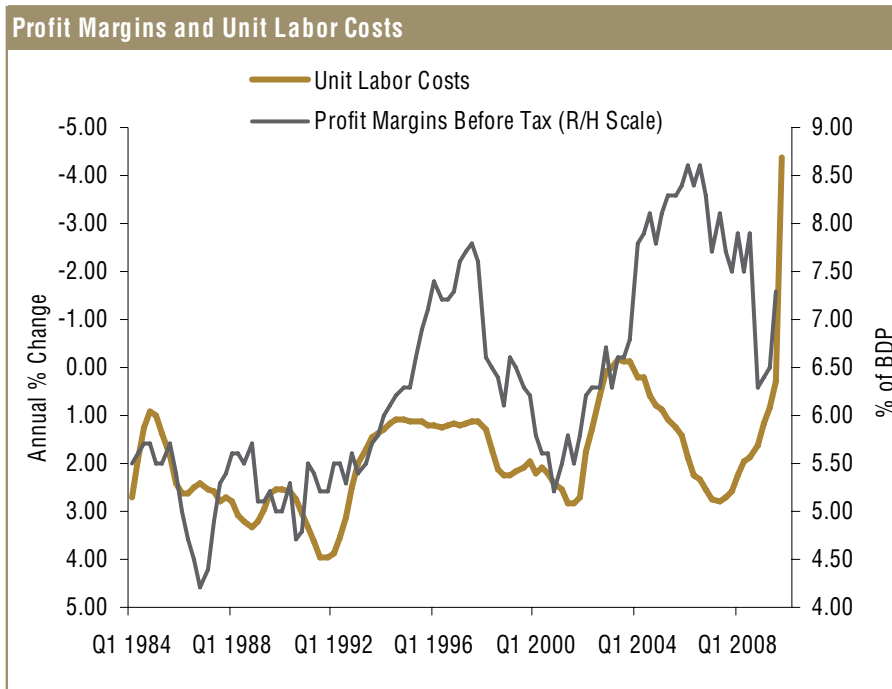


Source: Standish

- As the uninsured enter the healthcare market, demand is expected to increase by 32 million.
- The demand curve will shift out to the right and, depending on the elasticity of supply, that will determine how high the increase in demand drives the price of healthcare services.
- The math is easy as well: If demand (Q) rises, and prices (P) rise, then a lot of wood needs to be chopped to keep costs [C] down for the healthcare system to remain solvent.

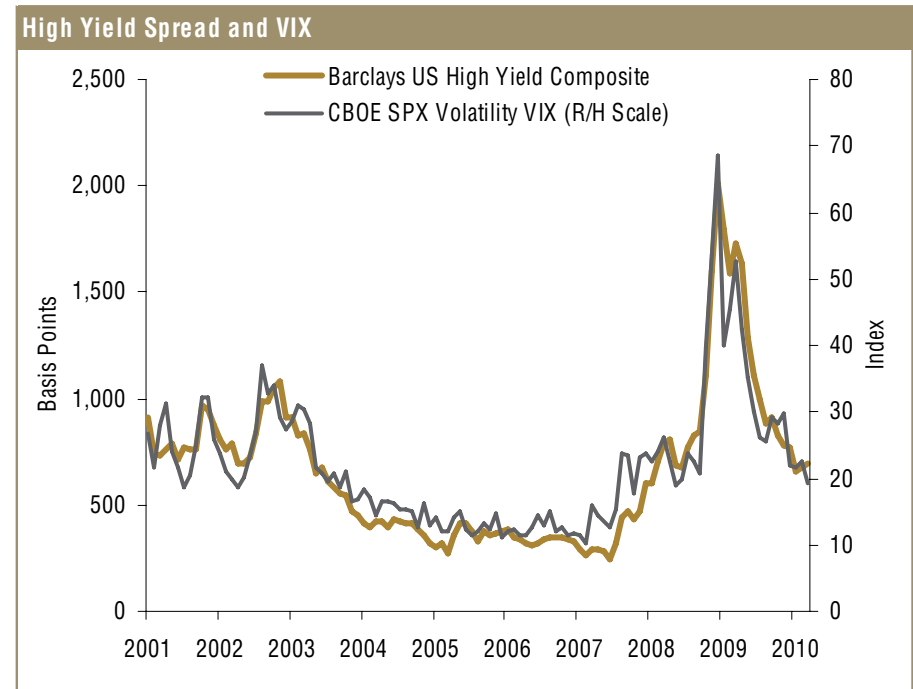
Please see important disclosures at the end of this presentation.

## Sweet Spot for Credit



Source: Thomson Reuters Datastream as of December 31, 2009

- Unit labor costs are a good proxy for profit margins.
- The outlook is promising for margins because firms have cut costs aggressively which is evident by the margin proxy.

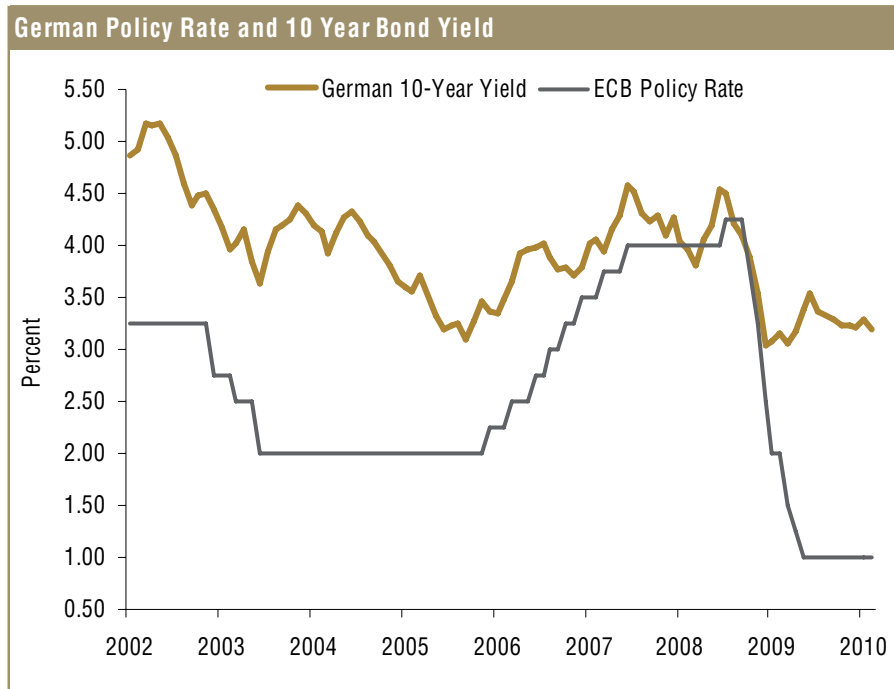


Source: Thomson Reuters Datastream as of March 1, 2010

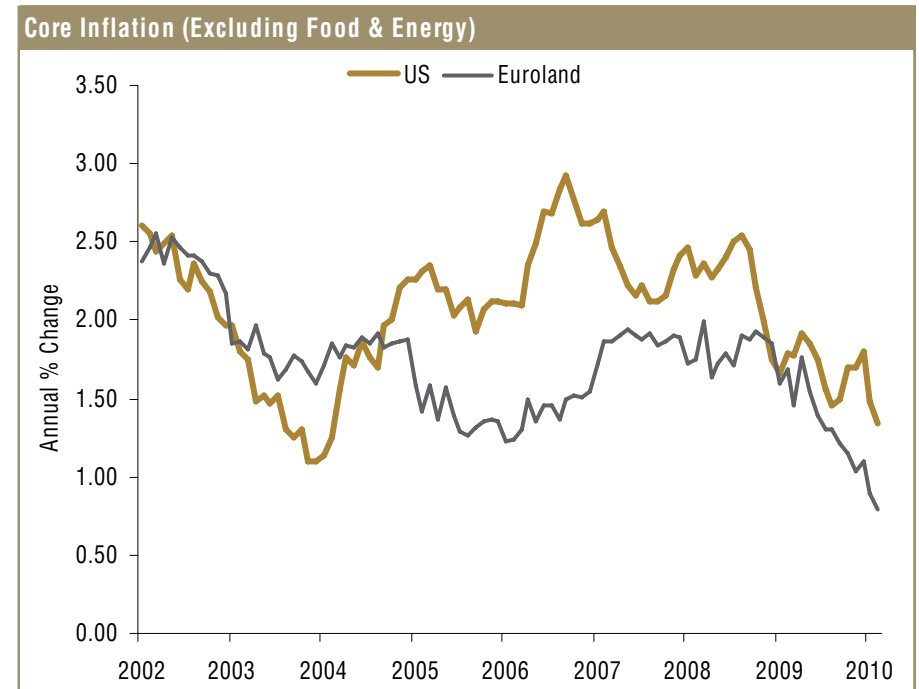
- Deleveraging is naturally helpful in reducing volatility, which shows in the graph as the VIX volatility index dropping.
- A drop in leverage and volatility favors corporate bonds over equities because equities are like a call option which benefits from higher volatility.
- Credit investing is like selling a put option which is short volatility. As volatility declines, the value of a short put rises and the value of a long call decreases.

Please see important disclosures at the end of this presentation.

## We Like European Bonds



Source: Thomson Reuters Datastream as of February 15, 2010



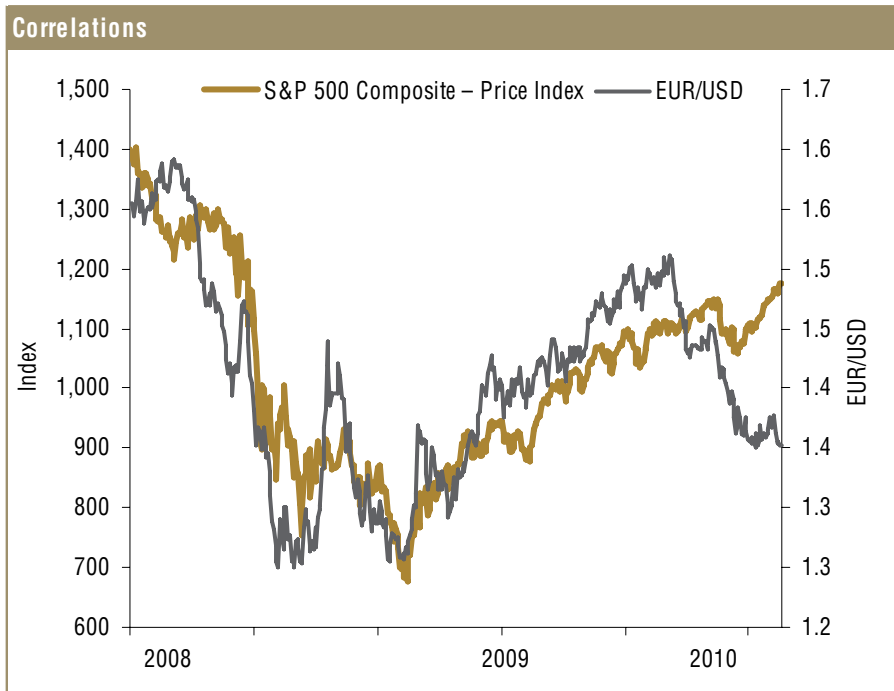
Source: Thomson Reuters Datastream as of February 15, 2010

- Policy rates should remain close to 1% in Europe for the foreseeable future.
- Just like in 2005-2006 this should encourage bond yields to drift lower.

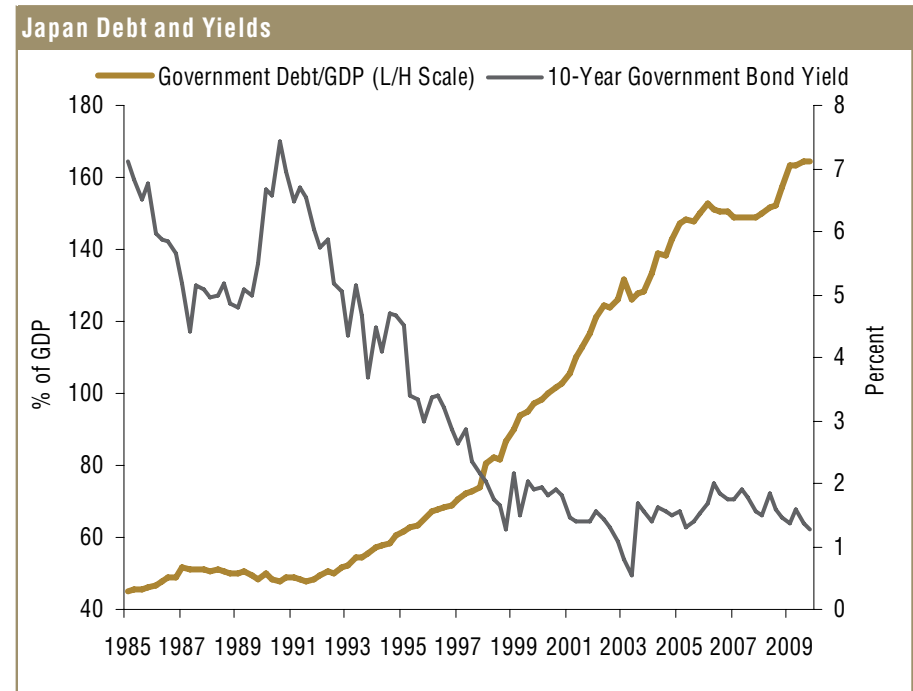
- European bond yields can drift lower because inflation rates are decelerating sharply.
- We highlighted in the consensus forecasts that Europe is looking like the weak link in terms of global economic growth.
- That raises the risk of deflation.

Please see important disclosures at the end of this presentation.

## New Correlations?



Source: Thomson Reuters Datastream as of March 24, 2010



Source: Thomson Reuters Datastream as of December 31, 2009

- During the financial crisis and immediately after, there were two highly correlated trades, i.e., risk on by investors in more speculative assets like the S&P 500, and the risk off trade was defined by investors seeking safety and security in assets like the dollar.
- However, as you can see in the chart, the dollar correlation with the risk on trade is breaking down and relative value is becoming more important.
- Speaking of correlations breaking down, look at how yields are dropping despite the rise in Japanese debt.

Please see important disclosures at the end of this presentation.

## Conclusions

- Global growth could surprise on the upside in 2010 from policy stimulus but the real fuel for long-term growth is profits, jobs, and income. For these reasons we think the 3% consensus forecast for US growth in 2011 seems high. We believe emerging markets will continue to outperform developed markets over the forecast horizon.
- Inflation should surprise on the downside in 2010.
- We believe healthcare reform in the US is the most critical element to reducing long-term debt and deficit imbalances.
- We remain in a global bond bullish environment. There is excess global capacity and low inflation. Access to credit is a necessary condition for sustained economic growth.
- Europe has many challenges ahead with an overvalued exchange rate and the need to restructure in the Mediterranean countries. European bonds should outperform relative to the US and Japan.
- Japan is a deflationary mess and provides many lessons for the US and Europe. One of those lessons regards the look of a balance sheet recession where the government becomes the borrower of last resort and yields stay low because the private sector is focused on debt minimization. Will that come to the US and Europe?
- We expect yields to stay lower for longer. Unfortunately, the global savings glut implies historically poor returns on those savings as evidenced by the decade long outperformance of bonds versus equities.
- We believe we are in the sweet spot of the cycle for corporate bonds.

## Disclosures

*This information is not provided as a sales or advertising communication. It does not constitute investment advice. It is not an offer to sell or a solicitation of an offer to buy any security. Many factors affect performance including changes in market conditions and interest rates and in response to other economic, political, or financial developments. Past performance is not a guide to or indicative of future results. Future returns are not guaranteed and a loss of principal may occur. This information is not intended to provide specific advice, recommendations or projected returns of any particular Standish Mellon Asset Management Company LLC ("Standish") product. Some information contained herein has been obtained from third party sources and has not been verified by Standish. Standish makes no representations as to the accuracy or the completeness of any of the information herein.*

*The enclosed material is confidential and not to be reproduced or redistributed without the prior written consent of Standish. Any statements of opinion constitute only current opinions of Standish, which are subject to change and which Standish does not undertake to update. Views expressed are subject to change rapidly as market and economic conditions dictate. Portfolio composition is also subject to change.*

*As of July 1, 2007, Mellon Financial Corporation and The Bank of New York Company, Inc. merged into a newly created entity, The Bank of New York Mellon Corporation. BNY Mellon Asset Management is the umbrella organization for The Bank of New York Mellon Corporation's affiliated investment management firms and global distribution companies.*

*This portfolio data should not be relied upon as a complete listing of the Portfolio's holdings (or top holdings) as information on particular holdings may be withheld if it is in the client's best interest to do so. Portfolio holdings are subject to change without notice and may not represent current or future portfolio composition. The portfolio date is "as of" the date indicated.*

*There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings.*

*It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.*

*The allocation distribution and actual percentages may vary from time-to-time. The types of investments presented in the allocation chart will not always have the same comparable risks and returns. The actual performance of the portfolio will depend on the Investment Manager's ability to identify and access appropriate investments, and balance assets to maximize return while minimizing its risk. The actual investments in the portfolio may or may not be the same or in the same proportion as those shown above.*

*These benchmarks are broad-based indices which are used for illustrative purposes only and have been selected as they are well known and are easily recognizable by investors. Comparisons to benchmarks have limitations because benchmarks have volatility and other material characteristics that may differ from the portfolio. For example, investments made for the portfolio may differ significantly in terms of security holdings, industry weightings and asset allocation from those of the benchmark. Accordingly, investment results and volatility of the portfolio may differ from those of the benchmark. Also, the indices noted in this presentation are unmanaged, are not available for direct investment, and are not subject to management fees, transaction costs or other types of expenses that the portfolio may incur. In addition, the performance of the indices reflects reinvestment of dividends and, where applicable, capital gain distributions. Therefore, investors should carefully consider these limitations and differences when evaluating the comparative benchmark data performance.*

*The information regarding the index is included merely to show the general trends in the periods indicated and is not intended to imply that the portfolio was similar to the index in composition or risk. Views expressed are subject to rapid change as market and economic conditions dictate.*

*The Barclays Capital U.S. Corporate High-Yield Bond Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. The index was created in 1986, with index history backfilled to January 1, 1983. The U.S. Corporate High-Yield Index is part of the U.S. Universal and Global High-Yield Indices.*

*The Barclays Capital U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety. The index was created in 1986, with index history backfilled to January 1, 1976.*

*The Barclays US Treasury bond index is part of Barclays Capital global family of government bonds indices. The index measures the performance of the US Treasury bond market, using market capitalisation weighting and a standard rule based inclusion methodology.*

*S&P 500 Index is considered to be generally representative of the U.S. large capitalization stock market as a whole. It is an unmanaged capitalization-weighted index of 500 commonly traded stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of those stocks. The index assumes reinvestment of dividends.*

*The S&P 500 index was created in 1957, although it has been extrapolated backwards to several decades earlier for performance comparison purposes. This index provides a broad snapshot of the overall U.S. equity market; in fact, over 70% of all U.S. equity is tracked by the S&P 500. The index selects its companies based upon their market size, liquidity, and sector. Most of the companies in the index are solid mid cap or large cap corporations. The S&P 500 is a market-weighted index.*

*The Trade Weighted Index measures the value of a country's currency in relation to the currencies of its trading partners.*



BNY MELLON  
ASSET MANAGEMENT