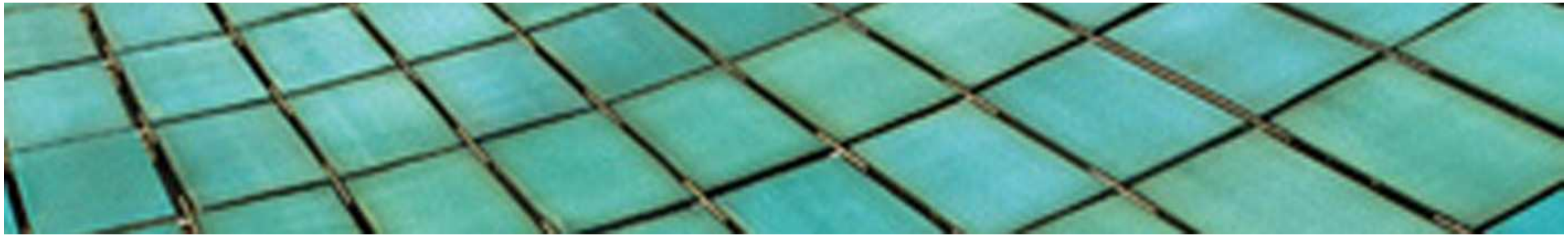
BNY MELLON
GLOBAL MARKETS



March 2011

Warnings from the past

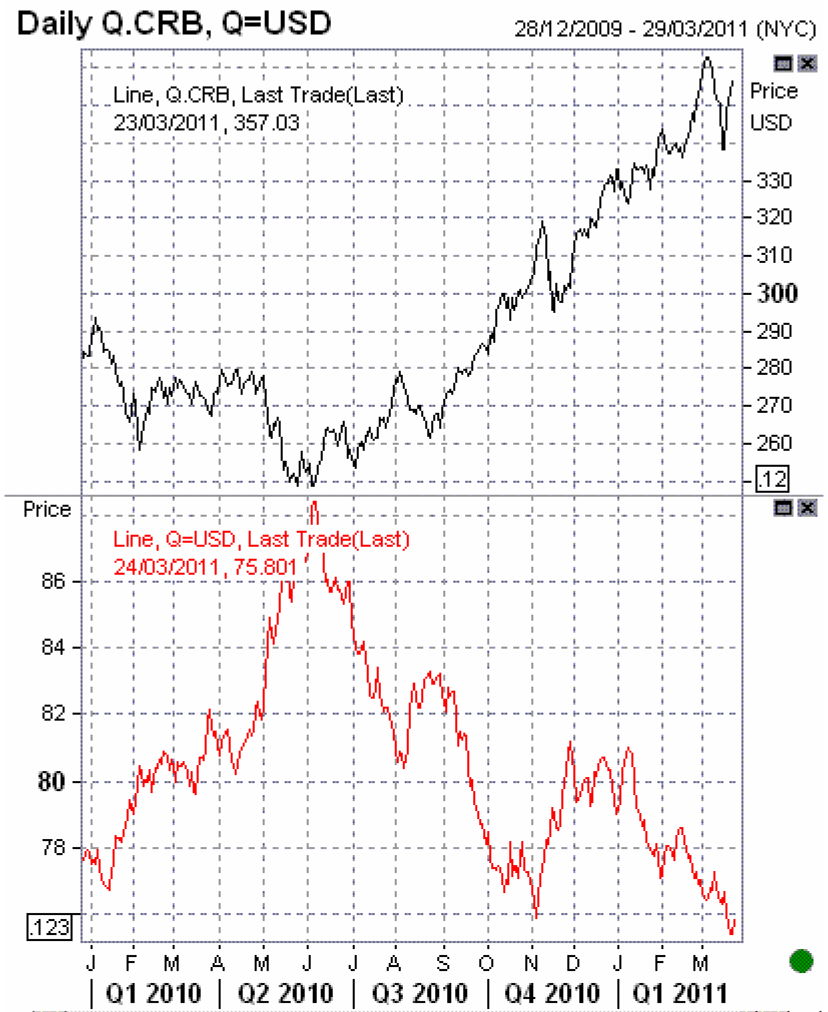
Presented by Simon Derrick

The post 2002 environment

- Since start of 2002 the average Fed Funds target rate has been just 2.16%. The average level of headline inflation through this period has been 2.35%.
- US was not the only nation pursuing an aggressively easy monetary policy through much of this period. In March 2001 Japan introduced policy of quantitative easing.
- US, Japan and China involved in extended battle over currency policy.
- Investor behaved in a rational manner and bought:
  - Currencies supported by central banks with a strong, anti-inflationary stance.
  - Precious metals such as gold
  - Equity markets in nations with currencies linked to the USD that were likely to benefit from export fuelled growth
  - Commodities (such as oil) that were likely to be in demand as export booms in China (and elsewhere) continued on.

The "so what"

- Latest rally in the CRB coincided almost exactly with the renewed downtrend that emerged in the USD index in the summer of last year.
- Arguable that one of the initial causes of popular dissatisfaction in nations such as Syria, Algeria and Egypt was the high cost of fuel and staple products.
- Net result has been the spread of unrest through Middle East, North Africa and beyond. Given that these nations account for around 34% of daily oil production, has sparked fears of a further round of inflationary pressures.
- Has led investors (understandably) to flee currencies where the central banks continue to send an accommodative message (e.g. the USD) and seek out currencies with overtly hawkish policy setters (e.g. the EUR).
- Has also seen renewed interest in commodity currencies. CAD has been particularly popular given its high correlation to oil prices over the past decade.
- No immediate indication that this trend has yet run its course given the seismic political shifts still taking place in the ME.

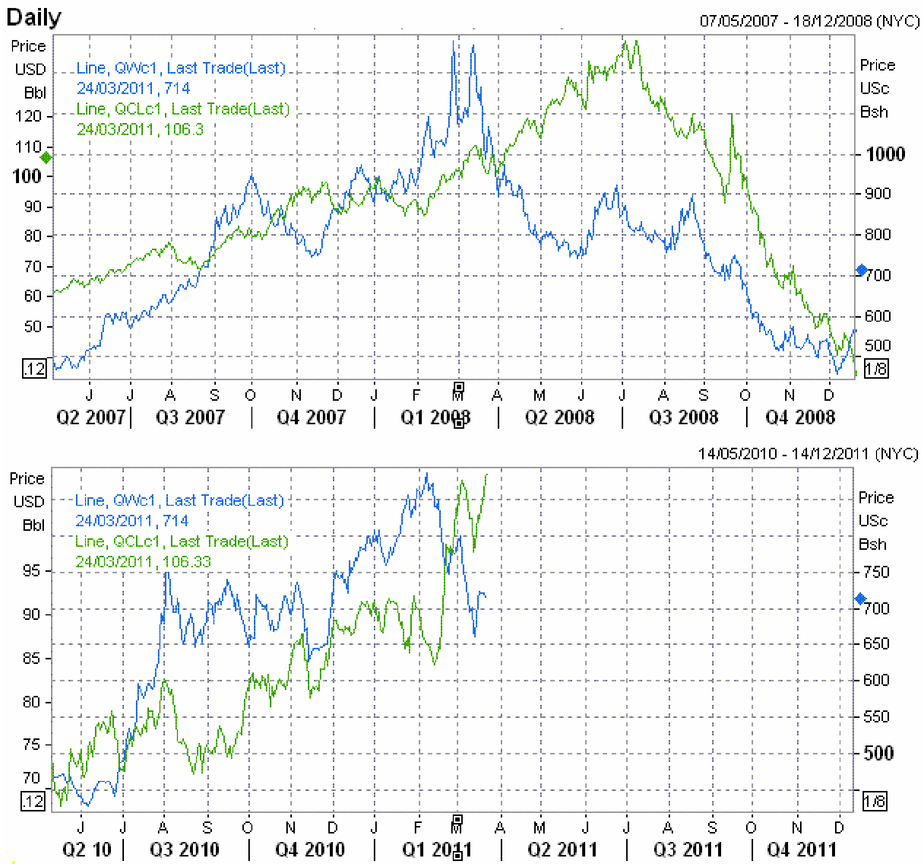


The hidden threat.

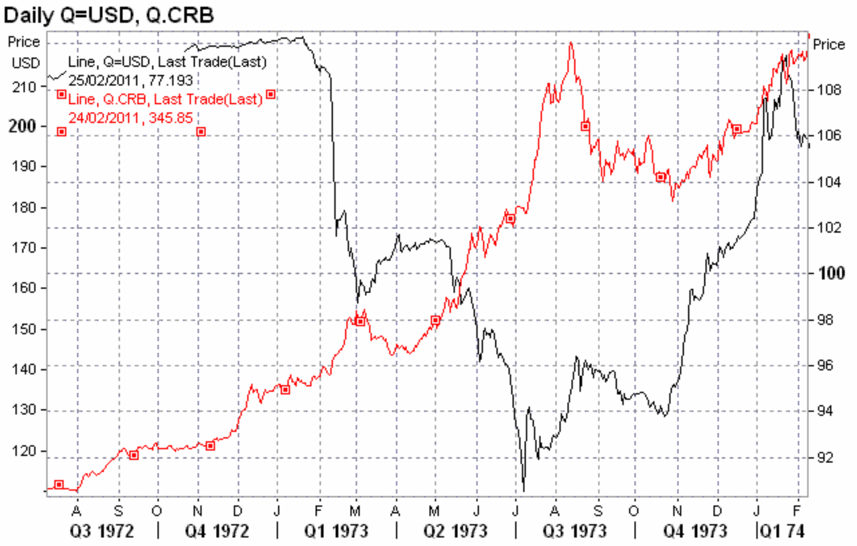
- What has been seen since last summer is entirely consistent with the forces that drove the previous two great bursts of commodity price inflation.
  - In 1973 it was President Nixon's decision in February of that year to devalue the USD by a further 10% and the subsequent move in March to allow the major currencies to float against each other that provided the catalyst for the flight into commodities.
  - In 2007 and 2008 it was the FOMC's aggressive easing policy that provided the spark.
- Unfortunately, the great commodity price booms of 1973 and 2007/2008 were followed by the two most vicious bear markets in equities in the past fifty years.
  - 1973 bear market (which actually started at the end of January of that year) saw the DJIA collapse by 44% over a 22 month period
  - The first signs of the 2007/2008 bear market emerged quite early on (October 2007) but the lion's share of losses came post May 2008). Overall the DJIA lost 54% between October 2007 and March 2009 (18 months).

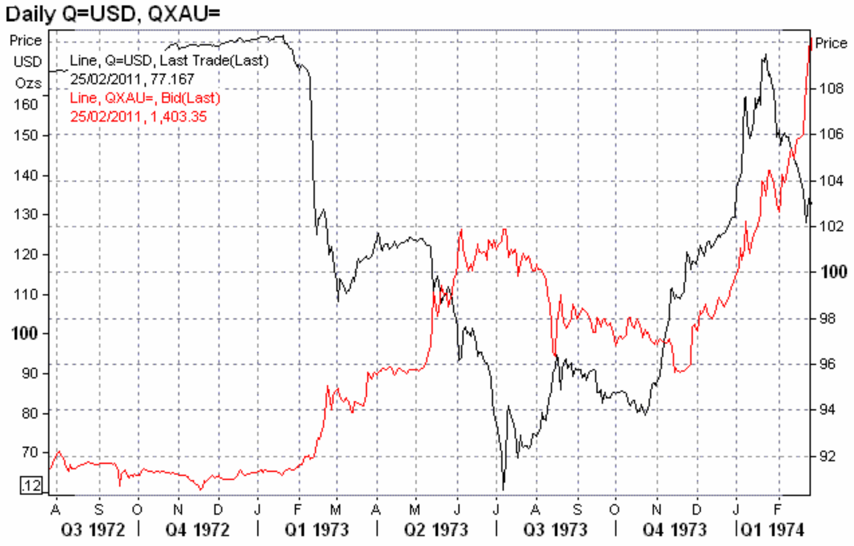
Early warning signals (comparing 2007/2008 to now).

- One of the most significant signals in 2007 was a marked reversal in the price of a number of basic foodstuffs well before oil prices peaked in July 2008.
- Notably, wheat futures staged a sharp reversal from the high seen in February of that year. By the time that the oil price (and, around a week later, the USD) changed course in mid July the price of wheat was down over 30%.
- Indicated a dramatic abatement in global inflationary pressures that would see investors turn from seeking out the currencies with the most hawkish central banks to, instead, favouring those with the most growth oriented monetary policy stance.
- Why does this matter now? Wheat prices have reversed dramatically over the course of the past two weeks. Since February 14th (i.e. the point at which the situation in Libya began to deteriorate) front month futures have lost a substantial 18%. Tellingly, this has come in the face of a 25% rise in front month NYMEX crude prices.



The “so what”....


Daily Q=USD, Q.CRB
Line, Q=USD, Last Trade(Last)
25/02/2011, 77.193
Line, Q.CRB, Last Trade(Last)
24/02/2011, 345.85
Q3 1972 | Q4 1972 | Q1 1973 | Q2 1973 | Q3 1973 | Q4 1973 | Q1 74


Daily Q=USD, QXAU=
Line, Q=USD, Last Trade(Last)
25/02/2011, 77.167
Line, QXAU=, Bid(Last)
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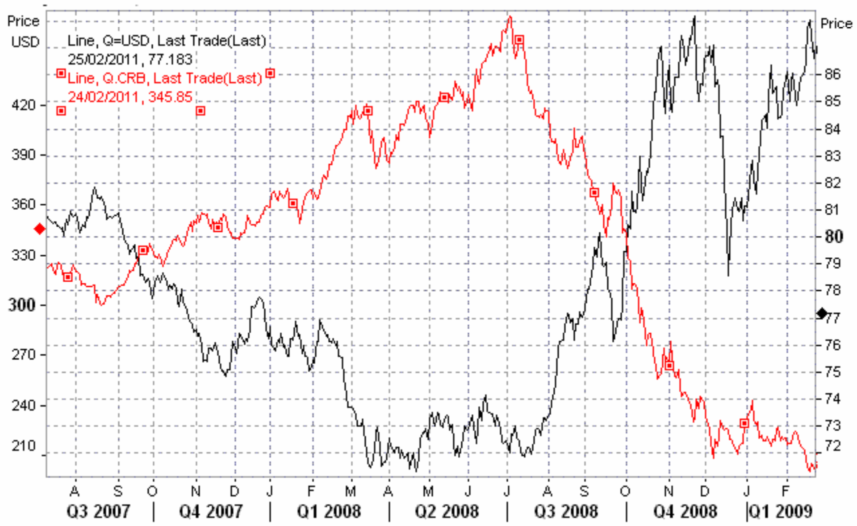
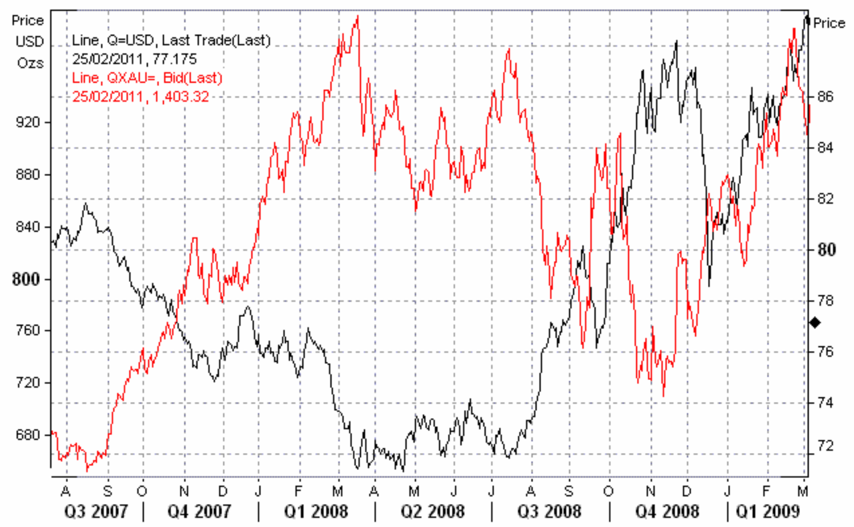
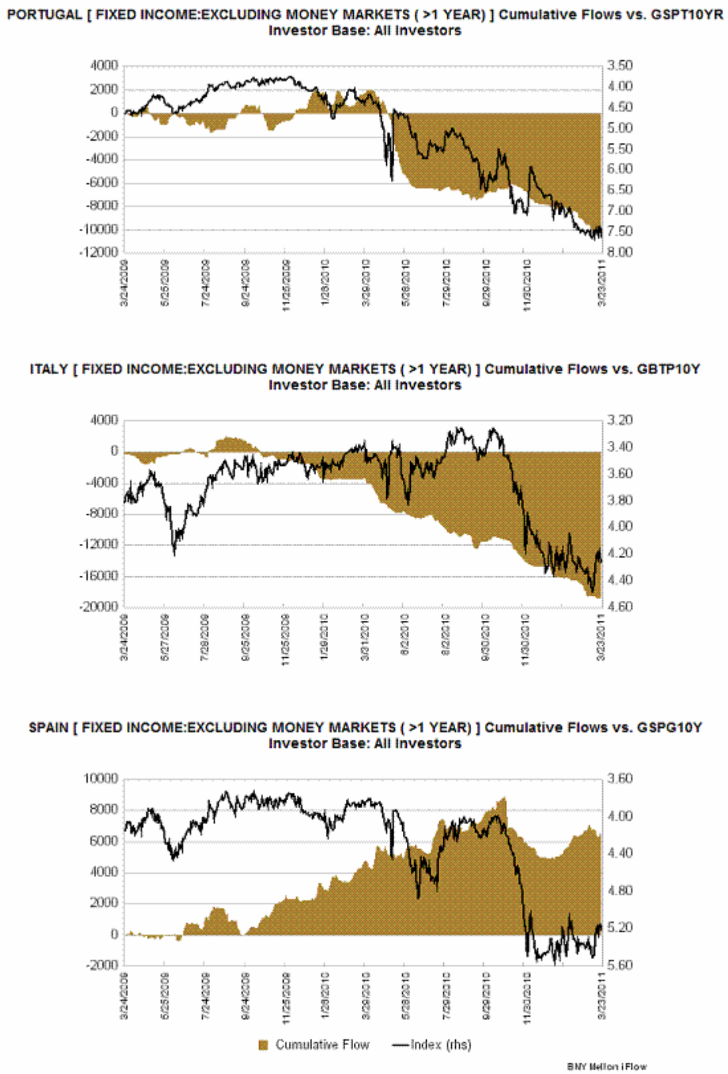
Q3 1972 | Q4 1972 | Q1 1973 | Q2 1973 | Q3 1973 | Q4 1973 | Q1 1974


Line, Q=USD, Last Trade(Last)
25/02/2011, 77.183
Line, Q.CRB, Last Trade(Last)
24/02/2011, 345.85
Q3 2007 | Q4 2007 | Q1 2008 | Q2 2008 | Q3 2008 | Q4 2008 | Q1 2009


Line, Q=USD, Last Trade(Last)
25/02/2011, 77.175
Line, QXAU=, Bid(Last)
25/02/2011, 1,403.32
Q3 2007 | Q4 2007 | Q1 2008 | Q2 2008 | Q3 2008 | Q4 2008 | Q1 2009

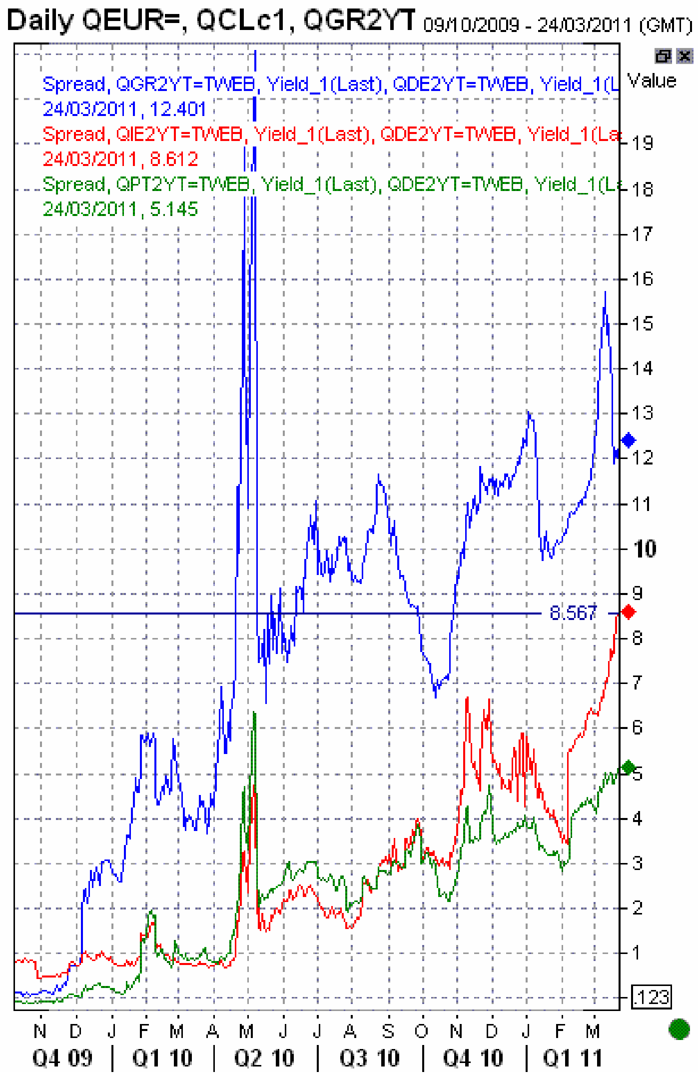
The inflationary threat has masked some deeper problems: the Eurozone

- We were optimistic about the outlook in January, (although we noted the potential for a third leg to the debt crisis). We argued:
  - European authorities have honed their crisis management skills (the latest evidence comes from Portugal)
  - Price movements and flows in each crisis proving progressively more muted
  - German Finance Minister Wolfgang Schäuble has commented that “in this crisis, Europe will find steps toward further unification.”
  - Latest moves of EFSF indicate real (if erratic) progress
  - Most importantly, China and Japan’s very public support for the region.
- Latest evidence suggests we were too optimistic.

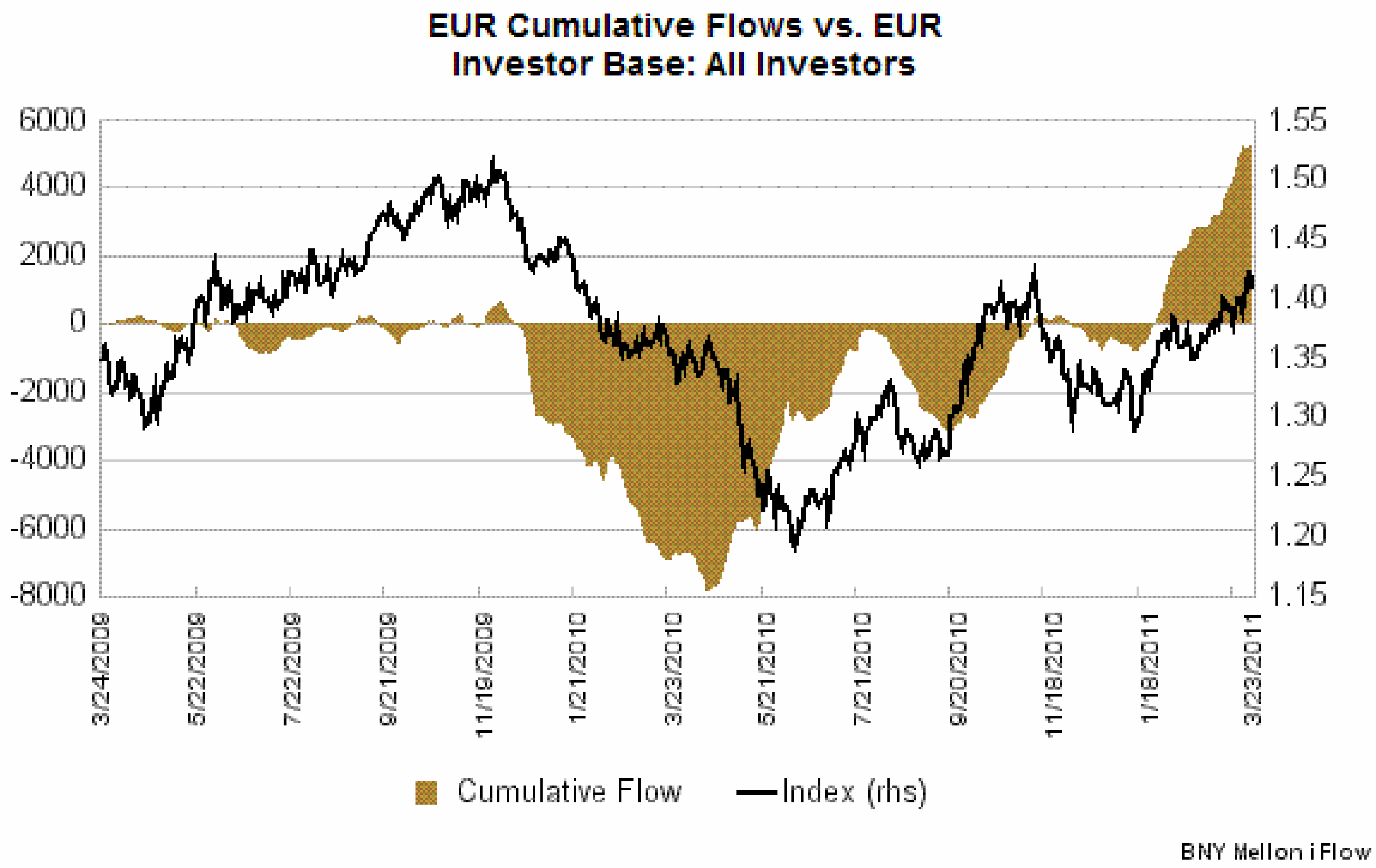


How wrong?

- Germany is pressing for further negotiations on the structure of the European Stability Mechanism.
- Given that the origins of latest leg of the crisis can traced back to the forceful rejection of joint Franco-German proposals in early February and that the seeds of the previous two legs could be traced back to German comments or intransigence, this news indicates that Germany has yet to learn its lesson.
- Worth noting that Finland also sounding increasingly unhappy.
- Strong indications that Eurozone nations will attempt to ring-fence Portugal with a pre-emptive bailout. EUR 80 Bn already being talked about.
- Also have to cope with Ireland playing hard ball over corporate tax rate. The threat of a new “burden-sharing” plan for bank bondholders a fairly direct swipe at Germany and France (German banks are owed EUR 99 Bn by Irish banks and French banks are owed EUR 30.9 Bn).
- Has turned the Eurozone summit from an opportunity to soothe investor concerns to, instead, yet another test of nerves for those that continue to support the region’s sovereign debt markets
- Even if immediate issues are resolved, question remains of how many times investors will be prepared to endure this continued inability to act in a co-ordinated and harmonious fashion.



And the EUR?


EUR Cumulative Flows vs. EUR
Investor Base: All Investors
6000
4000
2000
0
-2000
-4000
-6000
-8000
1.55
1.50
1.45
1.40
1.35
1.30
1.25
1.20
1.15
3/24/2009
5/22/2009
7/22/2009
9/21/2009
11/19/2009
1/21/2010
3/23/2010
5/21/2010
7/21/2010
9/20/2010
11/18/2010
1/18/2011
3/23/2011
Cumulative Flow
Index (rhs)
BNY Mellon iFlow

GBP: Still no anarchy in the UK ?

- 2010 started with concerns over whether a coalition or minority government would find itself without the mandate to make tough spending decisions.
- However, much as happened in 1974 and in 1977, GBP derived support from investors that seemed prepared to give the administration the benefit of the doubt.
- Investors rewarded for their faith as the new government laid out its spending reduction plans in October.
- Whether this honeymoon period lasts for GBP remains to be seen.
- As the latest public borrowing data from the ONS showed, the government has a tough job ahead of it.
- Moody's Investor Services: "Although the weaker economic growth prospects in 2011 and 2012 do not directly cast doubt on the UK's sovereign rating level, we believe that slower growth combined with weaker-than-expected fiscal consolidation could cause the UK's debt metrics to deteriorate to a point that would be inconsistent with a AAA rating."

Japan: will G7 succeed?

- "As we long have stated, excess volatility and disorderly movements in exchange rates have adverse implications for economic and financial stability. We will monitor exchange markets closely and cooperate as appropriate."
- Reasonable to suppose that the central banks will be happy if USD/JPY returns to conditions that had characterised trading from early November of last year onwards.
- This is not an attempt to drive USD/JPY aggressively higher in the way that happened back in 1995.
- Will they succeed now? Probably
- The MOF/BOJ did a good job last September in braking the appreciation of the JPY (albeit that it took another for USD/JPY to finally stabilise)
- History of pre 2001 multilateral actions is very firmly in favour of the central banks/finance ministry's succeeding in their efforts (whatever Secretary John Snow might have had to say in London in November 2004).

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