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Sorting Out the Sectors

While the global economy continues its long-term recovery, the improvement is expected to be more moderate in the latter part of 2011. Emerging markets are expected to continue outperforming developed markets but the rate of expansion is expected to slow down. Raw material and commodity prices (oil, wheat, base metals) remain high, which are positives for some companies and concerns for others. Consumer sentiment has improved from the recession a few years ago but remains muted given concerns with geopolitical events in the Middle East, continued uncertainty in European countries like Greece and Spain, the recent S&P downgrade of the United States and overall concerns with the possibility of another recession. According to Richard Hoey, Dreyfus Chief Economist, 'the risk of a full scale recession, especially in the U.S. and Europe, has risen substantially due to policy choices which have generated substantial financial stresses'. We could potentially see some of our Improving sectors shift into Stable or Deteriorating over the next six months if the global economy weakens. Nevertheless, within the investment grade space, we continue to expect companies will maintain solid liquidity and credit metrics. Credit ratings should generally remain stable as these companies have financial flexibility for cyclical credit weakness. In this report,

we have updated our sector ranks and comments within three categories - Credit Conditions Improving, Stable and Deteriorating. While most of the sector ranks are unchanged, Metals & Mining and Automotives moved up within their respective categories.

Credit Conditions Improving

1) Oil & Gas

For many of the independent and major oil producers, high liquids prices spurred strong earnings growth in the first half of this year, despite the slow pace of permitting for deepwater drilling in the Gulf of Mexico and disruptions in North Africa. Although natural gas prices remain relatively weak due to oversupply, they have enjoyed a modest recovery in 2011, as have chemical and refining earnings, although the magnitude of the improvement varies according to niche and geographic region. In the oilfield services sector, increased activity in the liquids-rich U.S. shale basins has spurred investments and demand for services; production from northern areas, such as the Bakken formation, has increased the need for midstream services, benefitting the pipeline partnerships. These partnerships are also enjoying an earnings rebound in 2011 due to contributions from recently-completed projects. Those oilfield services

providers with the most advanced technology, capable of providing multiple services at a single exploration venue, will have a competitive advantage. The opportunities posed by this environment also necessitate heightened capital expenditures, lessening the spare cash available for debt reduction. Nevertheless, it's likely that energy producers, pipelines and oilfield services companies will outperform industrials in general over the near term.

2) Metals & Mining

Demand and pricing have come off their recent highs but still remain strong. Short term demand is threatened by the recent macro events impacting developed countries. However, short term demand is buoyed by emerging market countries which have contributed more to global growth than developed countries over the last decade. During the quarter, high commodity prices benefited metals and mining companies by offsetting consistent input cost pressures and resulted in higher revenues and earnings for all companies we cover. The sector maintains an acquisitive appetite, which could dampen otherwise solid sector liquidity. However, overall demand remains strong and supply constraints persist. This suggests higher average prices, revenues and robust cash flows for the remainder of 2011.

3) Chemicals

Manufacturers of agricultural products, such as genetically modified seeds and herbicides, will continue to do well owing to growing affluence in emerging markets, resulting in demand for improved diets. Small- to moderate-sized acquisitions and joint ventures have recently increased the foothold of major players in this area. The magnitude of the recovery varies by product line; high value-added products, such as performance polymers and

industrial gases, are chalking up solid sales gains, while growth is more restrained for products which are commoditized, such as polyurethanes. The outlook for petrochemicals is mixed; for some manufacturers high oil prices are constricting margins. Still, we think that demand in emerging markets for the products made by the integrated and specialty chemicals producers will be positive for the sector in the near term.

4) Construction Machinery

With an improving global economy, favorable prices in metals and coal as well as agricultural commodities like corn, wheat and sugar, the sector continues to benefit from increased demand for machinery equipment. Growth continues, albeit at a more moderating pace, driven by developing countries while conditions in more developed areas like North America and Europe are showing signs of improvement. The impact from the Japanese earthquake and tsunami is expected to be manageable. The sector enjoys solid liquidity and a commitment to a healthy credit profile and strong credit ratings.

5) Diversified Manufacturing

Companies in this sector continue to benefit from improving end markets and a rebound in order trends. Demand is expected to moderate in the second half of the year but markets remain in recovery mode. Like the Construction Machinery sector, most of the growth is driven by emerging economies (Latin America, Asia-Pacific) whereas developed economies are showing signs of slower growth. The impact from the Japanese earthquake and tsunami should be manageable. The sector generates solid liquidity and maintains healthy balance sheets, which we expect to continue despite more M&A activity. The sector could be impacted by higher raw material costs but cost

savings initiatives should help offset the pressure on margins.

6) Railroads

Although the rate of revenue increase may slow, the railroads are still poised to benefit from increasing industrial production and improved operating efficiency due to cost reductions implemented during the economic downturn. Additionally, railroad operators have strong pricing power and are gaining market share versus the trucking companies. Rising fuel costs will likely continue to pressure margins this year, but we expect the impact to be lessened by fuel surcharges and fuel efficiency measures. Improving profitability and cash flow are partially offset by ongoing share repurchases and the cyclicity of end-markets.

Credit Conditions Stable

1) Aerospace/Defense

The aerospace sector showed continued signs of improvement in both commercial aerospace and the business jet market. Recent macro events could reign in the advances within the sector, as global financial fears may limit future purchases. However, backlogs remain large at all covered aerospace units and are sufficient enough to withstand any short term gyrations. During the quarter, defense companies began to feel the effects of U.S. budget cuts with revenues and margins pressured. Fiscal spending is at the forefront of the political scene and as a result these pressures will be magnified in the coming quarters. With that said, defense spending remains near historical highs.

2) Utilities

Despite modestly increased credit risk due to events at the nuclear power plant in Japan, we expect stable trends for the electric utility sector. Events in Japan are leading to heightened scrutiny

of the U.S. nuclear fleet, which could result in additional expenses and capital spending. There could also be delays in new nuclear construction or re-licensing, though approvals are proceeding as planned so far. Any new rules or regulations will likely be phased in over time, mitigating the impact on credit quality. Most companies are benefiting from a gradual recovery in industrial demand and low natural gas and power prices. Additionally, regulated utilities are generally able to recover expenditures for growth, maintenance, and environmental compliance through rate increases or other revenue mechanisms. Headwinds for the sector include upcoming environmental regulations, expected modest demand growth, weak commercial end markets and high dividend payout ratios.

3) Health Care (CNC)

For makers of medical devices, product recalls remain a concern. Also, the recession is pressuring sales of discretionary products, such as hip and knee replacements; as a response certain large companies are making sizable acquisitions, which confer a presence in non-discretionary areas such as trauma. Still, these large purchases, which may take a toll on near-term credit quality, are unlikely to be a frequent occurrence due to anti-trust issues and the relative scarcity of opportunities. Bolt-on acquisitions, on the other hand, should continue for the foreseeable future, as major purchasers of these products, such as hospital chains, are favoring larger suppliers who can address their various product needs. Government-mandated healthcare reform, which will impose a 2.3% tax on medical products in 2013, suggests that streamlining to cut costs is probably in the cards; since these companies haven't yet undergone the downsizing experienced by the pharmaceutical companies, it's likely that opportunities to enhance efficiency can be identified.

Despite the pitfalls, we continue to believe that an aging population and increased access to healthcare suggest steady demand for these products.

4) Media/Entertainment/Cable

A rebound in national and local advertising, the solid adoption of high-speed/digital packages and higher subscription rates has helped revenues in the sector. However, growth is mitigated by slower subscriber growth from high unemployment and watching TV on the internet versus through a traditional pay TV service as well as the inherent volatility in filmed entertainment. The sector is more focused on shareholder returns and M&A but leverage and ratings should remain fairly stable as companies manage these activities within their respective pre-stated leverage targets.

5) Telecommunications (Wireless/Wirelines)

Telecom companies continue to experience lower demand for voice telephony services and overall declines in fixed access lines in mature markets, offset by increasing demand for data services for mobile broadband and high speed internet. Smartphone sales, such as the iPhone and Android based handsets, have driven mobile data usage higher in both the U.S. and Europe and show little signs of slowing. Regulatory issues and competitive pressure continue to plague European telecoms, which have looked to Latin America and Asia for future growth prospects. Companies continue to invest heavily in infrastructure and wireless spectrum, accompanied by strategic M&A to complement organic growth. Most telecom companies remain committed to debt reduction as a means of improving financial strength and liquidity remains adequate. The sector will continue to face pressure from macroeconomic factors, which has led

to lower consumer discretionary income and slowing average revenue per user (ARPU) growth due to subscription service downsizing.

6) Technology

Companies are benefiting from the solid business replacement cycle for personal computers and servers, healthy global IT spending, and customers' growing need to store and access data quickly and cost-efficiently. Partially offsetting these factors are increasing competition, soft consumer spending in many developed countries, patent litigation, and reduced public sector budgets. The sector is also characterized by significant merger and acquisition activity and large share repurchases. We expect acquisitions and share repurchases to be completed within the context of current ratings for most companies. Given very strong balance sheets and cash flow generation, we believe that the technology companies have the flexibility to withstand competitive and cyclical pressures without a material decline in credit quality.

7) Retail

While consumer confidence is improved from the recent economic downturn, rising food and oil prices continue to be headwinds impacting the consumer, tempering purchases of big ticket items. Retailers' inventory levels have been lean with lower markdowns and fewer promotions which should help maintain margins. Retailers offering good value proposition and private label brands should benefit in this environment. Drug store sales should remain healthy given the aging population. Overall balance sheets and liquidity remains healthy.

Credit Conditions Weakening

1) Automotive

The Japanese automakers, which have a large presence in the shorter duration, investment grade space, are recovering

faster than originally expected from severe production disruptions and parts shortages caused by the March 2011 earthquake in Japan. Nevertheless, results for the first half of fiscal year 2012 are expected to be negatively impacted by reduced inventories and elevated costs. While much of the lost production will likely be made up later in the year, full year results will still be pressured. Global auto demand is continuing to recover, but uncertain consumer spending and the strong Japanese yen may dampen revenue growth and margin improvement. We expect companies' robust liquidity and financial strength to largely offset headwinds related to the events in Japan.

2) Food & Beverage

The sector is facing headwinds of high input costs, a focus on shareholder returns and M&A and higher event risk for potential leveraged buyouts (LBO). Margin pressure is expected to continue as prices for inputs like corn, soy and wheat have skyrocketed. Management has been raising prices selectively, focusing on product innovation and cost savings initiatives. M&A has been focused on tuck in opportunities in emerging markets, which is a growth area for this sector. And LBO chatter has increased due to the stable cash flow, low leverage and valuable business segments of the companies in this

sector. Credit quality could weaken but companies have the financial flexibility in their credit profiles and ratings to withstand slight deterioration. Overall balance sheets remain healthy and liquidity levels are good.

3) Consumer Products

Like Food and Beverage, the Consumer Products sector is grappling with high input costs, a focus on shareholder returns and higher event risk for potential leveraged buyouts (LBO). Management has been raising prices to help offset the pressure on margins but they run the risk that consumers, who are themselves feeling the pinch of higher food and oil prices will defect to generic brands. Companies have also been focused on product innovation and cost savings initiatives to help preserve margins. LBO chatter has increased given the sector's stable cash flow, generally low leverage and valuable business segments. Shareholder friendly activities are more of a focus to offset the impact of lower stock prices. Credit quality could weaken but companies have the financial flexibility in their credit profiles and ratings to withstand slight deterioration. Overall balance sheets remain healthy and liquidity levels are good.

4) Pharmaceuticals

Following a spate of transformative acquisitions over the 2008-2009

period, merger-related debt is being reduced steadily, thanks to solid spare cash generation. Nevertheless, the high level of patent expiries for blockbuster drugs over the 2011-2012 period is making for lackluster earnings comparisons in 2011. Leading pharmaceutical companies are responding via research collaborations, mid-sized acquisitions, an increased emphasis on non-pharma lines, such as consumer products and animal health, and a shift in focus to biologics, which are challenging for competitors to duplicate; select asset sales and spinoffs are also providing financial flexibility to pursue these strategies. These measures, and cost-cutting, including R&D outlays, are ameliorating the bottom-line impact of the expiries, although they also signal a shift in attitude towards developing new drugs in light of increasingly stringent regulatory hurdles. Future merger activity will likely expand footholds in the biotechnology and oncological spaces. These changes may eventually allow the companies to evolve into a business model which is less susceptible to patent expiries; consequently, our outlook for the intermediate-term is cautiously optimistic, but in the near term we continue to think that loss of exclusivity for key drugs will challenge earnings comparisons.

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