



February 2018

Bond Market Observations:

Groundhog Day

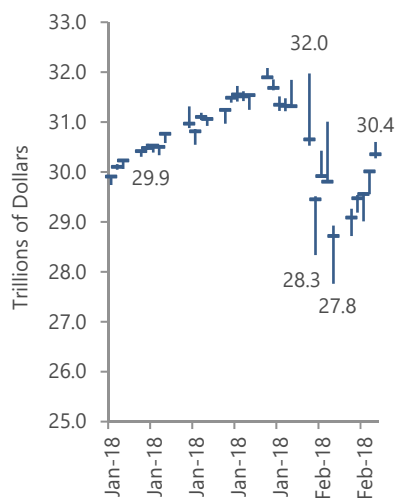
By: The Active Fixed Income Investment Committee

The monthly formal review of portfolio strategy by the Active Fixed Income Investment Committee typically kicks off the first Friday of the month, as the release of the US employment situation sometimes materially influences our economic outlook. Proper and fitting that payrolls printed on February 2nd, Groundhog Day, because our initial reaction was "Didn't we just do this?" Net employment gains in January were a touch stronger than expected, but the unemployment and participation rates were in line. The growth of average hourly earnings came in on the high side of expectations but meshed with our view that building cost pressures would put Fed tightening more meaningfully into play (with four moves in 2018 in the AMNA forecast) than market participants expected.

The comfort coming from the familiar lasted a few ticks past 8:30 am EST. Equity investors apparently recoiled in alarm that higher inflation and a firmer Fed would push Treasury yields higher. We are still not sure why this was scary. Monetary policy has to renormalize, and there is no better window to do so than when the economy starts at an unemployment rate near 4 percent and grows about one percentage point faster than its potential. Even a 1 percentage point increase in the fed funds rate leaves it below the Fed's assessment of its neutral rate. That is, monetary

policy remains accommodative in 2018. Nonetheless, a near \$4 trillion reduction in US equity market capitalization commands attention, to be sure, especially when accompanied by a blowout in the forward-looking implied volatilities of those prices.

US Exchange Market Capitalization

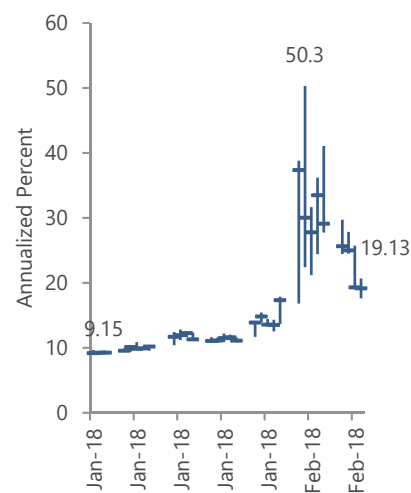


Source: Bloomberg (WCAUUS Index), with high and low estimated using S&P500 (SPX Index), accessed February 20, 2018

The next few trading days were taken from the script of "Groundhog Day", the movie. Writer and director Harold Ramis sculpted an arc of likeability for Bill Murray's character, starting from a low base. At first on repeating every day, the weatherman responded increasingly bizarrely (taking a

toaster into the tub, dressing in costume for the movies, and driving headlong into a quarry with the groundhog as hostage) before he got closer to normal and more appreciative of what he has.

S&P 500 Implied Volatility



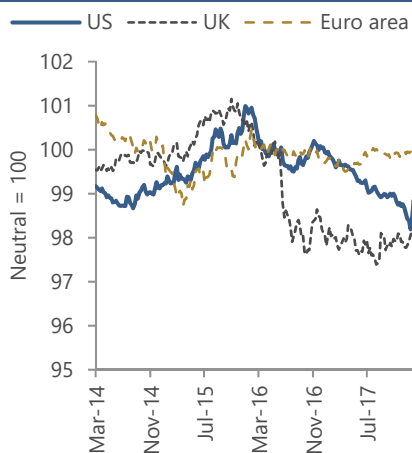
Source: Bloomberg (VIX Index), accessed February 20, 2018

The equity market took a bumpy trip to the quarry with bug-eyed investors strapped into the passenger seat, cycling through all possible moods, from despondency to exuberance. But, like Bill Murray's character Phil Connors, everyone got to a better place by the time the credits rolled. Equity prices ended a touch higher than

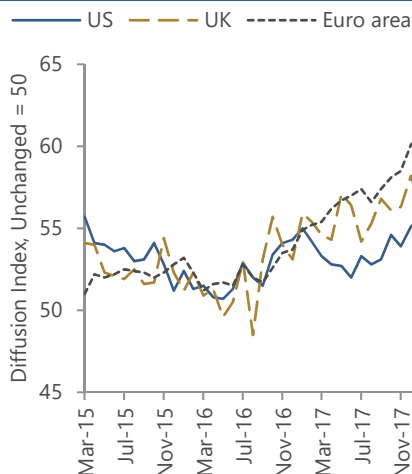
where they opened the year, and implied volatility, which we repeatedly referred to as “stubbornly and historically low” in prior Bond Market Observations, seems now to reflect a keener appreciation of risk. From a fixed-income perspective, this felt like an event internal to equity and derivatives markets as investors regained a firmer hold on economic reality.

The wild ride notwithstanding, there have been no material changes to our global economic outlook. Financial conditions in the US—about where they were when the Fed launched this firming cycle at the end of 2015 and appreciably easier than at the end of the next year—remain accommodative. Indeed, conditions are easy in the UK and about neutral in the Euro area, and all three economies are enjoying a relatively synchronous upswing in output even as much of their respective slack works down.

Financial Conditions Indexes



Manufacturing Purchasing Manager Intentions

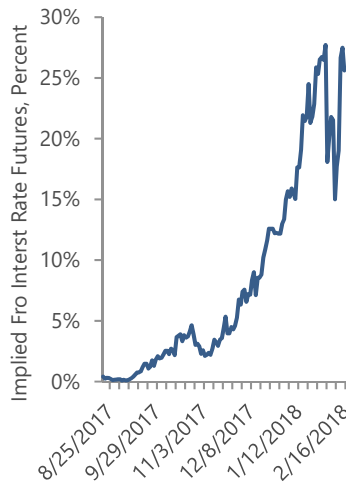


Source: Goldman Sachs (upper) and Markit (lower) accessed via Bloomberg, February 20, 2018

In the US, the legislated two-punch of tax reforms and spending increases provides significant impetus to aggregate demand and pushes up the budget deficit to over \$1 trillion in each of the next few years. Burgeoning government debt represents a medium-term headwind to the foreign exchange value of the dollar, which is why we believe it to be expensive vis-à-vis the currencies of both other advanced and emerging market economies. Further weakening in the dollar adds an international kick to building domestic cost pressures in 2018, putting US inflation on a gradual incline. When put together, this leads the Fed to hike four times by 25 basis points this year.

While this is more than currently built into markets, Fed officials will have plenty of opportunities to talk tightening into prices should events unfold as in our economic outlook. Until this sinks into the collective investor psyche, however, developed market sovereigns will be on the rich side and inflation break-evens cheap. True, the back-up in Treasury yields and widening of risk spreads got them closer to fair, but they are not there yet, especially in Europe compared to the US. Instructively, the past few weeks were something of an (un) controlled experiment showing that getting to yes (where the Fed is understood to be removing accommodation) may be stressful to investors but ultimately tolerated. Any replay would be an opportunity to get to a better place by trimming short duration positions as yields home in on fair value.

Probability of Four or More Fed Moves in 2018

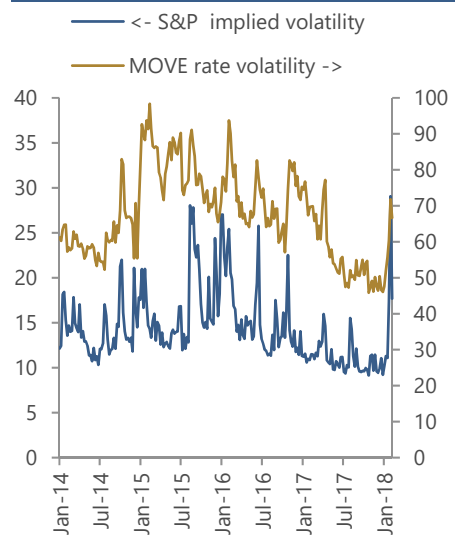


Source: CME, accessed via Bloomberg, February 20, 2018

Replicate this logic throughout a portfolio and across portfolios. US corporate spreads are also modestly expensive, but fundamentals are strong and technicals supportive. A risk event would widen spreads, but probably not much, suggesting that any bout of volatility provides the chance to increase credit exposure. Similarly, robust growth in China underpins emerging market economies and commodity prices. High-quality emerging market dollar debt looks valued fairly, and some frontier markets are attractive, for those willing to accept the associated elevated risk and illiquidity. The political calendars of emerging market economies are crowded, particularly in Latin America, which may create opportunities to add to risk position on overdone episodes of electoral angst.

The dust seems to have settled in equity markets for now, understanding this is always only a tentative judgment. Implied volatilities of both equity prices and Treasury rates have risen significantly, on net, but the latter from a higher level and by less. While rate volatility is higher, some options strategies are still available at minimal cost to keep a portfolio appropriately convex.

Implied Volatilities



Source: Bloomberg accessed February 20, 2018

As in our monthly investment landscape below, buy that protection and answer the door when opportunity knocks. The reason why the overall risk budget is lean,

emphasizes quality, and protected against outsized events is to enjoy the flexibility to add selectively to risk when markets temporarily push financial prices too low.

As Phil Connors learned, repetition creates an opportunity to improve.

The Investing Landscape

Economic Landscape

Despite the net decline in US equity prices and rise in volatility, financial conditions remain accommodative. Additional fiscal impetus further supports economic growth, likely exacerbating excess demand.

Other advanced economies are expanding synchronously and robust growth in China supports emerging market economies and commodity prices.

As of now, cost pressures are muted, but inflation is likely to tick higher.

The Federal Reserve rate will tighten more than currently built into markets.

With the Fed in the lead, central banks in developed markets are moving, albeit slowly, to renormalize monetary policy;

They thus far remain willing to lean against market instability.

Fixed-Income Valuation

Synchronized economic expansion makes developed market sovereign yields expensive.

Break-evens offer value and provide inexpensive protection to upside surprises to inflation.

The dollar appears expensive against other developed and emerging market currencies.

For institutional investors, municipal assets are somewhat rich.

Corporate spreads are modestly expensive but strong fundamentals and supportive technicals are likely to limit spread widening.

Uncertainty around political events open opportunities in emerging markets local currency.

High quality emerging markets dollar debt looks fairly valued, but some frontier markets look attractive.

While interest rate volatility has risen, it is still at historically low levels.

Valuations of securitized products generally appear fair to rich.

Investment Themes

Maintain short duration bias in core developed market sovereign securities but look for opportunities to trim positions as yields move closer to fair value.

Be biased toward increasing short dollar exposure.

Maintain modest exposure to break-evens.

Selectively remain overweight EM risk.

Maintain modest credit exposure and be prepared to add on bouts of volatility.

Be underweight tax-exempt municipal securities.

Maintain modest underweight on MBS and emphasize ABS versus CMBS.

Continue option strategies with minimal cost to keep portfolios sufficiently convex.

With the overall risk budget lean, emphasizing quality, and protected against outsized events, look for opportunities to add to risk

Source: BNYM AMNA as of February 20, 2018



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