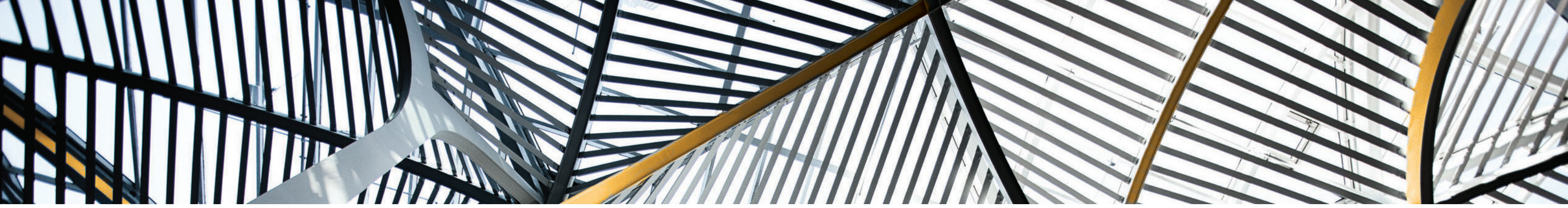


April 2017

Bond Market Observations:

The World is a Risky Place

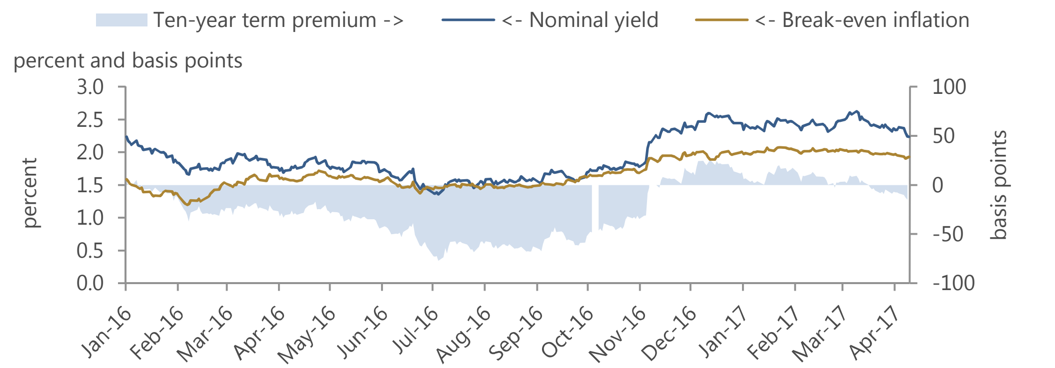
By: The Standish Investment Committee

STANDISH
A BNY MELLON COMPANY[SM]

A millennial potentially with impulse-control issues holds the nuclear launch codes in North Korea. The US military just dropped the heaviest nonnuclear ordinance in its inventory. Randomly in major cities, lone-wolf terrorists inflict horrific damage. Add to this the angst associated with orderly transitions in stable democracies as an election looms in France and another appears on the horizon in Germany.

Agreed. The world is a risky place. In our blinkered bit of that world, geopolitical concerns must be an important part of the recent rally in Treasury yields. As shown in the chart, the nominal ten-year Treasury yield shed 35 basis points in the past month. The flight-to-safety benefit to the US is evident in the estimate of the term premium, now at minus 15 basis points, as assessed by staff at the Federal Reserve Bank of New York.

Ten-year Nominal and Break-even Treasury Yields

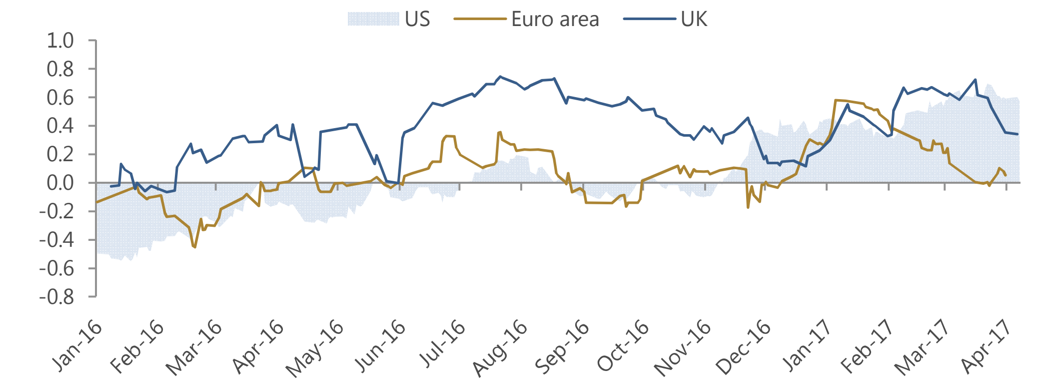


Source: Bloomberg, accessed April 14, 2017

The bad news is that this is climate, not weather. While we expect to get past the near-term political events in one piece and investors to settle down, safe assets will enjoy an outsized premium for some time in a world where official holdings remain large and risks are multifarious. Until then, though, we are wary of duration and desirous of protection from tail risks in the near term.

The Standish global macro view has not changed since last month's Global Macro Views and Bond Market Observations. If our economic forecast eventuates, steady global expansion pulled along by above-trend growth in the US and China helps to calm investors. True, the Trump administration has shown an enormous capacity to surprise, mostly of the disappointing sort of delaying change in economic policy. But we never let much enthusiasm about promises being kept creep into our outlook. We look to the data, which have run stronger than consensus. Once past the first-quarter statistical pothole in the US, advanced economies will be seen as expanding slightly faster than trend, pushing inflation up a tad. Advanced economies' advance and stable commodity prices provide a stable culture for growth in emerging market economies.

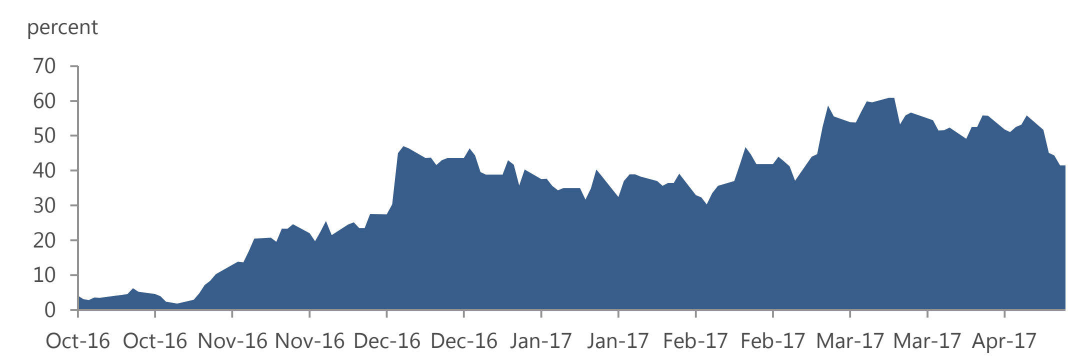
Economic Surprise Indexes



Source: Bloomberg, accessed April 14, 2017

Monetary policy is the moving part in the machinery. Market participants have gotten more worried about the world just as Fed officials have more strongly communicated their policy intent. We followed their instructions and wrote into our forecast two quarter-point hikes followed by the announcement of a soft-touch taper of reinvestments over the next three press-conference FOMC meetings. We think investors will come to believe the Fed, too, and realize that they have overdone the scaling back of firming forecasts (with the implied probability of a 50 basis points or more of hikes by December down 20 percent, to about 40 percent),

Probablity of at least a 50 basis points higher funds rate by December 2017



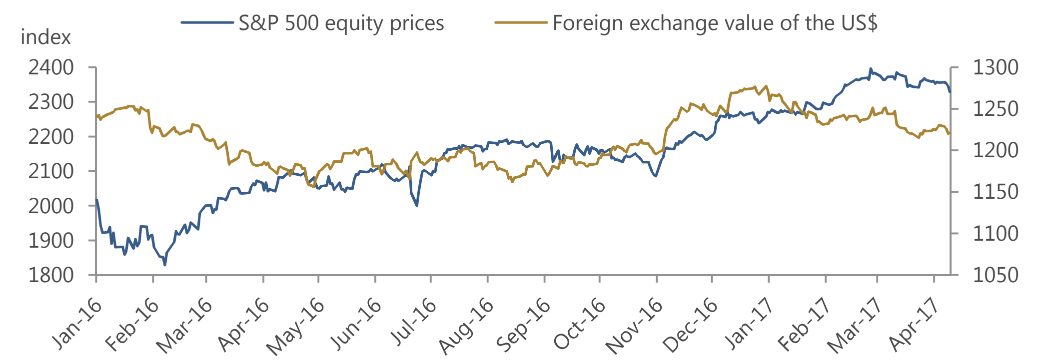
Source: Bloomberg, accessed April 14, 2017

This realization, along with a soothing of nerves, tells us that, right now, nominal Treasury yields are slightly rich. Put in perspective, though, Treasuries are not as expensive as German bunds, the prices of which are supported by ongoing European Central Bank purchases and flight from some of Germany's more strained Euro area counterparts. We retain our view that leaning away from bunds toward dollar-bloc sovereign securities may add value in a portfolio. Value in the US market can still be gotten in breakevens, which are modestly attractive given our view that the Fed will tolerate—evenly secretly desires—an overshoot of its inflation goal. We believe fundamentals should improve for US corporate credit, which now seems fairly priced, putting a premium on security selection.

We lived with subdued volatility in financial markets for some time and probably will for some time to come. The Fed abhors surprises and the ECB and the Bank of Japan are stuck in high-gear accommodation. Still, the US political process will likely deliver less than hoped, and, to repeat, the world is a risky place. When we get some visible reminder of that, the associated bout of volatility most likely represents a buying opportunity because the Fed has room and repeatedly shown the willingness to lean into adverse sentiment shocks.

Steady global growth and the steadying Fed help to explain the appreciation of the foreign exchange value of the dollar, on net, since the election. However, the mix of mild policy disappointments in our forecast—Trump policy initiatives falling short and Fed tightening surpassing expectations—imply that the dollar's gains are in our rearview mirror. This, along with our assessment that fundamentals in many emerging market economies are improving, suggests that there is value to be had in some local market sovereign securities.

S&P 500 and trade-weight exchange value of the dollar



Source: Bloomberg, accessed April 14, 2017

Volatility spikes, rising policy rates, and the prospect of a slimming Fed balance sheet combine to keep us away from MBS and CMBS. The part of the securitized sector piquing our interest remains ABS.

This brief survey of our investing landscape leads to our conclusions about portfolio strategy (the right column). The news relative to last month is our intention to maintain overall duration below portfolio benchmarks and our willingness to pay to protect against tail events. With the risk budget holding steady—and relatively lean—we should be well positioned to take advantage of the bouts of fear and uncertainty that our uncertain world provides.

Features of the Economic Landscape	Fixed-income Valuation	Investing Themes
Economic expansion seems assured.	Treasury yields are slightly rich given our expectations about monetary policy.	Overall duration should be slightly below benchmark.
Around a flat path of potential output;	Dollar rates are attractive relative to Bunds.	Remain long US and dollar bloc rates versus core Europe.
So, inflation ticks higher.	Break-evens are modestly attractive.	Remain long break-evens.
Public policy will likely buoy confidence. However, the legislative process may be rocky and elections loom, causing volatility to rise at times.	US corporate bonds are fair value, and fundamentals are improving. We expect dollar weakness from current levels. There is value in local emerging markets.	Remain overweight EM sovereign risk. Maintain exposure to corporate credit and ABS, emphasizing security selection.
The Federal Reserve would react to financial market instability. The scaling back of expectations about Federal Reserve rate tightening is overdone.	Low volatility environment is exposed to disappointment around policy implementation and election risk. MBS and CMBS will continue to be under pressure.	Remain underweight MBS and CMBS. Maintain the risk budget at current levels for now, but adjust composition to protect against tail risks.

Source: Standish as of April 14, 2017

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