Hopes and Fears and Radical Uncertainty

Saying Goodbye to 2016

Eight years of sluggish worldwide economic growth expectations and historically low interest rates in the developed economies finally appeared to be on their way out as 2016 drew to a close. The year began with fears of a recession and a sell-off in most risk asset classes. It ended with reaccelerating U.S. GDP growth, improving consumer and business sentiment, record highs in most major stock markets, and U.S. bond yields jumping by 70 bps in the last six weeks of the year.

President Donald Trump’s fiscal and deregulatory agenda was in large measure the inflection point for markets as the promise of fiscal stimulus and deregulation sparked hopes for faster business investment and consumption. A mix of policies which include lower corporate and individual tax rates, repatriation of over $2 trillion in overseas U.S. corporate profits, deregulation, and infrastructure spending, coming on top of an already-improving U.S. economy, is expected to be inflationary, producing higher medium-term interest rates and a stronger U.S. dollar (USD). Broadly speaking, these conditions tend to be very positive for growth-sensitive asset prices and less so for long-duration fixed income assets.

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As we enter 2017, the major question facing investors is whether revived growth expectations can translate into actual improvements in the real economy within the next 12-18 months to help support current market levels.

Markets have been quick to discount the potential of fiscal stimulus but are at risk if these policies are not delivered in full. Further, fiscal stimulus is being introduced eight years into a recovery and during a time of near full employment. Also, there remain structural headwinds in the labor market, with the lowest participation rate in decades, and stubbornly low labor productivity levels.

The fundamental question is whether the expected fiscal boost, even if it comes in a timely manner, can ultimately lift the U.S. growth rate through greater aggregate demand and productivity. BNY Mellon believes that this is one of the central issues for markets in 2017, and signals in either direction are likely to produce outsized market volatility. Unprecedented uncertainty associated with domestic and foreign policy choices, implementation, and outcomes is likely to be a source of volatility for all asset classes over the next 12 months, even as risk asset markets move higher in the near term.

The Hopes of the Trump Presidency

Expectations for Higher Growth and Rising Inflation

The economic environment of 2017 has the potential to be a pivot from the “low and slow” backdrop of previous years. The baseline expectation for 2017 is that fiscal stimulus and deregulation will encourage investment growth and consumption. The reflationary policies of the new Trump administration, coming on top of recent moves in inflation rates, are likely to send inflation expectations higher still. Global growth prospects have also improved, propelled by stronger manufacturing activity in China and a gradual uptick in activity in Europe.

12-MONTH FORWARD REAL GDP GROWTH (%)

GDP growth expectations have moved up.

MARKET INFLATION EXPECTATIONS (%)

Inflation expectations have moved up.

CHINA PRODUCER PRICE INDEX (%)

China reflation continues.


*Global data is based on the 10 largest world economies and GDP weighted. Data through November 30, 2016. The countries are U.S., China, Japan, Germany, France, Brazil, U.K., Italy, Spain, and Canada.

Source: Bloomberg, Data as of December 31, 2016.
In the U.S., the Federal Reserve (Fed) embarked on its second rate increase since the implementation of its near-zero interest rate policy begun in 2009. With the potential of three more raises in 2017, the Fed signaled that it expects economic growth to be strong enough to withstand further rate increases. For this dovish Fed, which had been so reluctant to normalize its rate policy over the past several years, it is a strong signal that the U.S. economy is finally healthy enough to absorb the tightening.

Increased expectations for Fed tightening.

The question for this Fed is whether it allows inflation to overshoot its target of 2% or acts more aggressively to subdue inflation risks. A more assertive Fed could inhibit growth at a critical stage of the cycle, while a less reactive Fed could see inflation move substantially above the 2% target over the medium term.

Implications for Equity Markets

Given the trends of higher growth and inflation expectations, and despite higher yields, we expect equity markets to appreciate, at least initially in 2017. Furthermore, a cut in corporate tax rates should increase corporate earnings, pushing stocks higher. Even if the underlying growth rate of the economy does not accelerate, tax cuts alone should be sufficient to support the recent move in equity prices into the next 6-12 months.

Current 2016 S&P 500 earnings per share are projected to come in at $119. If the corporate tax rate gets cut to 25%, S&P earnings move to $135-$140 for 2017 and $145-$150 for 2018, levels already being discounted in the market.¹ If oil prices stay in the $45-$55 range, which is nearly 100% higher than in Q1 2015, then energy companies will be a significant contributor to earnings. In the financial sector, 60% of the S&P 500 Financials sector (38 of 63 companies) saw an increase in their mean earnings per share (EPS) estimate for 2017 in Q4 2016.²

Increased growth and potential tax cuts support S&P earnings growth.

¹. Sell-side research estimates that every 5% cut in the corporate tax rate leads to a 4% bump in EPS. See Deutsche Bank, U.S. Equity Insights, December 2, 2016. Bloomberg data.
². FactSet.
Should the Trump policies actually stimulate the economy and bump GDP growth from an expected rate of 2.1% in 2017 to 3% or more by the end of 2017 into 2018, we believe that recent equity market levels could be poised to move higher still.

Nevertheless, markets look relatively expensive by historical standards. The forward 12-month P/E ratio for the S&P 500 is 17.1. This P/E ratio is above the 5-year average (15.0) and the 10-year average (14.4). We think this makes equities vulnerable to rate and inflation shocks should the current optimism not be fed with actual growth. And to the extent that tax reform gets stalled in Congress, current market valuations could be at risk. Signs that reflation is further away than hoped, that fiscal policies fail to reignite the growth rate, or that the business cycle is too advanced, could drive a market sell-off. If the Fed tightens more quickly than baseline expectations in 2017 and 2018, then markets could be particularly vulnerable to a downturn.


3. FactSet; Bloomberg.
Policy Divergence and the U.S. Dollar

The reflationary policies of the new administration are contributing to the strengthening of the dollar as the U.S. is expected to grow faster than other developed markets. In addition, Fed policy stands in contrast to that of other developed market central banks as the European Central Bank (ECB) is committed to further quantitative easing (QE) and the Bank of Japan is committed to negative rates. We believe that the USD could have another 10% to run against a basket of currencies and investors should take note. The strong dollar will act as a headwind to U.S. exporters, aid global exporters to the U.S., and weaken emerging markets as their sovereign debt is often USD-denominated. A slowing China and stalling emerging market growth rates could further strengthen the dollar beyond our base-case expectations. A rapidly surging dollar could hit U.S. growth and corporate profits and drag down inflation expectations. A fast-sinking euro and yen could also lead to a rise in inflation expectations in these regions, leading to central bank tightening earlier than expected.

Expected further USD appreciation.

Chinese currency under pressure.

Implications for Fixed Income Markets

The 10-year Treasury yield found its lowest level in the summer of 2016 amid Brexit fears and exited 2016 at nearly double that historically low rate on the back of expectations for economic and inflation growth. With the Fed dot plots suggesting three rate hikes in 2017, and with investor expectations for a reflationary fiscal policy, it seems clear that the 35-year bull market in fixed income is all but over. Further, on a technical basis, fixed income heads into 2017 expensive after years of support by central bank policies. Therefore, we believe that total returns could be hit with higher yields, particularly in the first six months of the year.

The prospect of rising rates signals that investors should diversify fixed income exposure within their portfolios to include less rate-sensitive sectors. We believe that investors should be cautious on longer-duration exposure and look for yield in other income-bearing debt instruments. A global strategy in sovereign debt, particularly in the developed economies where sovereign debt continues to be supported by central banks, is one way to maintain portfolio exposure to core fixed income. An unconstrained approach across the credit spectrum in corporate credit will also enhance yield and mitigate drawdown risk.

Corporate credit, particularly in the lower-rated companies, can enhance yield and should benefit from faster global growth, which would help support corporate profits and boost risk-on appetite. Floating rate loans, which are senior and secured credit instruments and are liquid credit assets, have the advantage of being floating rate. With limited duration risk, leveraged loans should continue to perform relatively well in the current market.

Markets reflect that default rates are likely to fall in 2017 as energy prices recover. While some companies carry high levels of leverage, they also have relatively healthy interest coverage ratios, which means they remain well placed to service their debt interest payments. Therefore, we do not believe that the credit cycle is ready to roll over in 2017. With the maturity wall pushed out until 2020-2023 as a result of easy money, we do not feel there is fundamental risk in leveraged credit. There will be a moment when companies will need to refinance their debt burden at markedly higher rates, possibly sparking restructurings and defaults, but that day remains several years down the road.

The performance of corporate credit, however, is dependent on the business cycle. To the extent that the economy fails to respond to fiscal stimulus, we could see volatility in these markets, with the non-investment-grade sector most vulnerable.

**U.S. HIGH YIELD DEFAULT RATES (%)**

- Ex-commodities
- Overall

*Source: BofAML Global Research. Data as of November 30, 2016. Default rates based on trailing 12 months.*

**HIGH YIELD AND LEVERAGED LOAN MATURITY PROFILE**

- Bonds
- Loans

*Source: BofAML Global Research. Data as of November 30, 2016.*

Default rates ex-commodities remain low.

Maturity wall pushed out until 2020-2023.
The Fears of the Trump Presidency

Growing Economic and Political Policy Uncertainty

With fiscal policy having the potential to drastically alter the economic landscape and yet with so much still unknown about what will occur, lingering policy uncertainty will be a major theme for global markets in 2017. This ambiguity should magnify both upside and downside risks to our expectations. Hanging over this market is the risk that the incoming administration’s reflationary policies do not get enacted and/or fail to sustain acceleration in aggregate demand growth. The critical question which threatens the baseline assessment is whether the expected fiscal boost can indeed translate to an increasing U.S. growth rate or whether it is coming at exactly the wrong time, at late cycle during a period of full employment. There is also the question of whether a newly hawkish Fed with five new members and a new chair by 2018 could strangle the recovery, putting expensive markets in jeopardy.

Risks abound. Labor force participation and productivity remain at generational lows and average wages are growing at an anemic rate, all of which suggests that a significant boost to aggregate demand must overcome structural headwinds. The U.S. labor market is already operating beyond the Fed’s estimate of full employment, with the headline unemployment rate at 4.6% and wage pressures building amid shortages of skilled labor.

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Labor force participation rate at generational lows.

U.S. labor productivity remains stubbornly low and an increase in labor productivity is needed to boost growth rates.

An increase in investment is needed for sustainable growth.
If the Trump administration follows through on its promise to restrict illegal immigration, then labor supply could tighten in certain industries. Restricted trade with China and/or Mexico or the imposing of tariffs on imported goods could clip the U.S. growth rate and raise the specter of a global trade war. The Brexit process is likely to be more disruptive than current markets are allowing for. A Trump rapprochement with Russia could encourage Russian adventurism in the “near abroad” of the Baltic states. Such action will call into question the North Atlantic Treaty Organization’s (NATO) commitment to these states as well as the credibility of the alliance as a whole. A visibly weakened NATO will no doubt have an impact on the Eurozone, the second largest economy in the world, as the stability of the military alliance is the bedrock of the economic union.

In Europe, national elections in France, Germany, and the Netherlands promise to be a source of uncertainty, and possibly volatility, in the sovereign bond market.

To the extent that trade and geopolitical realignments remain unrealized or are less tumultuous than feared, volatility could remain subdued, and therefore, risks recede.

A Bull Market for Active Management

The prolonged period of high correlations after the global financial crisis was difficult for active managers as it was hard to distinguish performance from the indices. Not only were sectors within the equity markets highly correlated, but correlations were also high across asset classes. Since the election, market correlations have declined, as investors rotated into “Trump trades” both within equities and across asset classes. Lower correlations tend to occur during calmer markets, as stocks trade on fundamentals and expectations of future growth. The recent weakening correlations could mean greater opportunities for outperformance by active managers as fundamental research, picking winners and losers, and investing across fixed income sectors should enhance returns.

Investing in an Age of Radical Uncertainty

Animal spirits ignited by the promise of fiscal stimulus and deregulation have sparked the hope of faster growth and consumption in the U.S. While we believe that 2017 should be a year of global economic growth, we also see an environment of emergent risks which historically expensive markets appear to be disregarding. With radical policy uncertainty emanating from the pace of rate increases, fiscal implementation and effectiveness, USD trajectory, potential trade disruptions, and geopolitical tensions, investors need to spread investment risk across different regions and should prize growth, quality, and inflation protection. Unconstrained equity and bond strategies, with the ability to invest globally, can seek to take advantage of the stronger dollar and increasing global growth. Investors should look to shield portfolios from inflation through real assets, inflation protected bonds, and rising rate credit instruments. To the extent that investors can accept limited liquidity, illiquid alternatives, such as private debt and private equity, can enhance real yields through private market investing. Most importantly, investors need to remind themselves that their investments should have a long time horizon and be well diversified to withstand any deviations from the reflationary scenario that markets appear to expect in 2017.
Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. Bonds are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. High yield bonds involve increased credit and liquidity risk than higher-rated bonds and are considered speculative in terms of the issuer’s ability to pay interest and repay principal on a timely basis. Floating rate loan securities may include irregular trading activity, wide bid/ask spreads and extended trade settlement periods. The value of any collateral, if any, securing a floating rate loan can decline, and may be insufficient to meet an issuer’s obligations in the event of non-payment of scheduled interest or principal or may be difficult to readily liquidate. Although generally less sensitive to interest-rate changes than fixed-rate instruments, the value of floating rate loan securities may decline if their interest rates do not rise as quickly, or as much, as general interest rates. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. Currencies can decline in value relative to a local currency, or, in the case of hedged positions, the local currency will decline relative to the currency being hedged. These risks may increase investment volatility. Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. Investing in real estate securities is similar to direct investments in real estate, including falling property values due to increasing vacancies or declining rents resulting from economic, legal, political or technological developments, lack of liquidity, limited diversification and sensitivity to certain economic factors such as interest rate changes and market recessions. Alternative strategies (including hedge funds and private equity) may involve a high degree of risk and prospective investors are advised that these strategies are suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment and who can bear the economic risk, including the possible complete loss, of their investment. The strategies will not be subject to the same regulatory requirements as registered investment vehicles. The strategies may be leveraged and may engage in speculative investment practices that may increase the risk of investment loss. Investors should consult their investment professional prior to making an investment decision.

An absolute return strategy is an unconstrained investment approach and performance is measured against a goal that reflects portfolio construction focused on risk management and is designed to deliver positive returns in changing market environments. Traditional “relative return” funds are managed to and measured against broad-based benchmark indices, rather than against “absolute” measures of principal risk. The Standard & Poor’s 500, often abbreviated as the S&P 500, or just “the S&P”, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 index components and their weightings are determined by S&P Dow Jones Indices. The Bloomberg Barclays Global Aggregate Index is a measure of global investment grade debt from twenty-four local currency markets. The multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. Nasdaq was created by the National Association of Securities Dealers (NASD) to enable investors to trade securities on a computerized, speedy and transparent system, and commenced operations on February 8, 1971.

Gross Domestic Product (GDP) is the broadest quantitative measure of a nation’s total economic activity. UMichigan Consumer Sentiment: Index of consumer confidence published by the University of Michigan on consumer attitudes and expectations in order to determine changes in consumers’ willingness to buy and to predict their subsequent discretionary expenditures. This index is comprised of measures of attitudes toward personal finances, general business conditions, and market conditions or prices. NPIB Small Business Optimism: Index designed from a survey asking small business owners questions related to their expectations for the future and their plans to hire, build inventory, borrow, and expand. China PPI (Producer Price Index): Measure of the change in the prices received by domestic producers for their outputs either on the domestic or foreign market. USD/EUR/JPY Inflation Swap Forward SYX: Indication of the market’s 5-year inflation expectations 5 years from now. Global Economic Policy Uncertainty: Index constructed to measure policy-related economic uncertainty based on three underlying components. One component quantifies newspaper coverage of policy-related economic uncertainty. A second component reflects the number of federal tax code provisions set to expire in future years. The third component uses disagreement among economic forecasters as a proxy for uncertainty. Global index is calculated as the GDP-weighted average for U.S., Canada, Brazil, Chile, U.K., Germany, Italy, Spain, France, Netherlands, Russia, India, China, South Korea, Japan, Ireland, and Australia. U.S. Labor Productivity: Nonfarm business sector output per hour worked. Labor Force Participation Rate: Percentage of the population either employed or unemployed but available and actively seeking work. U.S. Nonresident Fixed Investment: Real private sector spending on structures, equipment, and intellectual property. Implied Policy Rate: Projected federal funds rate by the Federal Reserve used for “FOMC Dots Median”. OIS (overnight indexed swap rate) implied forward rate used as a proxy to determine the market’s expectation of the future federal funds rate.

Investors cannot invest directly in an index. VIX: CBOE Volatility Index (VIX) reflects a market estimate of future volatility for the S&P 500 index based on a weighted average of the implied volatilities for a wide range of option strikes. U.S. Majors Dollar Index: Indicates the general international value of the USD by averaging the exchange rates between the USD and major world currencies. Shiller’s CAPE: Cyclically Adjusted Price-Earnings ratio (CAPE) based on the S&P 500 inflation-adjusted price divided by average earnings from the previous 10 years. U.S. Aggregate: Index used as a proxy for the performance of investment grade bonds in the U.S. Views expressed are those of the author(s) and do not reflect views of the firm overall. Views are current as of the date of this publication and subject to change. Forecasts, estimates and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission.


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Cyclical Adjusted Price-Earnings Ratio (CAPE)
CBOE Volatility Index (VIX)

UMichigan Consumer Sentiment
NPIB Small Business Optimism
USD/EUR/JPY Inflation Swap Forward SYX
Global Economic Policy Uncertainty
U.S. Labor Productivity
Nonfarm business sector output per hour worked
Labor Force Participation Rate
U.S. Nonresident Fixed Investment
Implied Policy Rate

GBX

Shiller’s CAPE
Cyclically Adjusted Price-Earnings ratio

VIX
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CBOE Volatility Index (VIX)

Cyclically Adjusted Price-Earnings ratio (CAPE)