Executive Summary

Investors entered 2017 with the anticipation that the Trump administration would usher in a period of fiscal stimulus which could reaccelerate economic growth.

The expected policy agenda and its far-reaching implications for growth, deregulation, trade and geopolitics were the overarching focus for markets as the year got underway. Monetary policy was seen as broadly accommodative and unlikely to derail the recovery. As expectations for increased global growth moved to the forefront, this set of factors has consistently pushed equity markets to new highs. Halfway into the year, it is clear that global economies are enjoying a synchronized cyclical upswing which is driving global risk assets higher.

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Nevertheless, from a strategy perspective, the risks embedded within the markets remain and we continue to see elevated risks at both ends of the risk spectrum. The right tail is dominated by growing economic growth and optimism fueled by a combination of fundamentals, hoped-for-but-as-yet-undelivered fiscal policy, expected slow normalization of rates, and deregulation. The left tail is dominated by unprecedented levels of policy uncertainty and expensive (but far from peak) markets that threaten to drive up the risk premium of risk assets. Policy has the potential to dramatically shape the economic and market landscape and this is a major source of risk in the market.

Stocks look expensive from the view of the Shiller CAPE index...
Despite noise out of Washington, and despite the very limited implementation of the promised fiscal agenda, so far the right tail has largely dominated as fundamentals and largely accommodative central banks drive equity markets to new highs. BNYM continues to believe that elevated risks remain on the left tail which emanate from many sources. There is the specter of a convergence of global tightening that could choke nascent recoveries; moderating inflation; pricey equity and fixed income markets; gross domestic product (GDP) growth that is struggling to achieve escape velocity past the 2% mark; labor market dislocations in developed economies; and geopolitical risks. Further, investors have become complacent since the implementation of extraordinary monetary policy, becoming acculturated to the steady performance of risky assets.

Historically low volatility levels despite policy uncertainty point to increased risks.

...but less so from the 12-month forward earnings read.
Economic Outlook: Four Observations

OBSERVATION ONE: Fiscal Policy Is Still Not Driving the Bus

The impediments to implementing the administration’s tax and deregulatory agenda have become quite clear, and with it, a more sober assessment of whether fiscal policy can indeed boost growth. As the Trump agenda has stalled in Congress, the reflation trade has unwound. Yields have fallen, the curve has flattened, and the U.S. dollar has weakened against most currencies. Inflation has dropped to levels well below the Federal Reserve’s 2.0% target.

Rate increase predictions shot up markedly after the election, but have since moderated...
Contrary to earlier expectations, monetary policy has shown that it still has room to move markets as the Federal Reserve’s commitment to incremental tightening has helped propel markets to new levels. This market reaction is consistent with data that show when rates rise from very low levels, it is usually a sign of economic strength and that strength is reflected in higher equity prices. The downward shift in inflation leaves investors expecting that the Federal Reserve (the “Fed”) will be quite slow in normalizing rates, underpinning asset prices. A similar dynamic is occurring in the UK and Europe.

U.S. 10-YEAR TREASURY YIELD (%)
OBSERVATION TWO: Whither Inflation?

Contrary to signals earlier in the year, readings on inflation have consistently moved away from the Federal Reserve’s 2% target. Near-full employment in the U.S. should lead to acceleration in aggregate demand growth and rising prices for goods and services. The reduced sensitivity of inflation to shifts in economic activity can be attributed to globalization, the reduction in labor bargaining power, and greater labor flexibility.

The changing structure of the U.S. economy has also played a role as technological innovation is disrupting traditional business models in many industries, putting a lid on prices. The technologically driven abundant oil supply coming from the U.S. is an obvious disinflationary force pushing its way throughout the economy.

Investors have reacted to the slowing inflation numbers by assuming the Fed will be largely accommodative, helping push risk assets higher. This expectation is in itself a risk factor as investors have become complacent about the continuation of accommodative monetary policy.

Inflation reads have recently come down. The Fed believes that this is due to “transitory” factors.

Recent inflation expectations have moderated.
OBSERVATION THREE: More of the Same, but Hope Springs Eternal

U.S. markets must contend with the discrepancy between the soft data which point to expectations of a stronger business environment and hard data which is not meeting elevated expectations. On the one hand, business and consumer confidence remain at elevated levels, which should support domestic demand; on the other, recent data have been slow to reflect that confidence.

This discrepancy reflects elevated, though softening, sentiment on the one hand and weakening economic data on the other.

Despite the slow trajectory of fiscal reform, sentiment remains elevated, albeit off the early highs.
OBSERVATION THREE: More of the Same, but Hope Springs Eternal (continued)

Investors had hoped to break free from the era of slow growth, low inflation, and historically subdued interest rates and were looking to fiscal policy as the blunt instrument to do just that. There is no doubt that in the past year, global economic activity has increased with a long-awaited cyclical recovery in investment, manufacturing, and trade. The International Monetary Fund (IMF) projects world growth to rise from 3.1% in 2016 to 3.5% in 2017 and 3.6% in 2018. Stronger activity, expectations of more robust global demand, stronger manufacturing activity in China, a notable uptick in activity in Europe, and subsequent optimistic financial markets are all positive occurrences.²

U.S. households are doing well, having recovered from the global financial crisis.

Investment is on the upswing, supporting the economy.

European activity is at its highest levels in several years.

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² IMF, World Economic Outlook, April 2017.
Despite this, structural impediments remain headwinds to growth. Investors find themselves in a place not much different from the one they had hoped to leave behind — steady if sluggish growth, global low rates, halting inflation, and low productivity. The data indicate that anticipation for a sustained period of 3% GDP growth sparked by the new administration has largely vanished. U.S. GDP is expected to come in around 2.2% for the year, slightly higher than trend. Without a fiscal boost, it will be challenging to push growth to 3% with the U.S. job market already at full employment, historically low levels of labor participation, and slow gains in productivity. Capital expenditure is restrained by the anticipation of possible new tax rules which could improve the treatment of capital expenditure write-offs.

The boost from consumption is trailing off.

The labor force participation rate remains at generational lows.

It will be hard to grow GDP without an increase in productivity.
OBSERVATION THREE: More of the Same, but Hope Springs Eternal (continued)

And yet hope springs eternal. The data out of emerging markets and Europe are encouraging. China has delivered stronger manufacturing data. And the U.S. is on an upward growth trajectory, higher than trend, even if not as steep as desired. Corporate earnings are strong and estimates are being revised upward. Rates remain low and policy accommodative, and the possibility of fiscal reform remains as a distant goal. Eurozone sentiment is the highest in 16 years, and recent elections there have had market-friendly outcomes.

**S&P 500 QUARTERLY NET INCOME GROWTH (% Y/Y)**

Increased earnings momentum is supporting buoyant equity markets.

**EMERGING MARKETS REAL GDP (% YOY): 2000 TO 2017**

Emerging markets are delivering increased growth rates.

**EUROZONE SENTIMENT**

Eurozone sentiment is the highest in 16 years.
OBSERVATION FOUR: Geopolitical Risks Grow

Geopolitical risks come from both the trade and the military side. The U.S. pledge to move away from multilateral international trade regimes in favor of a greater focus on state-led industrial policy and bilateral trade deals lies at the heart of the administration agenda. Recent U.S. trade actions are less punitive than feared, helping lead a rally in emerging markets. Nevertheless, unprecedented uncertainty associated with domestic and foreign policy choices, implementation, and outcomes is likely to be a source of volatility for all asset classes in the near future, even as risk asset markets move higher in the near term.

Heightened geopolitical risks in Asia and Europe and the administration’s preference for unilateral action increase the likelihood for an unintended outcome detrimental to both global assets and geopolitical stability. North Korea’s testing of an intercontinental ballistic missile (ICBM) and China’s unwillingness or inability to reign in the regime stand as major threats to global order and could affect growth in Asian economies. The pulling out of the Paris climate accord has alienated other participants and has isolated the U.S. on the global stage, making it harder to take alliances for granted.

China manufacturing is ticking upward.

While trade as a percent of global GDP has leveled off, it remains an important contributor.

China Manufacturing PMI

Monthly data as of June 2017. Source: Bloomberg.

Global Trade Relative to Global GDP

Annual data through 2016. Source: FactSet and Economist Intelligence Unit.
Market Outlook:  
2017’s Three Investment Themes Remain Intact

We believe there are three main investable themes for investors.

**THEME ONE:** Synchronized Global Reflation and Strengthening Fundamentals

Recent data have pointed to a synchronized strengthening of global economies which tends to support growth-sensitive assets, particularly equities. Fundamentals remain strong and there are few signals of a looming recession. Beyond the U.S., economic conditions in Europe and Asia have improved and recent data releases suggest these improvements can be sustained throughout 2017 and 2018.

Equities have historically done quite well in growth environments. BNYM believes that overseas markets in particular, including Europe, emerging markets and Japan are poised for outperformance. While acknowledging that the mood in mid-2017 has softened and investors appear to be taking a more cautious stance on the prospects for acceleration in U.S. growth, it is also true that, counter-intuitively, this sentiment is a necessary condition for risk assets to rally further if growth does indeed improve over the next 12–18 months.

While the U.S. recovery is in its ninth year, other countries are in earlier stages of the economic cycle, particularly Europe, Japan, and emerging markets. Investors looking to boost capital appreciation and leverage cyclical growth are advised to allocate a portion of their capital to faster growing markets, both equities and fixed income. As recovery in European and emerging economies boosts U.S. corporate earnings, investors should look to invest in U.S. and global sectors which benefit from this trend.


* Global data is based on the 10 largest world economies and GDP-weighted. Data through June 30, 2017. The countries are U.S., China, Japan, Germany, France, Brazil, U.K., Italy, Spain, and Canada.
THEME TWO: A Focus on Potential Rising Interest Rates

The synchronized global growth profile also points to an unanticipated new dynamic — possible convergence, if fitful and slow, in global central banking as the European Central Bank, Bank of England, and Bank of Canada have signaled intentions to tighten in the near future. With no obvious crisis left to fight, global central banks are more confident in growth and no longer need crisis-era monetary policies. A willingness to entertain a tightening cycle means that policy divergence could be on its last legs. Whether or not it actually happens is less important than the signal to the market that global central banks are becoming confident in economic recoveries and are closer to the end of quantitative easing than the beginning. Markets will anticipate and discount future moves.

Fixed income remains very expensive as economies have enjoyed a sea of liquidity for the last few years. A tightening cycle threatens fixed income portfolios with duration risk which is unlikely to be fairly compensated given current price levels. While it may still be too early to call the end of the three-decade bull market in interest rates, we believe the balance of risks has clearly and meaningfully shifted to the upside. This is a risk that directly and indirectly permeates many elements of an investor’s portfolio through exposure to fixed income and other interest-rate-sensitive asset classes. Unaddressed, rising interest rates can jeopardize both the income seeking and capital preservation goals of investors.

We believe that investors should reallocate capital towards unconstrained multi-sector fixed income products and increase global fixed income market exposure. In addition, investors should look to increase holdings of floating rate corporate debt, private debt, and investment-grade corporate credit, laddered bond structures, and other “hold-to-maturity” strategies.

The higher a bond’s duration, the greater its sensitivity to interest rate changes.

Bonds with low interest rates and high duration may experience price drops as interest rates rise.
THEME THREE: Continued Uncertainty and Greater Risk of Market Volatility

Policy and economic risks abound. The tension between the hard and the soft data, the pace of rate increases and the risk of over-tightening, fiscal implementation and effectiveness, populism, potential trade disruptions, and geopolitical flare-ups are all sources of tail risk. Most glaringly, the Trump administration has signaled it might dilute the U.S. commitment to international institutions and global integration after 70 years of post-war leadership. This shift is likely to produce an unstable international climate where previously trusted institutional channels are less effective in reducing cross-border tensions.

The ambiguity inherent in policy choices and the economic data could magnify downside risks to assets globally.

GLOBAL ECONOMIC POLICY UNCERTAINTY INDEX REMAINS ELEVATED

Despite the fact that policy uncertainty came off historical highs, in many ways policy uncertainty is worse than at the beginning of the year. This reading highlights a complacency within the market.
Investment Implications

The global economic backdrop has undoubtedly improved but remains vulnerable to a seemingly long list of risks. We expect risk assets to continue to climb the wall of worry, as investors wrestle with the implications of sustained if tepid economic expansion, slow-rising short-term rates, largely accommodative central banks, and unprecedented policy uncertainty. BNYM believes that investors need to evaluate whether their portfolio asset allocations are fully exploiting the market environment while compensating for inherent risks embedded within the market, asset classes, and portfolio construction.

At a time of heightened policy uncertainty, with the possibility that left tail risks dominate market sentiment, and with elevated market valuations for certain equity and credit assets, the markets are vulnerable to a correction. Investors should consider adopting a more unconstrained active approach which can avoid some of the drawdown risk implied by current market conditions.

Diversification, as an investment risk management tool, depends for its effectiveness on the degree of correlation between the asset classes and strategies that comprise portfolios. The evolving policy environment has the potential to destabilize correlations both within and across asset classes relative to the post-2008 investment environment.

Declining correlations suggest that diversification across asset classes and sectors could be an effective risk-management tool.

Lower correlations can allow for greater opportunities for active managers and the potential for greater benefits of diversification.

EQUITY RETURN CORRELATIONS BETWEEN S&P 500 AND SECTORS DECLINING

After a prolonged period of elevated correlations within and across risk asset classes, equity markets and sectors, correlations are falling, and sector-specific volatility is rising. We believe that the moment for active management has arrived. This divergence in performance should support active management. Analysis suggests this is beginning to happen. In a world where expected returns for market risk are subdued, active returns should be more explicitly emphasized as a potential driver of capital growth and income generation for investors.

Interest rates do not rise as quickly, or as much, as general interest rates. Investing in 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 schedule 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 loans 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. Management risk is the risk that the investment techniques and risk analyses applied will not produce the desired results and that certain policies or developments may affect the investment techniques available to managing certain strategies.

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.

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. The International Monetary Fund (IMF) is an international organization of 189 countries working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. NFIB 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. The Phillips curve is a single-equation empirical model, named after William Phillips, describing a historical inverse relationship between rates of unemployment and corresponding rates of inflation that result within an economy. Stated simply, decreased unemployment (i.e., increased levels of employment) in an economy will correlate with higher rates of inflation. The Purchasing Managers’ Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predeterend base of goods and averaging them. Core Consumer Price Index (Core CPI) is equal to CPI minus energy and food prices and is used to measure core inflation. The reason behind excluding energy and food prices is because the prices of these goods can be very volatile. The Global Economic Policy Uncertainty Index (GEPUI) is a GDP-weighted average of national EPU indices for 16 countries that account for two-thirds of global output. Global EPU is calculated as the GDP-weighted average of monthly EPU index values for the U.S., Canada, Brazil, Chile, UK, Germany, Italy, Spain, France, Netherlands, Russia, India, China, South Korea, Japan, Ireland, and Australia, using GDP data from the IMF’s World Economic Outlook Database. 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. 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. 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. The Bloomberg Barclays Global Aggregate Index provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government and agency corporate securities, and USD investment grade 144A securities. The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. The MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance of emerging markets. An investor cannot invest directly in any index.

Correlations measure the relationship between the changes of two or more financial variables over time.

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