Bond Market Observations: Déjà Vu, All Over Again

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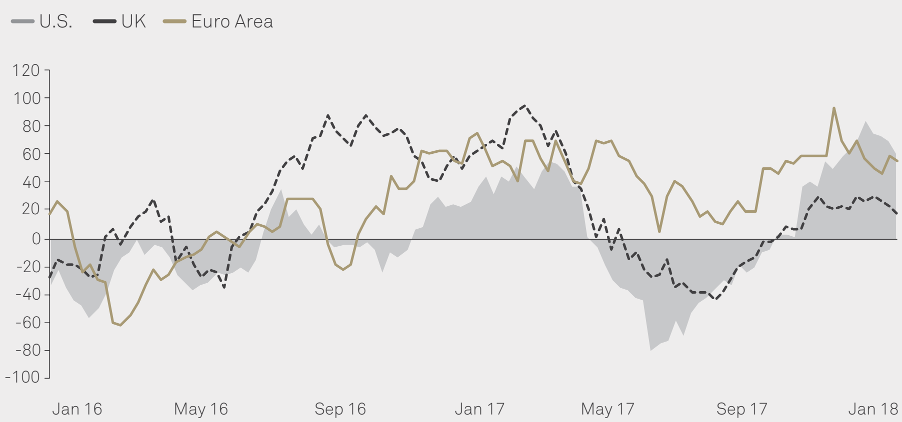
The late, great Yogi Berra was right, and we have been here before. Global economic growth is running above its longer-term trend, inflation in advanced economies is poised to rise, and the Federal Reserve will travel further up the firming path than commonly understood (with some other major central banks trailing behind). That has been our story for some time and, if anything, events over the past month give us more reason to stick to it.

CHART 1

ECONOMIC SURPRISE INDICES

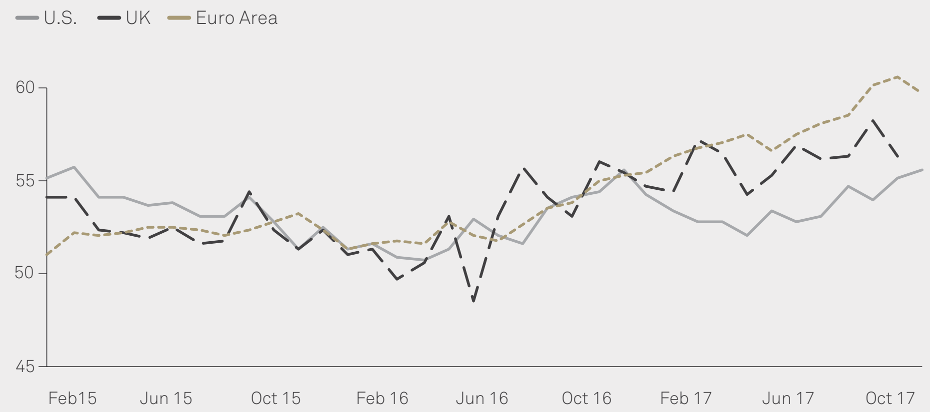


Source: Citigroup Markets, via Bloomberg as of January 25, 2018. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any Dreyfus product.

Part of this is data. In advanced economies, economic releases mostly ran better than expected, purchasing managers see their order books bulging, and "now-casts" of global GDP growth are firming. Partly this is about politics. President Trump scored a legislative victory with the passage of tax reform and the warring parties in Congress managed to keep the government running after only a short shutdown. The former imparts a modest boost to growth, reinforcing the impetus associated with ongoing deregulation, and both lessen the chance that the White House will resort to major counter-productive executive actions on trade.

CHART 2

MARKIT MANUFACTURING PURCHASING MANAGER INTENTIONS

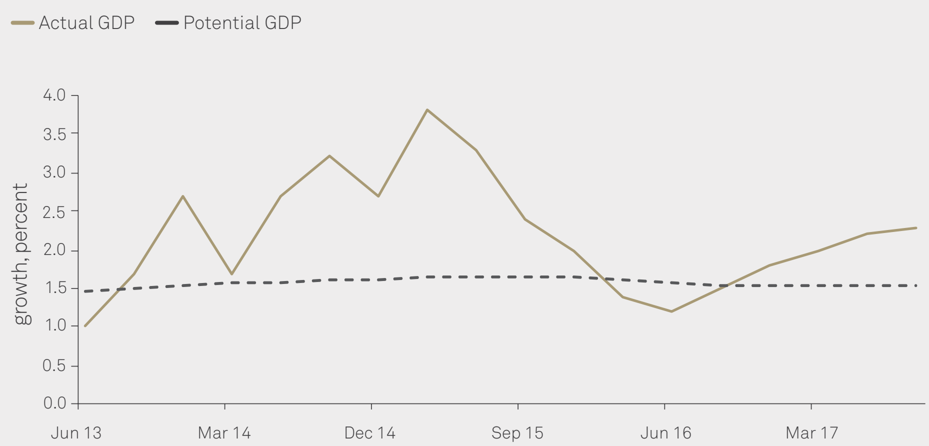


Source: Markit, via Bloomberg as of January 28, 2018.

Administration officials, however, were by no means operating on radio silence. In particular, when someone whose name appears on a currency admits he does not mind a weaker value of that currency, listen. Treasury Secretary Steven Mnuchin's remarks about the dollar, as well as the tenor of other comments and moves on tariffs, mark a more combative posture and add to downward pressure on the foreign exchange value of the dollar. At 4.1%, the U.S. unemployment rate is almost surely below its natural rate, and above-trend growth will further open the gap. Domestic pressure on costs is picking up as dollar depreciation adds impetus from abroad.

CHART 3

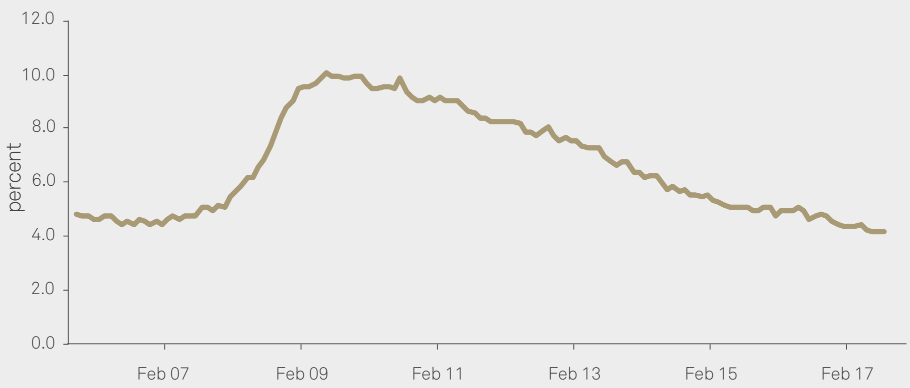
U.S. REAL GDP



Source: BEA and CBO, via Bloomberg as of January 25, 2018.

CHART 4

U.S. CIVILIAN UNEMPLOYMENT RATE



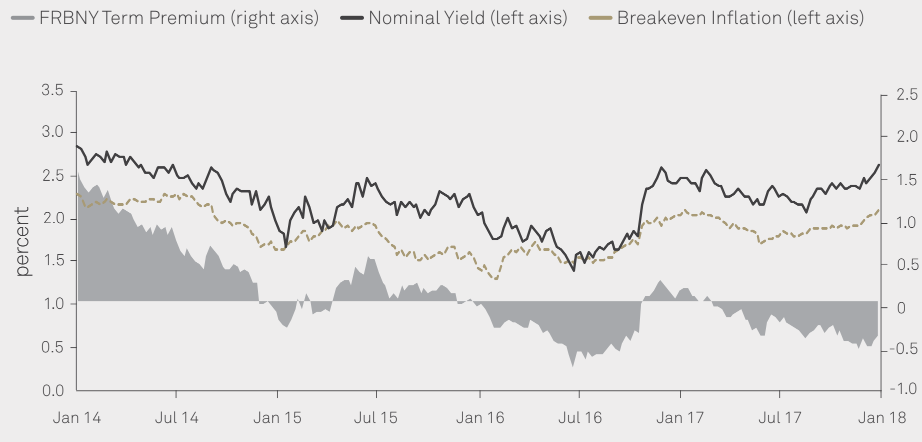
Source: BLS, via Bloomberg as of January 25, 2018.

Inflation is in play, and so too will be the Federal Reserve (the "Fed"). We suspect that Chairman Jerome Powell will emphasize continuity in the process of policy renormalization. Last year, the Fed acted at its four press-conference meetings, hiking the policy rate at the third meeting and announcing a plan to shrink its balance sheet at the fourth meeting. We think that the Fed will follow the same script this year, raising its target rate 25 basis points four times and following through with its plan to trim its balance sheet gradually.

This lower-for-longer path of the federal funds rate should prevent inflation from seriously breaching the central bank's 2% goal. True, market participants are not there yet, with about 80% of the probability weight resting on a year-end outcome below a target range of 2.25% to 2.5%. However, market participants will come around as long as data play out as in our forecast. As expectations are revised up and the Fed's balance sheet goes down, longer-term Treasury yields should extend their recent rise, implying that portfolios should be shy of their duration[1] benchmark. A more direct approach is to be long the trigger to Fed action, inflation. That is, break-even inflation looks cheap to us.

CHART 5

TEN-YEAR U.S. TREASURY YIELDS



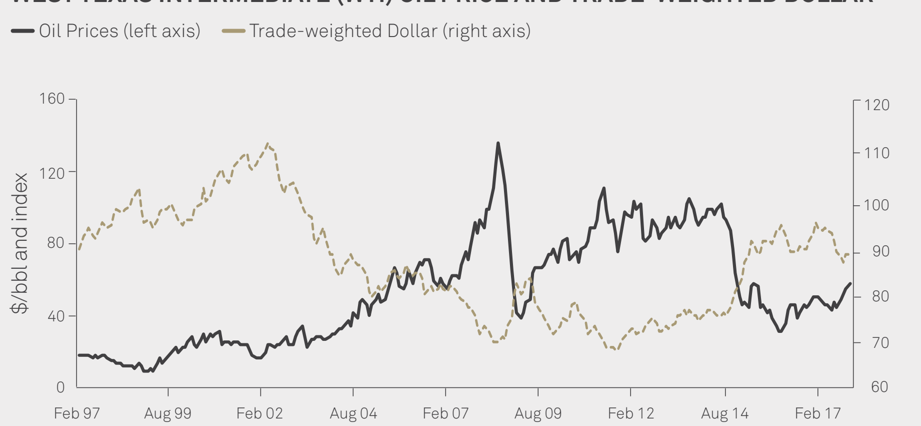
Source: Bloomberg, as of January 25, 2018.

Our view has been that fiscal laxity at home and central bank renormalization abroad would weigh on the exchange value of the dollar in the medium term, but the gradual realization that the Fed would tighten more than currently priced into markets might delay the adjustment. With U.S. officials talking the dollar down, the difference in timing of monetary policy action is likely to be no more of a speed bump to the dollar's descent.

A weaker dollar is the wind beneath the wings of commodity prices. Firm commodity prices and well-maintained growth in advanced economies and China keep emerging-market economies humming. This provides fundamental support to pockets of the high-yield sector and emerging-market sovereigns. As always, that is a terrain to tread carefully.

CHART 6

WEST TEXAS INTERMEDIATE (WTI) OIL PRICE AND TRADE-WEIGHTED DOLLAR

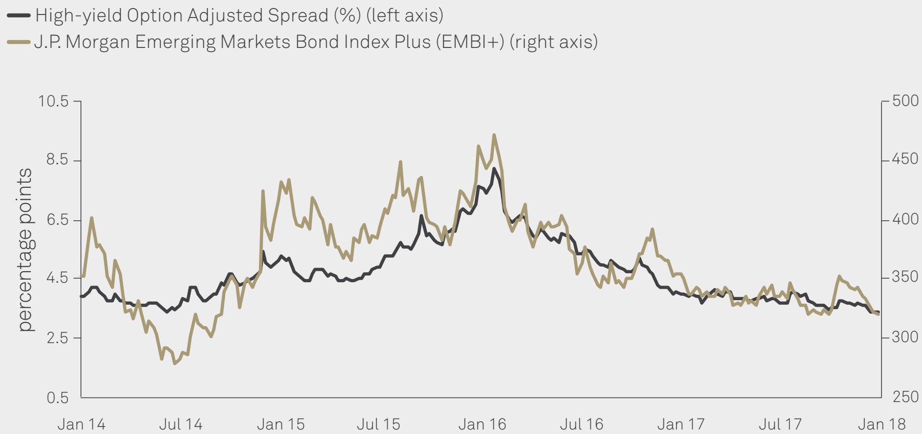


Source: Bloomberg, as of January 25, 2018.

The paradox of portfolio selection is that we are more confident about the outlook and more worried about asset choice. Yogi captured the reason when he explained a popular restaurant: “No one goes there nowadays, it’s too crowded.” Improved economic prospects have captured investor attention, crowding many markets. This both tightens most risk spreads and raises the risk of disorderly markets as the many who flocked in try to leave together should events turn dark.

CHART 7

SELECTED YIELD SPREADS

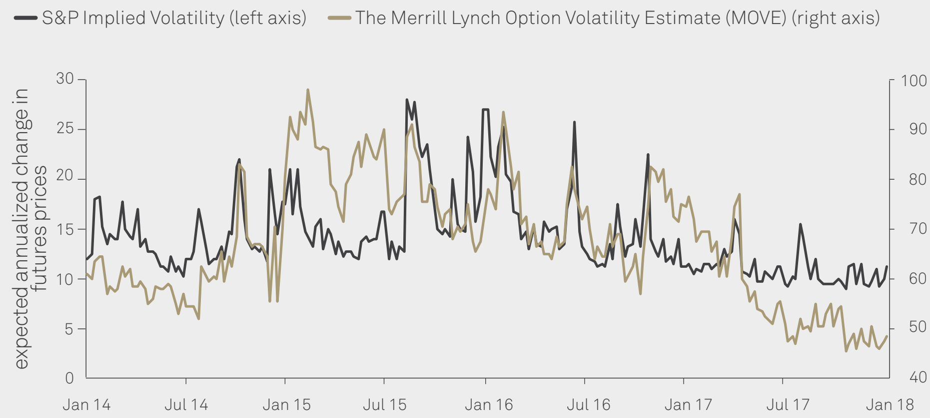


Source: Bloomberg, as of January 25, 2018. The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

This problem can be approached from opposite directions. We recommend keeping risk budgets lean to limit exposure to tail events or search out less crowded (and by definition thinner) markets to pick up carry at the cost of more risk. We suggest doing some of both, but judiciously and selectively regarding the latter. The environment amps up the reward to nimbleness. If bouts of uncertainty drive the prices of some assets into the fair-to-cheap zone, exercise that buying opportunity. Symmetrically, however, view investors getting especially exuberant in some market segments as opening the door to harvest profit. The net result should be a relatively lean risk budget that drifts higher in terms of quality.

CHART 8

IMPLIED VOLATILITIES



Source: Bloomberg, as of January 25, 2018.

There is one asset class that seems inexplicably cheap to us: implied volatilities. Despite dysfunction in Washington, D.C., Mideast hotspots, and squabbling among the family of nations, the volatility of equity prices and interest rates has trended lower. Take advantage of cheap protection from outsized events through options strategies at a minimal cost.

Let us finish with an admission. We may have subconsciously focused on baseball metaphors because everyone in our hometown is obsessed with another game in another sport coming soon. Also, baseball is the right description of much of investing. A major-league season is a long slog of 162 games feeding into a multitier playoff. Each game works without a clock. As a result, a strategy that is in its seventh inning might lead to a quick denouement or many extra innings. In addition, baseball provided its fair share of philosophers. Add Buck O'Neil, Satchel Paige, and Casey Stengel to the alphabetic list starting with Yogi Berra.

So, it is appropriate to end with two more quotes from number 8. Yogi once explained: "You've got to be very careful if you don't know where you are going, because you might not get there." hat is why we provide a monthly roadmap of our Active Fixed Income view on the global economy, fixed income valuations, and investment themes, as shown in Chart 9.

It is good to know where you think you are going. That way, as Yogi advised, "When you come to a fork in the road, take it."

CHART 9

INVESTING LANDSCAPE

Economic Landscape

- Advanced economies are growing faster than their potential, reducing slack in some, creating excess demand in others, and limiting the risk of a near-term downturn.

  Robust growth in China supports the expansion of other emerging market economies.
- 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;

  But they remain willing to lean against market instability.
- Volatility is stubbornly and historically low.

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.
- Tax-exempt municipal assets are somewhat rich.

  Corporate spreads are modestly expensive but strong fundamentals and supportive technicals are likely to keep spreads stable.

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

  High-quality emerging markets dollar debt looks fairly valued but some frontier markets look attractive.
- Interest-rate volatility is cheap.

  Valuations of securitized products generally appear fair to rich.

Investment Themes

- Maintain short duration bias in core developed market sovereign securities.
- Maintain a short dollar exposure.
- Maintain modest exposure to break-evens.
- Selectively remain overweight EM risk.
- Maintain modest credit exposure.
- Maintain a neutral position in intermediate high-quality 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.

The overall risk budget should stay lean, emphasize quality, and be protected against outsized events.

Source: BNY Mellon Asset Management North America, as of January 29, 2018.

[1]Duration is a measure of the sensitivity of the price—the value of principal—of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.

Risks

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. **Commodities** contain heightened risk, including market, political, regulatory, and natural conditions, and may not be suitable for all investors. **Equities** are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. **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.

The **J.P. Morgan Emerging Markets Bond Index Plus (EMBI+)** tracks total returns for traded external debt instruments (external meaning foreign currency denominated fixed income) in the emerging markets. The **Merrill Lynch Option Volatility Estimate (MOVE)** Index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2, 5, 10, and 30 year contracts. The **Standard & Poor's 500** (S&P 500) Composite Stock Price Index is a widely accepted, unmanaged index of U.S. stock market performance.

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