After a summer marked by geopolitical tensions, investors ended the third quarter of 2017 with renewed optimism in global growth.

While news headlines were breathlessly focused on geopolitical risk in North Korea and partisan rifts in Washington, markets barely paused to digest the news. Markets rose over the quarter, driven by a string of positive global economic data, central bankers acknowledging firming global economies, and a renewed late-September push for tax reform.

Notably, investor sentiment has become more upbeat relative to the summer, as signs of favorable macro fundamentals and corporate strength have been the dominant theme driving markets. Higher oil prices, a firmer U.S. dollar, a less dovish tone to central banks, a steepening yield curve, improving leading indicators, and a focus on U.S. tax cuts have all caused a rotation into year-long laggards, adding a firmer foundation to the market. As we move to close out the year, it is clear that the global economy is enjoying a synchronized cyclical upswing. Improving global growth, better economic surprises in developed economies, largely accommodative central banks and improving earnings momentum are all driving global risk assets higher.
While fundamentals have underpinned the recent appreciation of global assets, the risks embedded within the markets remain and BNY Mellon continues to see elevated risks at both ends of the risk spectrum. The right tail is dominated by optimism fueled by a combination of improving global growth and accommodative financial conditions. The left tail is dominated by high levels of policy uncertainty and rising market valuations. Policy has the potential to dramatically shape the economic and market landscape and this is a major source of uncertainty in the market.

1A tail event is the extreme price movement of an asset or asset class either up or down.
Helping Meet Investor Challenges

SUBDUED VOLATILITY A POTENTIAL CONCERN:
VIX AVERAGE OVER PRIOR 6 MONTHS

Daily data as of September 30, 2017. VIX index shown as trailing 6-month average. Source: Bloomberg.

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

STOCKS LOOK EXPENSIVE FROM THE VIEW OF THE SHILLER CAPE INDEX...

...but less so from the 12-month forward earnings read.

Risks emanate from many sources. There is the specter of a convergence of global monetary tightening which could choke nascent recoveries; moderating inflation; overvalued equity and fixed income markets; structural headwinds; and, of course, geopolitical risks. Further, investors have become complacent since the implementation of extraordinary monetary policy, becoming acculturated to the steady performance of risky assets.
Economic Outlook: Five Observations

OBSERVATION ONE: Nothing but Net: Global Growth Is Accelerating

Worldwide, the effects of the financial crisis are fading and policy stimulus has been successful in boosting growth. In the last few months, it has been clear that the global economy is enjoying a sustainable economic expansion with a long-awaited cyclical recovery in investment, manufacturing, domestic demand, and trade. For the first time in a decade, major developed and emerging economies are in sync, enjoying cyclical growth upswings, an occurrence which has been rare over the last 50 years. The International Monetary Fund (IMF) projects global growth to rise from 3.1% in 2016 to 3.6% in 2017 and 3.7% in 2018. Stronger activity, expectations of more robust global demand, an uptick in activity in Europe (with the exception of the UK) and Asia and subsequent optimistic financial markets are all positive occurrences.\(^2\) Expectations are for growth to accelerate in many economies over the next 12-18 months. And economic growth supports risk assets and capital markets.

GROSS DOMESTIC PRODUCT (GDP) GROWTH IS RISING IN BOTH ADVANCED AND EMERGING ECONOMIES

The global economy is enjoying a cyclical upswing.

Real GDP growth % change year/year, data shown on a quarterly basis as of June 30, 2017. Source: Bloomberg.

\(^2\)IMF, World Economic Outlook, October 2017.
Europe is notably strong with all countries experiencing positive GDP growth rates and most at an accelerating pace.

European activity is at its highest levels in several years.

Investment is on the upswing, supporting the economy.
OBSERVATION TWO: Just Right: Central Banks Are Supporting Markets Despite a Tightening Cycle

Central banks have responded to quickening economic activity by signaling the coming of policy normalization. In the U.S., the Federal Reserve’s (“Fed”) Federal Open Market Committee (FOMC) announced the long-anticipated beginning of unwinding of the Fed’s $4.5 trillion balance sheet. As it stands, the Fed owns $2.4 trillion of mortgage bonds, which is 29% of that market and $2.4 trillion in Treasuries, which equates to approximately 17% of that market. Chair Janet Yellen communicated that the unwind will be slow and programmatic, meaning that it will take a real economic dislocation to move the Fed from its plan. The current program is to run off $10 billion in securities in the first three months, with the amount rising to $50 billion per month over several quarters. This means that the Fed’s balance sheet would still be $3 trillion in four years’ time, a significant increase in central bank assets from the beginning of quantitative easing in 2008.

Early in the third quarter, markets had all but written off another rate increase in 2017 given the persistence of tepid inflation data. Nevertheless, a combination of stronger economic data and the Fed commitment to policy normalization has prompted market participants to expect a third rate hike before the end of the year. The Fed considers low inflation reads to be “transitory” and expects the economy to be strong enough to absorb the hikes.

The Fed’s commitment to a shallow tightening cycle has helped propel markets to new levels, a reaction 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. Yet the downward shift in inflation leaves investors expecting that the Fed will be quite slow in normalizing rates, underpinning asset prices.
Inflation reads have recently come down. The Fed believes that this is due to “transitory” factors.

Rate increase predictions shot up markedly after the election, but have since moderated...

---

1 An overnight index swap (OIS) is an interest rate swap involving the overnight rate being exchanged for a fixed rate. The fixed rate can be used to gauge the market’s expectations for the Federal Funds rate, which is the interest rate at which banks lend funds maintained at the Federal Reserve to another bank overnight.

Data as of October 2, 2017. Source: Bloomberg.
...which has been reflected in the 10-year Treasury yield.

A similar dynamic is occurring in Europe. European Central Bank (ECB) President Mario Draghi jolted the market in the summer when he noted that the strength of the European economy warranted a consideration of policy response and a further tapering of central bank asset purchases. While all indications are that policy normalization is at least three years behind that in the U.S., it is a signal to the market that the long-awaited recovery from the double-dip recession in Europe is finally at hand. All expectations are that even as the ECB tapers its bond purchases, policy will remain accommodative for several years to come.

The ECB is expected to keep stimulus in place for the next few years at minimum.
OBSERVATION THREE: In a Better Place: Soft and Hard Data Are Converging

Earlier in the year, market participants worried about the discrepancy between the soft data which pointed to expectations of a stronger business environment and hard data which was not meeting elevated expectations. In recent months, that gap has tightened, with economic activity in developed markets exhibiting strength and beating forecasts. This harmonizing of the hard and the soft data gives confidence in the sustainability of the recovery.

Data in the U.S. and Europe are noticeably stronger.

Despite the slow trajectory of fiscal reform, sentiment remains elevated, albeit off the early highs.

Eurozone sentiment is the highest in 16 years.
OBSERVATION FOUR: Still Here?? Structural Issues Remain

Despite this, structural impediments remain as 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. Anticipation for a sustained period of 3% GDP growth in the U.S. has recently revived. While U.S. GDP did indeed come in at a 3.1% rate for the second quarter, growth is expected to come in around 2.2% for the year, slightly higher than trend. The late summer hurricanes will clip third-quarter numbers in the range of 0.5%-1.0%, even as most participants expect a snap-back in the fourth quarter. In the longer term, 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. Other developed nations find themselves in the same place, with aging populations, stubbornly low inflation rates, and tepid growth expectations.

The boost from consumption is trailing off.

The labor force participation rate remains at generational lows. There have been recent signs of improvement.

SLOW CONSUMPTION GROWTH

U.S. Real Personal Consumption (% quarter/quarter, seasonally adjusted annualized rate, trailing 4Q moving average)

Quarterly data as of Q2 2017. Source: Bloomberg.

U.S. LABOR FORCE PARTICIPATION RATE

U.S. Labor Force Participation Rate (% trailing 3-month moving average)

Monthly data as of September 2017. Source: Bloomberg.
It will be hard to grow GDP without an increase in productivity.

Structural changes in the labor market are helping to keep down wage growth. It will be hard to boost domestic demand with tepid wage growth.

While the third longest historically, the recovery is also the most shallow. Nominal GDP, based on Q2 2017, would be 7.8% higher, or $20.8 trillion, if growth was in line with the historical median at this point of the cycle.

---

**U.S. LABOR PRODUCTIVITY**

- U.S. Labor Productivity (% quarter/quarter, seasonally adjusted annualized rate, trailing 4Q moving average)

Quarterly data as of Q2 2017. Source: Bloomberg.

---

**U.S. PRIVATE SECTOR AVERAGE HOURLY EARNINGS**

- U.S. Average Hourly Earnings (% year/year, 3-mth. moving average)


---

**WEAK U.S. ECONOMIC EXPANSION RELATIVE TO HISTORY**

- Current — Median

Cumulative growth through current business cycle compared to history post-World War II

*U.S. business cycle dates per NBER. Nominal GDP indexed to the max reached near the beginning of each recession. Current expansion began in Q3 2009 and data is through Q2 2017. Recessions between Q1 1980 to Q3 1980 and Q3 1981 to Q4 1982 combined as one. Sources: National Bureau of Economic Research (NBER) and Bureau of Economic Analysis (BEA).
OBSERVATION FIVE: Don’t Touch That Button: Policy Risks Grow

Policy risks come from the geopolitical side and from the monetary policy side. 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 rein in the regime stand as major threats to global order and could affect growth in Asian economies. Should North Korea acquire the ability to deliver a nuclear warhead on an ICBM, there would be a significant reordering of the security regime in Asia, with major economic and military implications for Japan, South Korea, and China. This shift is likely to have long-lasting reverberations in all Asian economies. On the trade side, the U.S. pledge to move away from multilateral international trade regimes in favor of bilateral trade deals lies at the heart of the administration’s trade agenda. Even so, recent U.S. trade actions have been less punitive than feared, helping lead a rally in emerging markets and currencies since the beginning of the year.

On the monetary policy side, there is a real, though low, risk of a policy mistake. The lack of global inflation is the central conundrum for central banks given that all have the policy mandate of price stability. Therefore, if the causes of low inflation remain a “mystery,” then we have a policy problem. On the one hand, low global and domestic inflation reads are keeping central bankers cautious in normalizing policy. Some members of the FOMC believe that the hesitation to raise rates could lead to a future inflation spike, leaving the Fed with no choice but to act aggressively. Others believe that any rate increase in the current tepid inflation environment could choke nascent recoveries given the clear global down drift of wage growth and service and goods inflation. With central bankers engaged in open debate over the inflation “mystery,” the risks of a policy mistake in either direction grow.

Despite fears of a contraction, global trade has picked up steam in the last couple of years.
Recent inflation expectations have moderated.

Further, the FOMC will have three open seats, including that of the Chair, as Janet Yellen’s term expires in February 2018. While Chair Yellen remains in the running to remain at the post for a second term, it is also the case that one of several other candidates with a more hawkish tilt could get the seat. The question is whether a Fed with three new members would react to economic data in a more hawkish or dovish direction. There remains the possibility that a more hawkish Fed could lead to a policy-induced correction in the markets.
BNY Mellon believes 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, are accelerating, and recent data releases suggest these improvements can be sustained throughout 2017 and 2018. Equities tend to do quite well in growth environments. BNY Mellon believes that overseas markets, including Europe, emerging markets and Japan are poised for outperformance.

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.
THREE 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 Fed, ECB, and BOE (Bank of England) have signaled intentions to normalize policy. With no obvious crisis left to fight, global central banks are more confident in growth and no longer need crisis-era monetary policies. 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.

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, 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.

**FIXED INCOME YIELD AND RISK:**

*BLOOMBERG BARCLAYS GLOBAL AGGREGATE INDEX YIELD AND DURATION*

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.

*Yield-to-worst and modified adjusted duration. Daily data as of September 29, 2017, based on Bloomberg Barclays Global Aggregate Index. Source: Bloomberg*
THEME THREE: Continued Uncertainty and Greater Risk of Market Volatility

Policy and economic risks abound. The pace of rate increases and the risk of over-tightening or under-tightening, fiscal implementation and effectiveness, potential trade disruptions, and geopolitical flare-ups are all sources of tail risk.

The ambiguity inherent in policy choices could magnify downside risks to assets globally. In particular, U.S. markets are currently pricing in a greater than 50% chance of a tax overhaul, which puts downside risk to markets should the plan fail to make its way through Congress.


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 complacency within the market.
**Investment Implications**

The global economic backdrop has undoubtedly improved but remains vulnerable to structural headwinds and policy choices. 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 policy uncertainty. BNY Mellon 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 downside 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.

**EQUITY RETURN CORRELATIONS BETWEEN S&P 500 AND SECTORS DECLINING**

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

BNY Mellon believes that the moment for active management has arrived. 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. 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 driver of capital growth and income generation for investors.
RISKS

Asset allocation and diversification cannot assure a profit or protect against a loss. 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. Floating rate loan securities may include irregular trading activity, wide bid/ask spreads and extended trade settlement periods. The value of 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. 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.

Forward price to earnings (forward P/E) is a measure of the price-to-earnings (P/E) ratio using forecasted earnings for the P/E calculation. A drawdown is the peak-to-trough decline during a specific recorded period of an investment, fund or commodity. A drawdown is usually quoted as the percentage between the peak and the subsequent trough. 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. 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 Global Economic Policy Uncertainty Index (GEPU) 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 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. The Nikkei 225 Stock Average is Japan’s premier stock index. It includes the top 225 blue-chip companies listed on the Tokyo Stock Exchange. An investor cannot invest directly in any index.

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

Views expressed are those of the advisor stated and do not reflect views of other managers or 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. The Dreyfus Corporation and MBSC Securities Corporation are companies of BNY Mellon. © 2017 MBSC Securities Corporation, 225 Liberty Street, 19th Floor, New York, NY 10281.
Learn More

Advisors:
Call 1-877-334-6899
or visit dreyfus.com

Individual investors:
Contact your financial advisor
or visit dreyfus.com