Power to the People

*The US consumer has caused GDP to outperform expectations this year – so is it time for fixed income investors to back the consumer?*

Many feared a US recession in 2019. The ISM Manufacturing Index, which measures monthly production levels, hit a 10-year low of 47.8 in September 2019,¹ which traditionally would have been a harbinger of a cyclical downturn.

However, in Q2 and Q3 2019, US GDP outperformed expectations, mainly due to the strength of domestic consumption.

Why has the consumer been relatively strong? The unemployment rate is at a 50-year low following the longest economic expansion on record.² As employers have competed for workers, wage growth has accelerated among the lowest-paid contingent of the population (Figure 1).

*Figure 1: The lowest earners are seeing the fastest wage growth³*

This is crucial because the lowest-paid workers have historically been more likely to consume additional income they earn. In economics jargon, this is known as having a higher ‘marginal propensity to consume’. The highest paid, by contrast, are more likely to save any incremental income they earn.

It is also crucial because US consumption accounts for 70% of GDP⁴ – so it should be no surprise that a healthy consumer can drive GDP growth. But most corporate fixed income investors are less likely to be exposed to consumer risks, they’re exposed to corporate risks. So is consumer-led growth good for corporates – and hence – their portfolios?

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¹ CNBC: US manufacturing survey shows worst reading in a decade. October 1, 2019
² Whitehouse.gov: US unemployment rate falls to 50-year low. October 4, 2019
⁴ The Balance: Personal consumption expenditures, statistics, and why it’s important. June 25, 2019
The answer is yes and no. Higher wages can mean lower profit margins, but it can also mean higher sales thanks to higher consumption. Corporate bond picking strategies may be best-placed to pick the corporate winners while avoiding the losers.

A strategy can also potentially benefit from accessing consumer credit risks directly. This can be particularly appealing because consumer leverage has been trending lower since the 2008 global financial crisis (whereas corporate leverage is currently trending up). 5

**Directly accessing consumer credit risks**

Consumer credit risk can be accessed through the $16trn 6 secured finance market, via public and private investments:

Public securities
- Prime residential mortgage-backed securities (RMBS)
- Mortgage insurance (MI)/mortgage servicing rights (MSR) RMBS
- Consumer asset-backed securities (ABS)

Private debt
- Mortgage pools
- Bridging finance
- Auto/credit card pools

The secured finance market is far less crowded than the corporate bond market. This is partly why it offers a complexity premium 7 over comparably-rated corporate credit. Unlocking this complexity premium commands specialist skills for analyzing, modeling and investing. Mainstream strategies such as Core 8 and Core Plus 9 portfolios can add allocations to structured credit given appropriate manager capability and guideline flexibility.

**How we approach it**

While no investment strategy, or risk management technique, can guarantee returns or eliminate risk in any market environment, the BNY Mellon Core Plus Fund has exposure to several of these sectors including an overweight 10 to securitized credit 11. Within that, it has an 8.2% 12 overweight to ABS, driven by its exposure to the auto loan market, as well as investments in MSR/CMBS among other assets.

It also focuses on security selection within corporate credit 13. It is overweight in investment grade corporate debt and currently favors credits that are likely to benefit from the strength in the American consumer while taking a more cautious approach elsewhere.

For more on The BNY Mellon Core Plus Fund, click here (link to microsite landing page).

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5 McKinsey Global Institute: A Decade after the global financial crisis: What has (and hasn’t) changed. August 2018  
Investors should consider the investment objectives, risks, charges and expenses of a mutual fund carefully before investing. To obtain a prospectus, or a summary prospectus, if available, that contains this and other information about a fund, contact your financial advisor or visit im.bnymellon.com. Read the prospectus carefully before investing. Investors should discuss with their advisor the eligibility requirements for Class I and Y shares, which are available only to certain eligible investors, and the historical results achieved by the fund’s respective share classes.

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. The use of **derivatives** involves risks different from, or possibly greater than, the risks associated with investing directly in the underlying assets. Derivatives can be highly volatile, illiquid, and difficult to value and there is the risk that changes in the value of a derivative held by the portfolio will not correlate with the underlying instruments or the portfolio’s other investments. 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. **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. **Mortgage-backed securities**: Ginnie Maes and other securities backed by the full faith and credit of the United States are guaranteed only as to the timely payment of interest and principal when held to maturity. The market prices for such securities are not guaranteed and will fluctuate. Privately issued mortgage related securities also are subject to credit risks associated with the underlying mortgage properties. These securities may be more volatile and less liquid than more traditional, government backed debt securities. Investors cannot invest directly in any index.

Definitions

The **ISM Manufacturing Index** monitors changes in production levels from month to month, and is an important economic indicator. **Complexity premium** is excess return to be gained from a sector or asset class that is more complex in nature or requires more skill to efficiently access. **Core portfolios** are low-risk fixed income portfolios that are usually made up of investment grade bonds. **Core Plus portfolios** are low to moderate-risk fixed income portfolios with the ability to add exposure to high-yield, global and emerging market debt to a core portfolio of investment grade bonds. An **overweight** is the amount of a particular asset in a fund, which is in excess of what is held in the benchmark or index that it follows. **Securitized credit** is fixed income sector comprised of debt securities backed by pools of residential and/or commercial mortgages and other assets. **Corporate credit** is the amount of money extended by a company to a lender or investor.

Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon Investment Management product.

**As of September 30, the BNY Mellon Core Plus Funds’ sector weightings were:** Investment Grade Corporate (43.73%), MBS (19.13%), Treasury (16.74%), ABS (9.10%), HY Corporate (3.81%), CMBS (2.49%), EMD (2.21%), Government Related (2.06%) and Cash and Equivalents (0.73%).

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