Why global fixed income, why now?

The risk of inflation is being underestimated by markets and could foreshadow a “nightmare scenario” that forces the Federal Reserve (Fed) back into a hawkish mindset, in the opinion of Brendan Murphy, portfolio manager of the BNY Mellon Global Fixed Income Fund. In this type of scenario, he says, he feels fortunate to be able to look outside the U.S. fixed income market within his global fixed income mandate.

Whether inflation is provoked by increased tariffs on goods, or a rise in wages due to a tight employment market; if it starts to overshoot, Murphy believes the Fed would have no choice but to return to rate hiking.

What happens if this trend continues?

U.S. average hourly earnings (AHE) rise while unemployment falls
12-month change, %

Source: Bureau of Labor Statistics and Federal Reserve Board, March 31, 2019. For illustrative purposes only.

“If the Fed were to return to tightening, which we do not completely discount, this would in turn be bad for equity market volatility and for some fixed income asset classes – as seen by the market reaction at the tail-end of 2018, when investors felt the Fed could be tightening too quickly relative to the strength of economic fundamentals.”

He says while the Fed’s influence does not stop at the U.S. border, the ability to access fixed income in other regions of the world does help to minimize the impact of Fed policy and associated rhetoric on his portfolio. Additionally, should a sharp inflation risk not materialize, he has the flexibility to pivot quickly.
Caution warranted
Even so, Murphy says, the BNY Mellon Global Fixed Income Fund is positioned as conservatively as it was during the global financial crisis.

“We are de-emphasizing our allocations to riskier sectors such as high yield and emerging market debt. We have the ability to be 25% invested in high yield bonds and are close to zero in the portfolio at the moment. We have also reduced our emerging market debt exposure following the rallying of the asset class in Q1 of this year.”

He does not believe inflation will “go through the roof” but thinks that even a small amount of inflation above the Fed target of 2% could be sufficient to tip the balance toward rate hikes.

“We have been re-allocating towards sovereign bonds, especially those that are inflation-linked, in Japan, New Zealand, the U.S and Europe. Additionally, because implied volatility is low right now (since market participants are somewhat sanguine on risk) it is relatively inexpensive to buy put options to hedge against future market volatility, which we are taking advantage of.”

Implied volatility is low in bond markets
Merrill Option Volatility Expectations (MOVE) Index - the higher the reading the higher the expectation of volatility

Source: Bloomberg April 30, 2019. For illustrative purposes only.

Through a combination of “linkers” and put options, Murphy says the portfolio has upwards of 20% allocated towards protecting against an inflationary threat. The last time the portfolio was positioned so cautiously was 2007, he says.

Battening the hatches
“If there are events that start to squeeze risk premiums – be that a bubbling over of trade wars, Brexit fall out, or U.S./Middle East tensions – we feel we are well positioned for that volatility.

\(^1\) All references to asset allocations sourced from Mellon, as of April 30, 2019
“At present we do not feel that valuations are compelling enough to warrant significant allocation to riskier asset classes, such as high yield and emerging market debt. Fundamentally speaking, we also don’t think we are in an environment to dial up risk,” Murphy adds.

Overall the fund allocation to credit (across the investment grade and high yield universe) is around 16%, while in the past when valuations and fundamentals were more supportive (such as in 2009) corporate credit exposure in the portfolio was as high as 65%.

**Flexibility to move**

Asset allocation over time

---

**Finding opportunity**

Since the BNY Mellon Global Fixed Income fund is hedged back to the dollar, an area Murphy is seeing opportunity to add to total return is through what he calls “hedged yields”. Through this, he says he is able to realize potentially greater gains from bonds in Europe, such as German Bunds.

Murphy adds: “We believe there is almost $10 trillion worth of bonds across the world that are trading at negative yields right now, including some German bunds. The differential between the U.S. base rate and most other developed countries is about as high as it has ever been at c.3%. It sounds counter-intuitive but this means we can realize returns through buying negative yielding bonds in Europe and hedging back into dollars.”

Outside these idiosyncratic opportunities, which are a function of unprecedented monetary policy since the financial crisis, Murphy is also finding opportunities in peripheral Europe and some emerging markets. He says longer-dated bonds in Italy and Belgium represent great value on a spread basis to Germany,
while high quality Asian bonds in countries like China and South Korea should benefit from the easier monetary policy stemming from slowing growth in the region.

Looking towards the remainder of 2019, Murphy expects to maintain his cautious allocations but says he has “plenty of room” to add to riskier asset classes if he starts to see a glimmer of improvement in fundamentals.

Since his allocation to corporate credit is very low on a historical basis, this is the first place he would look to add risk. “We would look to the sectors where we believe market dislocations are occurring currently. We followed a similar tactic in 2018: when emerging markets were pressured earlier in the year and when corporate credit came under more pressure in the fourth quarter. In both cases, investors such as ourselves who could step in as liquidity providers ultimately benefited as spreads snapped back in Q1 of this year.”

All investments involve risk, including the possible loss of principal. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

**No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.**

Investors should consider the investment objectives, risks, charges, and expenses of the fund carefully before investing. Investors should receive a prospectus, or a summary prospectus, if available, that contains this and other information about the fund, and should be advised to read it carefully before investing.

**Definitions:** Merrill Option Volatility Expectations Index (MOVE) reflects a market estimate of future Treasury bond yield volatility. Chart label definitions: Developed Govt & Cash – Developed Government bonds and cash assets, IG – Investment Grade credit, HY – High Yield credit, EM – Emerging Market Debt, ABS – Asset Backed Securities, RMBS – Residential Mortgage Backed Securities, CMBS – Commercial Mortgage Backed Securities, CMO – Collaterized Mortgage Obligations, Covered – Covered Bonds, MBS Passthrough - Mortgage Backed Securities passthrough is where the principal and interest rate payments made by the mortgages in an underlying pool of mortgages is passed through to the holders of the MBS.

**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. Investing in foreign domiciled 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 are subject to increased credit risk and are considered speculative in terms of the issuer’s perceived ability to continue making interest payments on a timely basis and to repay principal upon maturity. 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.

Mellon is a global multi-specialist investment manager dedicated to serving our clients with a full spectrum of research-driven solutions. Mellon Investments Corporation (Mellon) is a registered investment adviser and an indirect subsidiary of The Bank of New York Mellon Corporation.

BNY Mellon Investment Management is one of the world’s leading investment management organizations and one of the top U.S. wealth managers, encompassing BNY Mellon’s affiliated investment management firms, wealth management organization and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the Corporation as a whole or its various subsidiaries generally.

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. Please consult a legal, tax or investment advisor in order to determine whether an investment product or service is appropriate for a particular situation.

No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. BNY Mellon Investment Management, Mellon and BNY Mellon Securities Corporation are subsidiaries of BNY Mellon. ©2019 BNY Mellon Securities Corporation, distributor, 240 Greenwich Street, 9th Fl., New York, NY 10286.

MARK- 62957-2019-05-23

6940WHYHO-0619