When planning to jump out of an airplane, it is appropriate, downright prudent, to expect the law of gravity to operate. After all, it reliably explains why you will hurtle faster and faster to the ground.

It is less appropriate, downright foolish, to assume automatically that the grayish-green backpack handed to you at the outset was a functioning parachute. A few questions are in order, such as, is this a bargain model, who packed it, and how long ago was that? After all, parachuting is all about acting on a theory—the chute will likely open—for which empirical support offers comfort and contrary evidence is unsettling.

The Federal Reserve (the “Fed”) is operating on the same principle as a hopeful parachutist. Policymakers delivered the second quarter-point hike of 2017 last month, according to plan, and gave every indication of following through with their promised unfinished business of starting to reduce the size of the balance sheet and tightening the policy rate one more time this year. The Fed is acting on a theory, that an unemployment rate in the neighborhood of 4.25% presages inflation picking up to the Fed’s goal. For now, there is a discomforting downward tug of inconvenient facts. The same employment report that showed the unemployment rate ticking lower to 4.3% also reported three-month-average net job gains of 120,000, distinctly slower than earlier in the year.

**U.S. Civilian Unemployment Rate (Feb 2006-May 2017)**


Charts are provided for illustrative purposes only and are not indicative of the past or future performance of any Dreyfus or Standish product.
In general, incoming economic data across the major economies were less upbeat, with disappointments in store on net in the U.S. and the UK. In-quarter tracking estimates of U.S. real GDP growth, at around 3% or slower, deflate the notion of a rebound from the subdued first-quarter pace of expansion. Over the past month, both the U.S. and UK proved their penchant for providing political drama, raising the odds of counterproductive economic outcomes. And core inflation over the past few months moved in the wrong direction for two central banks seeking to return to their price-stability goals from below, the Fed and the European Central Bank (ECB).

Still, we commiserate with Fed Chair Janet Yellen, in that the fundamentals in place would seem to support a tepid U.S. expansion outpacing the even more sluggish growth of potential output. With resource slack turning from positive to negative, inflation should rise over time. Another tightening in 2017 seems logical, and certainly more likely than the less-than-a-fair-coin-toss probability currently embedded in futures market prices for the December Federal Open Market Committee (FOMC) meeting. That is, we believe the scaling back of policy expectations overshot the mark. Important in this assessment is that the Fed has already cumulatively revised down its guidance on rates to a shallow incline leveling out at 3% in the distant future. Such a gradual firming, catching up to improved domestic confidence and offset in part by a boost to spending from ongoing regulatory relief and future fiscal impetus, should not be threatening to global economic expansion.

**U.S. Core Consumer Price Inflation**  
(Jan 2006-May 2017)

**Other Advanced Economies Consumer Price Inflation**  
(Jan 2006-May 2017)

After all, accommodative monetary policy appears to be getting some traction in the euro area and Japan. The Chinese economy continues to bulldoze ahead with 6.5% real growth, which should extend through the remainder of the year as its leadership buffs its record in advance of the November party conference. Although oil prices dropped below $45 per barrel, where we place the lower end of its trading range, incentives align to keep the Organization of the Petroleum Exporting Countries (OPEC) disciplined enough to prevent a free fall. Expanding commodity demands and stable oil prices should support the growth of emerging market economies. This adds up in our economic outlook to 3.25% global GDP growth in 2017 and 3.5% in 2018.

**WTI Oil Price**

(Feb 1997-May 2017)  
(Nov 2015-June 2017)

Two features of this expected economic performance are of note.

First, given the slow pace of potential output growth in advanced economies, above-trend expansion does not feel especially inspiring in a historical context. Moreover, even modest disappointment in the climb up that shallow hill would seem to threaten continued progress. That is how we take investors’ reaction to disappointing data of late.

We think the global economy will continue to advance, albeit slowly, which leads to our second point. Central banks stand willing to step in should there be a faltering in activity or a whiff of financial market instability. In such circumstances, monetary policy easing would be accomplished by putting off the policy renormalization that investors currently expect. In the U.S., Fed officials would talk their way out of their rate guidance, even beyond the market’s current state of disbelief. In Europe, the ECB would wriggle out of its asset-purchase constraints to put off signaling the beginning of the program’s end this year. These events are not part of our baseline, but they are part of our explanation for the low levels of forward-looking volatility in financial markets. Indeed, volatility is stubbornly and historically low. But so, too, is the growth of potential output. The key is that policymakers and investors are more resigned to the role of demographics and productivity in suppressing the growth of aggregate supply in advanced economies. In that environment, real returns remain low, excesses do not build, and slow growth is safe growth.

![Implied Volatilities](Jan 2014-June 2017)

![Ten-Year U.S. Treasury Yields](Jan 2014-June 2017)

Note also the relative stances of monetary policy: The Fed is exiting the pool, while the ECB is only now contemplating moving out of the deep end. Both will likely move faster than markets currently expect, but the ECB has considerably more territory to cover in the process of renormalization, so that European yields remain more distorted than their U.S. counterparts.

We think that the Fed will get what it wants—a return to its goal of 2% inflation in the Personal Consumption Expenditures (PCE) price index. This implies a modest overshoot in Consumer Price Index (CPI) inflation, albeit a touch less distinct than we projected last time, and that breakeven inflation rates are cheap.

Uninspired but unscary economic performance in advanced economies suggests to us that developed market corporate spreads have gotten to fair value. Similarly, the foreign exchange market already priced in any good news the U.S. economy could offer by the spring. From here, we expect dollar weakness, which makes local-currency exposure to emerging market (EM) economies attractive. There is value in some dollar EM obligations, selectively, where economies are growing quickly or resolving policy problems.

Lastly, while mortgage-backed securities (MBS) have not participated in the recent rally in fixed-income markets, they still look slightly rich to U.S. Treasury securities. We believe the Fed’s assumption that its balance-sheet runoff will be slow and well-telegraphed and share its expectations that the effects will be slight. But that is reflected in prices now and it is hard to envision circumstances working out to the benefit of MBS.

These features of the economic landscape and fixed-income valuation are summarized in the first two columns of the figure below. We believe that the investing themes in the last column follow logically. As with the economic outlook and assessment of fixed-income valuations, they are not much changed from May in the advice to follow the Fed out the jump bay door. But it seems important to emphasize the bottom line first because it acknowledges
the risks involved. Opportunities for return are limited and easily wiped out by the manifestation of an adverse tail-risk event, or an extreme price movement of an asset or asset class either up or down. In such an environment, it is appropriate to maintain a relatively lean risk budget and emphasize more liquid risk factors. With volatility low, it is prudent to increase portfolio convexity. That is, take advantage of the ongoing sale on back-up chutes. The risk budget should be biased to slightly below the duration of the portfolio benchmark and tilted toward dollar-bloc duration and away from core European instruments, the relatively more distorted asset class. After that, position portfolios to the Fed's desired outcome, higher U.S. inflation, and its consequence, a weaker dollar.

RISKS
All investments involve risk, including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing. 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 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. Mortgage-backed securities: Ginnie Maes and other securities backed by the full faith and credit of the United States are guaranteed only against default. 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