Investing Through Cyclical Growth, Secular Headwinds

Eight years removed from the Great Recession, the U.S. economy is still trying to shake off its “low and slow” growth pattern. Since the initial recovery in 2009, U.S. economic growth has trended within a tight range, averaging 2.1%, and has yet to establish or sustain a faster pace of expansion.

With positive cyclical forces now building within the U.S. economy, investors will need to be selective when allocating capital as extended asset valuations may portend lower investment returns and higher portfolio volatility in the future.

Risks

Cyclical
U.S. economic growth is expected to improve given a number of positive cyclical factors, including a recovery in manufacturing and continued strength in employment. Optimism around U.S. fiscal stimulus, deregulation and tax reform has also helped investor sentiment. Given the strength in financial markets, however, it is difficult to determine exactly what is already reflected in asset prices.

Secular
Secular factors, such as trends in demographics and long-term productivity, serve as an overhang to the economy, and have already influenced long-term risk and return assumptions in the markets. Investors need to be mindful of these factors when allocating capital with long-term time horizons.

Investing
With U.S. equity valuations reaching historically elevated levels and interest rates seemingly poised to rise, investors should be aware of the potential risks building within their portfolios.

Opportunities

Active Management
Active strategies that focus on fundamental research and have the flexibility to look across and within geographies, sectors and asset classes may have the ability to invest in the highest-quality growth opportunities while sidestepping lower-quality, higher-risk investments. These strategies have the potential to deliver attractive risk-adjusted returns and to help dampen volatility so that a portfolio may grow over time and help investors meet long-term objectives.

Think Outside the Style Box
Identify which risks can cause the most damage in a portfolio and ensure they are managed accordingly. Investors should consider active strategies that have time-tested, low-correlated returns to other asset classes to help manage financial market volatility when it spikes. Alternative, multi-asset strategies that have allocation flexibility and focus on capital growth and preservation can potentially help protect against large drawdowns.1

“Barbell” Approach
A “barbell” approach to investing, which utilizes strategies that seek to capitalize on return potential on one side and capital preservation in the case of an unexpected correction on the other, can be a helpful strategy for investors to seek to mitigate portfolio volatility and help protect against uncompensated risk.
## Investment Considerations

### Active Management
Active equity and fixed-income strategies that rely on fundamental research to identify quality investment opportunities in a low-growth environment across countries and sectors can potentially help deliver consistent risk-adjusted returns and help investors meet long-term objectives.

### Alternatives
Alternative, multi-asset strategies that focus on asset allocation flexibility and capital preservation can help defend portfolios against extended volatility associated with a shift in central bank monetary policy.

### Think Outside the Style Box
For income seekers, consider equity and fixed-income strategies that balance the growth of both principal and income while preserving capital, and do not solely focus on the highest-yielding, higher-risk assets.

## Helping Meet Investor Challenges

Dreyfus is committed to help investors navigate complex global financial markets by aligning challenges presented by a changing investment environment with opportunities identified through a better understanding of risk. With a confluence of opposing forces at play, we help to identify opportunities which can improve investment outcomes in different market cycles.
Cyclical

Is the Momentum in Cyclical Economic Factors Sustainable?

CHART 1

- Eight years removed from the Great Recession, the U.S. economy is still trying to shake off its “low and slow” growth pattern. Since the initial recovery in 2009, U.S. economic growth has trended within a tight range, averaging 2.1%, and has yet to establish or sustain a faster pace of expansion.

- A number of encouraging developments over the past year suggest U.S. growth could potentially break out of this range to the upside.

CHART 2

- After starting 2016 in a recession, U.S. manufacturing has gradually picked up the pace of expansion and continues to show signs of strength.

- Outside of the U.S., global, Eurozone and China manufacturing also appear to have bottomed and have been gradually improving, which could further support U.S. momentum going forward.

CHART 3

- Since the U.S. elections, corporate and consumer confidence has materially improved on the expectation that fiscal stimulus, deregulation and tax reform will support a higher level of economic growth.

- While we would stress the word “expectation,” we would note that these confidence indicators are typically a leading predictor of economic growth, even if only marginally.
Secular Forces Weighing on Long-Term U.S. Growth Prospects

CHART 4

- While the return to more “normal,” cyclical economic growth is encouraging in the current environment, we believe investors need to be mindful of the secular headwinds weighing on the long-term growth prospects of the economy.

- Chart 4 shows the rolling 3-year real U.S. GDP growth going back to the late 1940s. Over this time, real U.S. GDP trend growth has moved lower and currently sits at about 2% today.

CHART 5

- These secular headwinds are largely demographic in nature, including an aging population, but also include the longer-term trend of lower growth in potential labor force productivity.

- Chart 5 shows the Congressional Budget Office’s projections for potential real GDP looking out to 2047. The potential labor force is expected to shrink from current levels given a contraction in the working age population. The potential labor force productivity, which consists of capital accumulation and total factory productivity, is also expected to grow at a moderate pace going forward relative to history.

Source: Federal Reserve Bank of St. Louis, as of March 31, 2017.

Investing Through Cyclical Growth and Secular Headwinds

**CHART 6**
- While the positive cyclical developments are encouraging, they are coming in the eighth year of an equity bull market where valuations are already extended relative to history. While economic and financial market cycles do not carry expiration dates, investors do need to be aware of the risk that extended valuations can have on future returns.

- Chart 6 shows the S&P Cyclically Adjusted Price–Earnings (CAPE) Ratio versus the 10-year forward total return for the S&P 500 Index. As of April 2017, the ratio stood at 29.2x, which suggests investors can expect the prospective 10-year total real return for the S&P 500 to be in a range of roughly 0% to 5%.

**CHART 7**
- An extended period of accommodative monetary policy has led to a divergence in risk (duration) and return (yield) within the U.S. fixed income market.

- With U.S. growth now showing signs of improvement, the U.S. Federal Reserve has started the gradual process of policy normalization. While duration risk* was more manageable when interest rates were falling, now that they are starting to rise, investors need to be mindful that they likely will not be compensated for this risk given still low yields.

**Sources:** Prof. Robert Shiller, Yale University, Newton, April 2017. *Past performance is no guarantee of future results.*
A drawdown is the peak-to-trough decline during a specific recorded period of an investment, fund or commodity.

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. 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. 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. Alternative strategies (including hedge funds and private equity) may involve a high degree of risk and prospective investors are advised that these strategies are suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment and who can bear the economic risk, including the possible complete loss, of their investment. The strategies will not be subject to the same regulatory requirements as registered investment vehicles. The strategies may be leveraged and may engage in speculative investment practices that may increase the risk of investment loss. Investors should consult their investment professional prior to making an investment decision. Asset allocation and diversification cannot assure a profit or protect against loss.

Charts are provided for illustrative purposes only and are not indicative of the past or future performance of any Dreyfus product.

The Conference Board’s Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. This monthly report details consumer attitudes and buying intentions, with data available by age, income, and region. The Cyclically Adjusted PE (CAPE) ratio is a valuation measure, generally applied to broad equity indices, that uses real per-share earnings over a 10-year period. The P/E 10 ratio uses smoothed real earnings to eliminate the fluctuations in net income caused by variations in profit margins over a typical cycle. The University of Michigan's Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on broad consumer expectations regarding the overall economy. The Institute for Supply Management (ISM) Purchasing Managers Index (PMI™) Report on Business is a composite index based on the diffusion indices of five of the indices with equal weights: New Orders (seasonally adjusted), Production (seasonally adjusted), Employment (seasonally adjusted), Supplier Deliveries (seasonally adjusted), and Inventories. A PMI™ reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining. The Conference Board Measure of CEO Confidence™, a monthly survey of 100 CEOs from a variety of industries in the U.S. economy, seeks to gauge the economic outlook of CEOs, determining their concerns for their businesses, and their view on where the economy is headed. A reading above 50 indicates that the CEOs surveyed are more bullish than bearish on their economic outlook. The National Federation of Independent Business (NFIB) Small Business Optimism Index is a composite of 10 seasonally adjusted components based on the following questions: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job openings, expected credit conditions, now a good time to expand, and earnings trend. The S&P 500 Composite is one of the most commonly used benchmarks for the overall U.S. stock market, and is an index that tracks the performance of the largest 500 U.S. companies. An investor cannot invest directly in any index.

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