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Bond Market Update:

Beam Them Up, Scotty

By: The Active Fixed Income Investment Committee

Part of the attraction of the *Star Trek* franchise is glimpsing potential technologies two and a half centuries from now. Early adopters of the series had a three-decade lead on Amazon's Alexa on how to talk to a computer. Among the wonders of the imagined future is the transporter, offering a decided commuting improvement from Boston's Massachusetts Bay Transportation Authority (MBTA). Alas, the transporter proves as unreliable as the MBTA in practice. A repeated plot device revolves around a transporter mishap. Among those, a protagonist (not the red-shirted ones who return as rice pudding) is transported back duplicated with split and amplified personalities. Thereafter, the crew of the USS Enterprise copes with the twins of an extremely virtuous and completely evil Kirk or an even-more logical and weepily emotional Spock.

This feels familiar right now. At some point in the past two years, Scotty beamed US economic policy making from an alien planet to Washington, DC, but the transporter duplicated, split and amplified an aspect of its familiar personality. This time, the duplication rotated around the axis of predictability.

The skittish and risk-averse policy design settled at 20th and C Streets, NW. There, at the Federal Reserve building, officials shun surprise, abhor headlines, and suck drama from every speech opportunity and data release. They firm at even-numbered meetings, signal action at odd-numbered ones, and will keep at this preset pace until the firming cycle is over. Federal Reserve (Fed) officials apparently view keeping on message more important than keeping inflation from overshooting their two-percent goal. With the economy retaining momentum, fiscal impetus remaining, and financial accommodation lingering, expect more of the same.

The Investment Committee does, which is why we changed the emphasis on the entries about the Fed in our Investment Landscape¹ update. An inflation overshoot is now, not in the future, as in the first column. The Fed has made us even more confident in its slow upward climb of the funds rate. They have already raised short rates to make the front end an attractive carry opportunity, but some of that return will be offset as rates rise slightly more than currently expected.

The transporter settled the mischief-making doppelganger at 1600 Pennsylvania Avenue, NW. We wake to tweets opening new fronts with old partners, with no guidance to the strategic endpoint of the new tactics. President Trump pushes on individual vulnerabilities, apparently letting the systemic implications sort themselves out.

This has been the arc of our political plotline since the presidential election. However, the aggressive curvature of that arc surprises us. So much so that we now believe the trade dispute will get worse before it gets better. That is, we give up on the timeline that the mid-term elections would discipline the president. Accept that there are more trade uncertainties and that they will weigh more on foreign economies than our own.

Financial market pricing also intrudes on portfolio choice. High-yield spreads have narrowed to plausible risk-adjusted alternatives. Part of it is the industrial composition of borrowers and part is due to the receptiveness of alternative funding sources—loans. As a result, seek other opportunities within a lower risk budget to live long and prosper.

¹ A procedural note: We are committed to refreshing our Investment Landscape every month. But to avoid unneeded repetition, we will henceforth provide a bottom-up review in the last month of every quarter. For the other two months—such as this one—we will update only the changes in the outlook.

The Investing Landscape

Economic Landscape

The trade dispute will probably get worse before it gets better, but the hit to economic activity is likely to be modest.

In the US, accommodative financial conditions and fiscal impetus supports above-trend economic growth, exacerbating excess demand and putting upward pressure on costs.

Most other advanced economies should grow above trend, as long as neither internal nor external politics derail the process.

Robust growth in China supports emerging market economies and commodity prices, although there are multiple risk events.

As inflation overshoots the Federal Reserve's (Fed) goal, modestly more tightening is in store than currently built into markets.

With the Fed in the lead, central banks in developed markets are moving, albeit slowly, to renormalize monetary policy;

They thus far remain willing to lean against market instability.

Fixed-Income Valuation

Above-trend economic growth makes developed market sovereign yields expensive.

Break-evens offer value and provide inexpensive protection to upside surprises to inflation.

The dollar appears expensive against other developed and emerging market currencies.

For institutional investors, municipal assets are fairly valued, with the exception of the five-year maturity, which looks rich.

With fundamentals remaining strong, investment-grade corporate spreads are fair.

High-yield spreads are somewhat expensive.

Market and political uncertainties create opportunities in emerging markets local currency and dollar debt.

Interest rate volatility remains low.

The flattening of the Treasury yield curve provides attractive carry at the short end that will offset capital losses some as rates rise.

Valuations of securitized products generally appear fair to rich.

Investment Themes

Be biased toward short duration positions in core developed market sovereign securities.

Maintain short dollar exposure, where appropriate through option strategies given increased probability of tail risks.

Maintain modest exposure to break-evens.

Remain overweight investment-grade hard-currency EM debt.

Maintain modest credit exposure but look to gradually step up the quality of the holdings.

Rotate from short-duration municipal securities to longer duration ones or taxable bonds, where appropriate.

Maintain modest underweight in MBS and emphasize ABS versus CMBS.

Continue option strategies with minimal cost to keep portfolios sufficiently convex.

Look for opportunities to reduce risk selectively.

Source: BNY Mellon Asset Management North America as of August 2018.



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