BNY MELLON

Bond Market Observations

APRIL 2016

STANDISH

"Given the risks to the outlook, I consider it appropriate for the committee to proceed cautiously in adjusting policy."

— Janet Yellen, Chair of the Federal Reserve Board of Governors

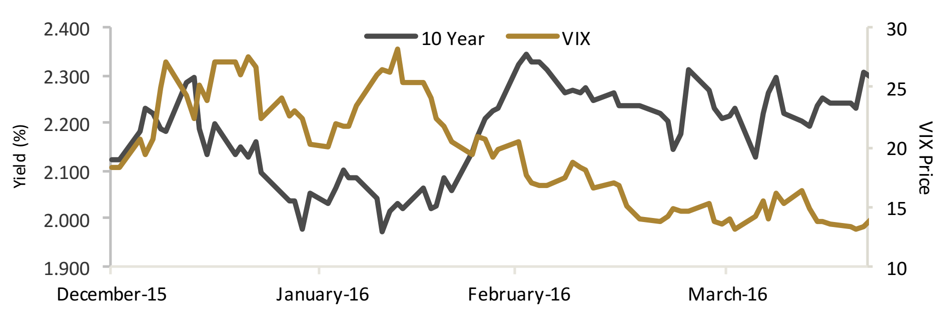
THE FEDERAL RESERVE LOOKS ABROAD

- The Federal Reserve placed much of the burden for their lower Fed Funds forecast on economic and financial market developments outside the U.S.
- The subsequent turn toward positive market sentiment has not altered our base case for a muddle-along scenario for the global economy.
- It is not yet time for a short duration stance in U.S. rates given heightened uncertainty around the medium-term global outlook.
- Emerging Markets should benefit from easier policy in developed markets and stability in commodity prices.

The Federal Reserve downgraded their rate forecast from four hikes down to two in 2016. They assigned much of the rational for the shallower path of monetary policy on economic and financial market developments abroad. This places the burden of proof on an improved outlook from here to justify Fed action. Over the near-term, the global landscape is littered with events potentially important to the outlook: the referendum on whether the UK stays in the European Union, a possible impeachment of the Brazilian president, policy uncertainty and volatility out of China, national elections in Japan and a new president in the U.S.

While global uncertainty abounds, a Federal Reserve that is leaning toward easier monetary policy has proved to have a calming effect on markets. This has been exhibited through lowered financial market volatility, a stem in the persistent decline in commodity prices, and limited near-term U.S. dollar strength. However, the recent turn toward positive market sentiment has not altered our base case for a muddle-along scenario for the global economy associated with a gradual normalization of Fed policy. We continue to have medium-term concerns on the global outlook, but feel near-term stability should provide opportunities.

10-Year U.S. Treasury Yield and Market Volatility



Source: Bloomberg as of March 31, 2016

Not FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

For Use with Financial Professionals Only. Not for Use with the General Public.

A SHALLOWER PATH AND U.S. INTEREST RATES

With the FOMC's revised forecast from four to two hikes in 2016, the Fed has moved in-line with our base case of two rate hikes this year, which represents the upper bound of Fed tightening. While potential upside inflation risks increase with a shallower Fed Funds path, we believe that it will take time for a potential inflation surprise to flow through to the broader economy, leaving inflation risks as a 2017 story. Therefore, we believe that the U.S. economy will muddle-along, but with greater probability of tail risks given limited cushion for government officials globally to accommodate a policy mistake or geopolitical event.

> "While potential upside inflation risks increase with a shallower Fed Funds path, we believe that it will take time for a potential inflation surprise to flow through to the broader economy, leaving inflation risks as a 2017 story."

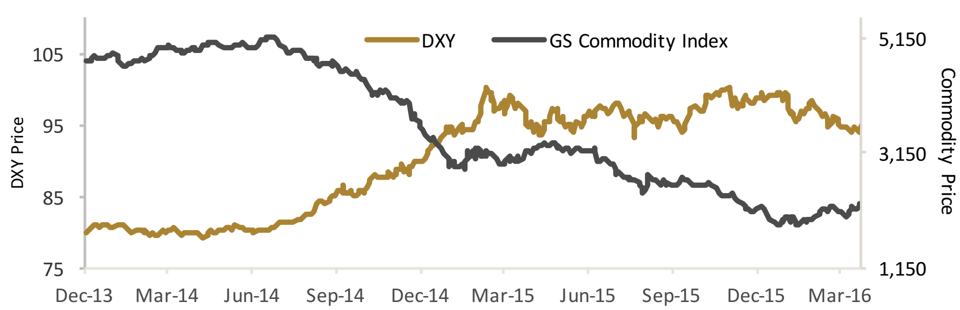
Our concerns about global growth and the risk of extraneous shocks are both shared with FOMC officials and priced into the Treasury market. The Treasury 10-year yield of 1.9% is not indicative of U.S. economic fundamentals. In our view, U.S. rates are being artificially lowered by nearly 50 basis points driven by increased demand due to attractive global relative value influenced by global central bank easing, and a flight to safety rally following risk aversion in the first quarter. If these factors subside, we would expect rates to rise towards our fair value estimate driven by fundamentals. However, given the potential for volatility in the next several months, we would not expect any rate rise to be material, especially prior to the UK vote on leaving or remaining in the European Union.

While tactical duration positions have potential to add value, we do not believe that a structural short duration position is warranted given the limited magnitude of any potential rise and the heightened uncertainty surrounding the macroeconomic outlook.

SLOWER POLICY NORMALIZATION AND POSITIVE EMERGING MARKET SENTIMENT

The decline in commodity prices since the summer of 2014 have taken a toll on Emerging market (EM) countries as natural resources are a primary driver of EM revenues and EM countries are net exporters of commodities globally. The impact has not only been felt from the decline in oil, but also lower prices across the commodity complex, including copper, iron ore and steel. One of the primary catalysts for the unprecedented fall in commodity prices was the slowdown in demand from China, which coincided with a period of increased commodity production and therefore supply to the market. This supply/demand imbalance, coupled with U.S. dollar strength as the market expected tighter monetary policy in the U.S., caused a period of dislocation and stress across markets.

Inverse Relationship Between the U.S. Dollar and Commodity Prices



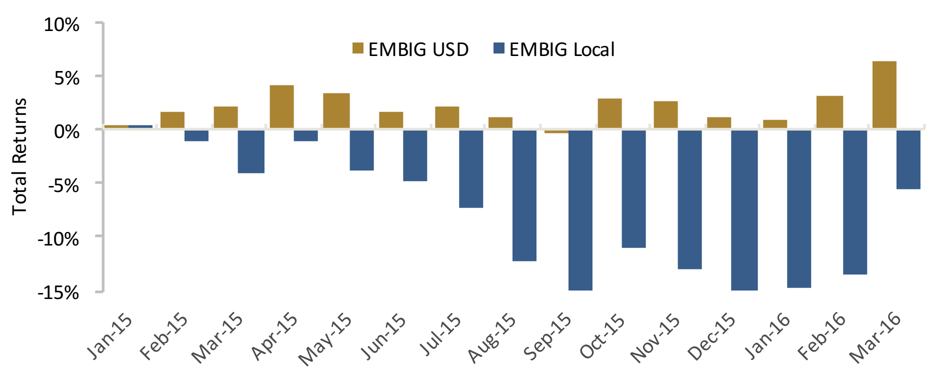
Source: Bloomberg as of March 31, 2016

However, the trend appears to have bottomed with lower net new supply across the commodity complex and a moderate resurgence of demand. Chinese officials have taken steps to boost economic activity through additional fiscal stimulus. Along with Chinese GDP data, the March report on retail sales, industrial production and fixed asset investment all exceeded expectations. In addition, a more dovish Fed coupled with additional stimulus from the European Central Bank has helped continue to push investors into riskier assets. Therefore, moderated downward pressure on export prices from reduced supply coupled with unexpected demand stability from China should benefit EM current account balances and help stabilize corporate profits.

"Our macro-economic forecast for a muddle-along scenario is broadly supportive for EM over the next few months."

Our macro-economic forecast for a muddle-along scenario is broadly supportive for EM over the next few months. Looking at external factors, we are constructive on the sector due to commodity price stabilization and loose monetary policy in developed markets. Outside of idiosyncratic stories, we are seeing positive signs with improving current account deficits in high deficit countries as well as falling inflation in countries with elevated inflation levels. Renewed positive EM market sentiment is reflected in strong demand for new issues of both sovereigns and corporates and the resurgence of issuance from frontier markets. However, internal factors within specific EM economies are more mixed given the absolute low level of commodity prices and uncertain political backdrops. We see value in credit specific stories within the EM space, but our expectation for increased volatility surrounding global events tames our willingness to greatly increase allocations to the sector.

Monthly Emerging Market Index Returns



Source: Bloomberg as of March 31, 2016

Improved market sentiment from both better Chinese data and a more dovish tone from the Federal Reserve are good news near-term for risk assets. However, the duration of the market's enthusiasm remains a concern. Looking at the recent past, markets that get a boost from additional expansionary global central bank policies have typically lasted one to two quarters before fundamental concerns again rise to the surface. While there are pockets of opportunity, overall we are looking for more attractive entry points to broadly increase risk in portfolios.

For Use with Financial Professionals Only. Not for Use with the General Public.

DRY-BMOCMTY-0516

BNY MELLON