

BOND MARKET OBSERVATIONS

JUNE 2014, PART I*, GLOBAL ECONOMIC OUTLOOK

By Thomas Higgins, PhD, Chief Economist & Global Macro Strategist

*Part II, our Global Investment Outlook, will be released in July/August 2014.

EXECUTIVE SUMMARY

- Despite the poor start to 2014, we continue to expect a resynchronization of global growth as the recovery in developed markets begins to filter through to emerging markets.
- We still expect above trend U.S. economic growth and a reduced level of accommodation from the Federal Reserve to result in higher U.S. Treasury yields and a stronger U.S. dollar.
- No matter how well policy makers attempt to prepare markets for the eventual exit from ultra-easy monetary policy, the threat of a disruptive adjustment in financial markets remains high.
- Though we still see opportunities in emerging market debt, the strength of the recent rebound suggests investors will need to be more discriminating going forward.

MODEST DOWNWARD REVISIONS TO STANDISH 2014 GROWTH OUTLOOK

As we approach mid-year, we are taking this opportunity to review our economic projections for 2014 and discuss the risks to our outlook for the second half of the year. The global economy got off to a slow start this year. In developed markets (DM), revised data show that the U.S. economy contracted sharply in Q1 and euro zone growth outside of Germany disappointed. While the Japanese economy expanded at a respectable clip, this was primarily because consumers made purchases ahead of an increase in the value added tax in April.

Meanwhile, growth in emerging markets (EM) continues to be subpar. Although Eastern Europe has been bolstered by the strong German economy, the crisis in Russia and Ukraine has weighed on growth in the region. Economic activity in Developing Asia has been undermined by a combination of weak global demand, political turmoil in Thailand and the ongoing correction in the property sector in China. Latin America has struggled with lower commodity prices and tighter monetary policy in high inflation countries such as Brazil. Most recently, the insurgency in Iraq has highlighted that geopolitical risk remains elevated in the Middle East with

potential consequences for global growth given the region's role in world oil markets.

Despite the poor start to 2014, we continue to expect a resynchronization of global growth as the recovery in DM economies begins to filter through to EM economies in the coming quarters. High frequency indicators already suggest a rebound is underway in the United States following a weather related drag during the winter months. In addition, the recent monetary easing by the European Central Bank (ECB) and lower sovereign borrowing costs in peripheral Europe have lessened systemic risk in the euro area and raised growth prospects for later this year. Finally, sounder macroeconomic policies and structural reforms in some EM countries have boosted investor confidence and helped reverse the capital outflows that began when the Federal Reserve first announced its intention to taper quantitative easing (QE) in May 2013.

Therefore, we have only shaved three-tenths off our global GDP forecast leaving us at 3.3% for this year and 3.7% in 2015. By contrast, we have raised our global inflation forecast slightly to 3.7% this year and 3.4% in 2015, but this masks considerable differences in price pressures below the surface in both DM and EM economies. We continue to believe a pick-up in EM growth will benefit the performance of EM dollar and local currency debt, but the strength of the recent rebound in these markets suggests investors will need to be more discriminating about where they put their money going forward. We also still expect that the combination of faster U.S. economic growth and a reduced level of accommodation from the Fed will result in higher U.S. Treasury yields and a stronger U.S. dollar.

GLOBAL ECONOMIC OUTLOOK FOR 2014

	2014 GDP Forecast		2014 CPI Forecast	
	January	June	January	June
World	3.6%	3.3%	3.5%	3.7%
Developed Markets	2.0%	2.0%	1.6%	1.8%
Emerging Markets	4.9%	4.7%	5.3%	5.5%

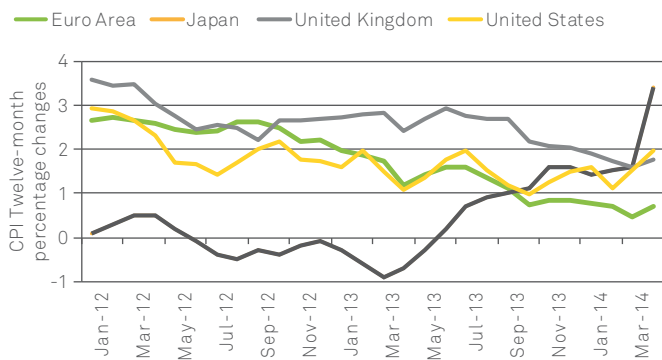
Source: Standish as of June 2014

WHAT WE GOT RIGHT AND WRONG

Back in January, we made three economic predictions which we believed would result in three specific market outcomes. First, we forecast that there would be a bottoming of inflation in DM economies, with the exception of euro area, and that this would put upward pressure on U.S. Treasury yields. Second, we stated that there would be a resynchronization of global growth as the recovery in DM filtered through to EM economies. We believed that this would lead to a rebound in EM dollar and local currency debt markets. Third, we anticipated that diverging monetary policies between the G-4ⁱ central banks would result in a stronger U.S. dollar. Thus far, our track record has been pretty good with roughly two-thirds accuracy and we are hopeful that that percentage will move higher as events unfold in the second half of the year.

However, the market reaction has not always been consistent with what we thought the economic fundamentals would dictate. For example, inflation in the United States appears to be heading higher as rents and medical care costs rise. Indeed, the U.S. consumer price index (CPI) troughed at 1.1% in February before increasing to 2.1% in May. We expect this trend to continue as the improving labor market gradually translates into faster wage growth. Yet, the yield on the benchmark U.S. 10-year Treasury bond has declined from 3.0% at the beginning of January to 2.6% in early June. From our perspective, U.S. Treasury yields continue to be overvalued based on economic fundamentals and should move higher over the remainder of this year. In fact, our proprietary models suggest fair value is well above 3%.

G4 INFLATION BEGINS TO PICK-UP



Source: The U.S. Bureau of Labor Statistics (BLS), Eurostat, the Japanese Ministry of Finance, and the U.K. National Statistics Office as of June 13, 2014

So why have Treasuries rallied in 2014? It is likely a combination of factors. To begin with, very low government bond yields in other DM economies may be boosting demand for Treasuries. Ten-year German Bunds and Japanese government bonds were yielding just 1.4% and 0.6%, respectively, in early June. Furthermore, a large number of investors are already short duration betting that Treasury

yields will move higher, which means fewer investors are looking to put on the trade. Additionally, disappointing global growth and heightened geopolitical risk has increased the flight to safety bid for Treasuries. Lastly, investors may be pricing in further easing by the ECB and potentially the Bank of Japan (BoJ) putting downward pressure on global bond yields. We believe the downward pull from these factors will fade as the U.S. economic data, particularly on the labor market, continues to improve and inflation gradually trends higher.

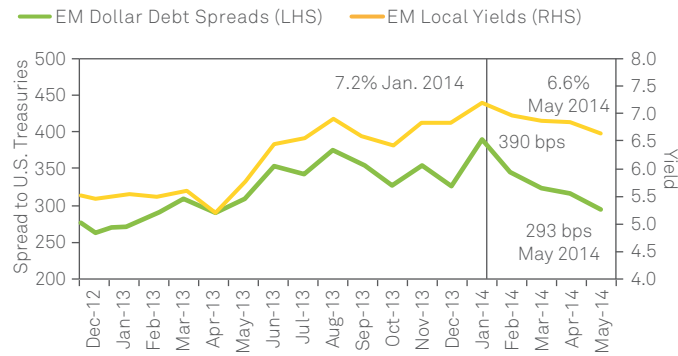
Our second prediction was that there would be a resynchronization of DM and EM economic growth in 2014 and that this would bolster demand for EM debt. Though we are still far from a broad based recovery in EM, we are seeing hopeful signs on this front. For example, in Eastern Europe, countries such as Poland and the Czech Republic have benefited from their strong ties to the German manufacturing sector. The Polish economy expanded 3.4% year-to-year (y-o-y) in Q1 2014 following growth of 2.7% in Q4 2013, while Czech GDP increased 2.5% y-o-y after growth of 1.1% in Q4 2013. At the same time, concerns about Chinese growth have eased somewhat after the economy expanded close to the government's 7.5% full year target in Q1 2014. Looking ahead, we expect real GDP growth to moderate to 7.2%, but a slightly weaker Chinese renminbi and more supportive monetary and fiscal policies should prevent a more serious deterioration in the growth outlook.

Elsewhere in EM, sounder macroeconomic policies and structural reforms have boosted investor confidence. For instance, Russia and Brazil have responded to recent currency weakness by raising interest rates rather than introducing capital controls. On the reform front, Mexico has adopted new laws aimed at liberalizing the energy and telecommunications sectors to raise productivity and Colombia continues to build a strong institutional framework with its sound monetary policy and an improving fiscal position. Finally, India's new Prime Minister Narendra Modi is expected to repeal food and fuel subsidies to help rein in the country's budget deficit.

Foreign investors have responded well to these developments and both EM dollar and local currency debt have rallied. The JP Morgan EMBI Global (EM dollar debt) had a total return of 9.1% and the JP Morgan GBI-EM Global Diversified (EM local debt) had a total return of 6.0% through June 9, 2014. However, as we cautioned at the beginning of the year, investors will need to be more selective in choosing the countries they allocate money toward since idiosyncratic risks have the potential to lead to greater disparities in EM performance going forward. We continue to like spreads in Latin America, particularly Mexico, Brazil and Colombia. On the currency front, we believe the Mexican peso, Polish zloty, and Indian rupee have the potential to strengthen in the coming months for the reasons cited above. We are more cautious on the Thai baht, the Turkish lira and the South African rand given geopolitical risk and macroeconomic uncertainty in these countries.

ⁱ Group of Four (G-4) includes the United States, euro area, Japan and the United Kingdom

EMERGING MARKET DEBT HAS RALLIED IN 2014



Source: JP Morgan as of June 2014

Our third and final prediction at the beginning of the year was for a further divergence in monetary policy between the G-4 central banks with the Fed and the Bank of England (BoE) slowing reducing the level of accommodation, while the BoJ and the ECB did the opposite. We thought that this would be supportive of the U.S. dollar, particularly against the Japanese yen and the Canadian dollar.

Although our expectation for monetary policy was correct, the U.S. currency's performance in 2014 has been mixed. The U.S. dollar has strengthened against the Canadian dollar, but it weakened versus the yen. The dollar is also slightly stronger versus the euro following the ECB's decision to lower its deposit rate into negative territory and intensify the preparatory work for its proposed purchases of asset backed securities at its June meeting. Overall, the broad trade weighted dollar is up 0.5% in nominal terms as of mid-June. We believe that stronger U.S. economic growth and rising inflation expectations will lead to further dollar strength in the second half of the year as investors begin pricing in interest rate hikes by the Fed by the middle of 2015.

WHERE COULD WE BE WRONG?

We continue to have a high degree of confidence in our 2014 outlook, but as we witnessed during the first half of the year, unforeseen events can increase ones forecast error. Some of the risks we highlighted back in January remain the same. For instance, we continue to worry that EM growth may remain sluggish due to structural factors. We would also add that geopolitical risk remains high in several EM countries and this could weigh on economic and financial market performance in the months ahead. Indeed, though it is not our base case, the insurgency in Iraq could lead to a spike in oil prices with global repercussions. At a minimum, ongoing uncertainty about the future of the Iraqi state is likely to keep a floor under the price of oil in the near-term.

Yet, other risks have moderated. For example, our concerns about deflation in DM economies have eased somewhat following the more aggressive action taken by the ECB at its June policy meeting and the rebound in inflation in the United States and Japan. We remain concerned that this may lead to a spike in U.S. interest rate volatility, particularly if U.S. economic growth rises above potential during the second half and inflation begins to trend back toward the Fed's 2% target as we expect.

A new risk we see evolving relates to the exit from ultra-easy monetary policy in the United States and United Kingdom. Both the Fed and the BoE have indicated that they are likely to raise interest rates sometime in 2015 as long as their economies continue to perform in line with their expectations. No matter how well policy makers attempt to prepare markets for this inevitability, the threat of a disruptive adjustment in financial markets remains high, especially given the very low level of volatility.

In the forthcoming July/August Bond Market Observations, our CIO David Leduc, will discuss the implications of our global economic outlook for the global investment outlook.

All data sourced by Standish.

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. The information in this document is not intended to be investment advice, and it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for Professional Clients only. This material is not for onward distribution to, or to be relied upon by, retail investors. Any statements and opinions expressed in this document are as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon or any of its affiliates. The information contained in this document has been provided as a general market commentary only and does not constitute legal, tax, accounting, other professional counsel or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. This document is not investment research or a research recommendation for regulatory purposes as it does not constitute substantive research or analysis. To the extent that these materials contain statements about future performance, such statements are forward looking and are subject to a number of risks and uncertainties. Information and opinions presented in this material have been obtained or derived from sources which BNY Mellon believed to be reliable, but BNY Mellon makes no representation to its accuracy and completeness. BNY Mellon accepts no liability for loss arising from use of this material. If nothing is indicated to the contrary, all figures are unaudited. **Any indication of past performance is not a guide to future performance. The value of investments can fall as well as rise, so you may get back less than you originally invested.** This document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country in which such distribution or use would be contrary to local law or regulation. This document may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this document comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this document in their jurisdiction. **The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.** This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Investment Management. This document is approved for Global distribution and is issued in the following jurisdictions by the named local entities or divisions: UK and in mainland Europe (excluding Germany): BNYMIM EMEA, BNY Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorised and regulated by the Financial Conduct Authority. **Germany:** Meriten Investment Management GmbH which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. **Dubai, United Arab Emirates:** Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. This material is intended for Professional Clients only and no other person should act upon it. **Singapore:** BNY Mellon Investment Management Singapore Pte. Limited Co. Reg. 201230427E. Regulated by the Monetary Authority of Singapore. **Hong Kong:** BNY Mellon Investment Management Hong Kong Limited. Regulated by the Hong Kong Securities and Futures Commission. **Japan:** BNY Mellon Asset Management Japan Limited. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Fund Trusts Association, Japan and Japan Securities Investment Advisers Association. **Australia:** BNY Mellon Investment Management Australia Ltd (ABN 56 102 482 815, AFS License No. 227865). Authorized and regulated by the Australian Securities & Investments Commission. **United States:** BNY Mellon Investment Management. **Canada:** Securities are offered through BNY Mellon Asset Management Canada Ltd., registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada, and as an Investment Fund Manager and Commodity Trading Manager in Ontario. **Brazil:** this document is issued by ARX Investimentos Ltda., Av. Borges de Medeiros, 633, 4th floor, Rio de Janeiro, RJ, Brazil, CEP 22430-041. Authorized and regulated by the Brazilian Securities and Exchange Commission (CVM). The issuing entities above are BNY Mellon entities ultimately owned by The Bank of New York Mellon Corporation. BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • BNY Mellon Western FMC, Insight Investment Management Limited and Meriten Investment Management GmbH do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon Western Fund Management Company Limited is a joint venture between BNY Mellon (49%) and China based Western Securities Company Ltd. (51%). The firm does not offer services outside of the People's Republic of China. • BNY Mellon owns 90% of The Boston Company Asset Management, LLC and the remainder is owned by employees of the firm. • BNY Mellon owns a 19.9% minority interest in The Hamon Investment Group Pte Limited, the parent company of Blackfriars Asset Management Limited and Hamon Asian Advisors Limited both of which offer investment services in the U.S. • The Newton Group ("Newton") is comprised of the following affiliated companies: Newton Investment Management Limited, Newton Capital Management Limited (NCM Ltd), Newton Capital Management LLC (NCM LLC), Newton International Investment Management Limited and Newton Fund Managers (C.I.) Limited. NCM LLC personnel are supervised persons of NCM Ltd and NCM LLC does not provide investment advice, all of which is conducted by NCM Ltd. Only NCM LLC and NCM Ltd offer services in the U.S. • BNY Mellon owns a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC).

Issued as at 24/06/2014 IC0298-24-06-2014 (1M). T0525 06/14.

本情報提供資料は、BNY メロン・グループ（BNY メロンを最終親会社とするグループの総称です）の資産運用会社が提供する情報について、BNY メロン・アセット・マネジメント・ジャパン株式会社が審査の上、掲載したものです。当資料は情報の提供を目的としたもので、勧誘を目的としたものではありません。当資料は信頼できると思われる情報に基づき作成されていますが、その正確性、完全性を保証するものではありません。ここに示された意見などは、作成時点での見解であり、事前の連絡無しに変更される事もあります。

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕 一般社団法人 投資信託協会
一般社団法人 日本投資顧問業協会