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VANTAGE POINT

Shifting tides

Q1 2024

BNY MELLON
INVESTMENT MANAGEMENT

INTRODUCTION

Welcome to another edition of Vantage Point, the quarterly economics and markets outlook from the Global Economics and Investment Analysis (GEIA) team at BNY Mellon Investment Management.

The news since we last published has been uniformly positive for the US economy. Growth was strong in the third quarter, surprising to the upside, while inflation – core and wage inflation included – has come in lower than expected. That has raised hopes for a 'soft landing' and equity markets have responded in kind, rising +6% since the end of September, even as bond markets have sold off. In Europe, the story hasn't been nearly as upbeat, as the economy seems to be slipping into recession, with Germany looking particularly weak. At the same time, inflation has fallen too, core surprising to the downside in September and October. The Chinese economy appears to be stabilising after a weak patch through Q2 and Q3, in part thanks to further relaxation of both monetary and property-focused, fiscal policy. Japan remains an outlier – saddled with similar inflation problems to the US and Europe but responding very differently in terms of monetary policy. Meanwhile, the UK continues to suffer from much higher inflation than its peers, without any obvious growth outperformance. And, of course, geopolitical tensions have risen further with events in the middle east.

Against that background, most central banks have decided to pause raising interest rates, following the Federal Reserve's (Fed) lead, even though not all are in the same boat. Broadly speaking, the view has taken hold that we are at the peak of interest rates, even if they could stay 'higher for longer'.

That narrative has been particularly influential in the bond markets, where 'higher for longer' translated into a market sell off during September and October. Rate cuts that had been priced in for Q2 next year have largely been taken out of market expectations, resulting in higher yields along the curve, notably in the 1–3-year section. However, tighter monetary policy for longer is not the only explanation for what went on in fixed income markets. 5-year, 5-year forward interest rates rose too and, since these should be relatively immune to monetary policy expectations, several other explanations have been deployed to understand what has been going on.

First, some are pointing to not just 'higher for longer', but 'higher for ever'. This is the idea that the equilibrium neutral nominal and real interest rate has risen, so even if rates come down at some point, they will eventually settle at levels much higher than we saw during the post Global Financial Crisis (GFC) period (2008-19). We recently published an exhaustive paper (see on our public site here) looking at precisely this question and end up concurring with the markets that a number of real factors, together with higher underlying inflationary pressure, point to policy rates averaging 4½% or higher over the next decade.

Second, and related, markets have been increasingly focused on the outlook for fiscal policy, particularly in the US, where the budget deficit stands at 8% of GDP even while the economy is at full employment. In a world where the interest rate on government debt stands above the potential growth rate of the economy, public debt trajectories suddenly start to look dangerously explosive and, in the absence of comforting noises from governments about running responsible fiscal policies in future, bond prices have taken a hit. Term premia have risen sharply, on US Treasuries rising nearly 100 basis points since August, and moving into positive territory convincingly for the first time since 2015.

Some of that fear dissipated in November, and Treasury yields headed back towards 4.5%, as inflation continued to surprise to the downside. But leveraged institutions remain net short of Treasuries and institutions like the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) have warned that this represents a significant threat to global financial stability.

Against that background, the key questions remain the same as a quarter ago. Do we 'need' a recession to bring inflation sustainably down to target? Could inflation rebound from here? What would that mean for the idea that rates have peaked? Will higher rates cause 'something to break'? If we get a soft landing, could rates come down sooner than expected? Have we really emerged from the post-GFC regime and, if so, where will interest rates settle in the longer term? Are public debt levels unsustainable? How do we factor in greater geopolitical uncertainty? To what extent does market pricing get the answers to these questions right?

As usual, we take the uncertainty about the answers to these questions seriously and address the issues in our mutually-exclusive economic scenarios. These remain the same as last time, though we have amended our probabilities a little.

We think the least likely outcome remains some kind of global 'Immaculate Disinflation' (10%), whereby inflation falls steadily back towards target almost everywhere without necessitating a recession. The situation in Europe alone makes that an unlikely outcome, though clearly there is a greater chance of it happening in the US. As we have noted before, this scenario requires economies to work in a very different way than during previous inflation shocks. Inflation would have to be largely supply driven and the fall in global goods prices, facilitated by the reformation of global supply chains post-Covid, would have to be the major contributor to it falling back. Some proponents argue the so-called 'Phillips curve', relating inflation to economic slack, is highly nonlinear, becoming much steeper when unemployment is low. In that world, a relatively small economic slowdown could generate a large and rapid fall in inflation, though presumably it also leaves economies vulnerable to a rebound if demand strengthens again. Other proponents have argued for 'long transitory': the idea that what we've seen is really just a post-Covid upward shock to relative prices and the aggregate price level, which has just taken a bit longer to work its way out of the system. A final argument is that inflation expectations remain relatively well anchored and that the short-run Phillips curve is shifting back in rapidly. As mentioned, we recognise the possibility that one or more of these arguments holds true, especially in the US, but we remain sceptical that they will explain inflation behaviour everywhere in the next year.

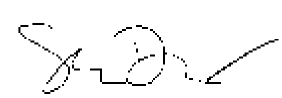
The opposite view remains 'Unavoidable Recession' (40%). In this scenario, leaving monetary policy too loose for too long during 2021-22 has had inflationary consequences that can only be solved by tightening monetary policy sufficiently to create a (mild) recession. High rates of wage and core services inflation in several countries lend support to this narrative. In this world, the last percentage point or two of disinflation proves the most difficult to achieve. In fact, in this scenario, inflation plateaus and then rebounds from current levels, thanks to relatively robust economic growth. The central bank 'pause' turns out to be premature and rates must rise again in the first half of 2024. The upshot is a marked weakening of economies in the second half of next year, notably the US. It is important to note timing differences among the major economies however. It looks very likely this process is already underway in Europe and possibly the UK, whereas the story as told above applies with a lag in the US. Given a long run of downside inflation surprises in several countries, some might be sceptical that inflation could rebound from here. However, a recent IMF study of many historic inflation episodes from around the world concluded that rebounds or second waves are the norm not the exception.[1] An important contribution comes from Chinese growth, which weakens into 2023, as property-related concerns intensify, and policy is insufficiently stimulative to boost economic activity significantly.

Our single most likely scenario this time is 'International Divergence' (50%), in which the economic outcome in the US and some other countries is significantly better than in most. In other words, this scenario is a combination of the previous two, in which the US undergoes a soft landing of sorts, while Europe and the UK move into recession at the end of 2023 and into early 2024. This leads to a divergence in economic and market performance, with rate cuts coming earlier in Europe and the dollar strengthening. China stabilizes, but growth remains lacklustre relative to previous trends. **The key implication is that the probability of recession in the US in the next twelve months has fallen to 40%, the first time it has been odds against in our forecasts for over a year.**

As usual, each scenario is a fully formed economic forecast. We probability weight them and present our forecasts in the form of fan charts that account for 90% of the likely outcomes. There remain tail risks however, most notably related to geopolitical uncertainty and financial stability. In each of our scenarios we have therefore allowed for a small (<10%) probability that oil prices spike upwards in response to geopolitical events. This tends to skew our inflation forecasts upwards and our growth forecasts downwards.

The implications for markets remain similar to last time. Given upside risks to inflation and rates, and downside to growth and activity, we remain cautious about risk though, given the shift in probabilities, a bit less so than last time. Our recommendation is to remain slightly overweight fixed income, notably at the shorter end, harvesting the income return. It is not clear to us that equities and high-yield credit have priced in interest rate risk sufficiently, though the higher probability of a soft landing in the US makes us more favorable towards US equities than elsewhere. Understandably, we continue to moderate our US equity underweight and prefer adding quality factor exposure over size (i.e., small caps).

We hope you enjoy this edition of Vantage Point and the 2024 outlook. As ever, we welcome your feedback and wish you a very happy 2024.



SHAMIK DHAR
CHIEF ECONOMIST

[1] Ari, Anil, et al. "One Hundred Inflation Shocks: Seven Stylized Facts." IMF, 15 Sept. 2023, www.imf.org/en/Publications/WP/Issues/2023/09/13/One-Hundred-Inflation-Shocks-Seven-Stylized-Facts-539159.

VANTAGE POINT SUMMARY

We summarize the outlook in the graphics below. These show: 1) our 12-month forecasts of GDP growth, inflation, and monetary policy relative to their long-term trend; 2) how our fan chart forecasts differ from market expectations– in terms of expected returns and expected uncertainty.; and 3) our investment conclusions, based on the largest discrepancies between our own views and what the market is pricing in. Our conviction around our tactical investment views is higher when the level of uncertainty around our forecast is lower.

TABLE 1: SUMMARY OF OUR 12 MONTH OUTLOOK

How to read the heatmap. Green indicates above trend growth, below target inflation, policy accommodation and lower-than-average levels of uncertainty. Grey indicates economic growth in line with trend, inflation in line with target, a neutral policy stance, and average levels of uncertainty. Red indicates below trend growth, above target inflation, a tight policy stance, and higher-than-average levels of uncertainty.

		Growth	Inflation	Policy	Takeaway
Summary of VP outlook	**Average expectations**	Red	Red	Red	Despite better US outlook, global growth is below trend over the next 12 months on average; inflation is still above target and policy remains restrictive.
	Uncertainty	Red	Red	Red	Uncertainty is high on the timing of the recession and the policy reaction to slow/negative growth and high inflation.

TABLE 2: OWN FORECAST VS THE MARKET

How to read the heatmap. Green indicates that we expect growth to be higher than the market believes, inflation to be lower and policy accommodation to be greater. Green also indicates that uncertainty around our macro expectations is lower than the market is pricing. Grey indicates that expectations (or uncertainty around expectations) for economic growth, inflation and policy are broadly in line with the market. Red indicates worse than expected growth, greater than expected inflation and a tighter than expected policy stance. Red also indicates that uncertainty around our macro expectations is higher than what signalled by the market.

		Growth	Inflation	Policy	Takeaway
Vantage Point vs market pricing	**Average expectations**	Red	Grey	Red	We see a greater risk of growth disappointing, and tighter policy vs expectations. We think inflation will be broadly in line with market expectations.
	Uncertainty	Red	Red	Red	Our fan charts imply greater uncertainty in the outcomes for growth, inflation, and policy, compared to what is priced in option markets.

TABLE 3: SUMMARY OF 12 MONTH INVESTMENT CONCLUSIONS

How to read the heatmap. Green indicates overweight. Grey indicates neutral. Red indicates underweight. Polarized possible outcomes for the economy mean this is an environment to tighten risk budgets and not make bold directional bets.

Asset class	Q4 '23	Q1 '24	Conviction	Rationale
Cash	Green	Green	High	Cash attractive given income returns and optionality it provides.
Fixed Income	Green	Green	Medium	Benefits from high yields and provides a hedge for elevated recession risks.
Equities	Red	Red	Medium	Too much optimism is priced in by the market over the near term, and risks of slower growth, high inflation and tighter policy remain elevated.
Credit	Grey	Grey	Medium	Elevated yields are attractive, but spreads remain compressed providing a limited buffer for slower growth, particularly in lower quality credits.
Alternatives	Green	Green	Medium	Focus on assets less sensitive to growth, and/or that benefit from an increase in risk and upside inflation surprises given risks remain to the upside.

Source: BNY Mellon Investment Management, as of November 15, 2023.

EXECUTIVE SUMMARY

Our New Scenarios in Brief

PROBABILITY

50%

Scenario 1
International divergence

- The US undergoes a soft landing, similar to 'Immaculate Disinflation'.
- However, struck by a bigger terms of trade shock, Europe's outlook darkens with slumping growth and only modestly easing inflation.
- For Europe, the picture is more like 'Unavoidable Recession' – the standard economic model applies here.
- China fails to sufficiently stimulate its economy and counteract the deepening slump in its real estate sector.
- Meanwhile, faced with a worsening outlook in China and Europe, Japan's outlook worsens as well, and its core inflation re-weakens.
- US macro exceptionalism re-strengthens the USD index modestly in 2024. Financial conditions for emerging markets (EMs) tighten.
- The Fed cuts rates by mid-2024 in response to worsening global conditions and a quicker easing of domestic inflation.
- US equities and corporate credit stage a relative rally, versus their European and EM counterparts.

The US labor market continues to successfully rebalance, prompting a timely Fed pause and subsequent declines in the policy rate. US fiscal measures result in higher corporate investment and productivity-enhancing measures. Combined with ongoing deceleration in core inflation, this allows US corporates and consumers to continue spending despite higher refinancing needs, as interest rates decline while growth remains on track, but core inflation does not prove worryingly sticky. However, the euro area and China are not as lucky, with stagflation risks in the euro area materializing and the deleveraging process in China meaningfully stymieing growth. The resultant divergence in growth is exacerbated by the strength of the US dollar, which tightens global financial conditions, but also induces the Fed to cut the policy rate in response to global instability concerns in the second half of 2024. An oil price spike on geopolitical concerns could weaken growth globally, but the US would be more shielded than other major economies as a net energy exporter and given robust consumer and corporate balance sheets.

PROBABILITY

40%

Scenario 2
Unavoidable recession

- The Fed pauses too soon, and US inflation begins to rise early in 2024 prompting further tightening through the first half of next year.
- Wages and core/services inflation re-accelerate in 2024 on what proves to be insufficient policy tightening.
- In response, Fed policy rates must be hiked further to around 6%, and US Treasury yields shift a leg higher to above 5% temporarily.
- Borrowing costs rise and excess savings are exhausted. Similar trends ensue in Europe as well. No meaningful offset from China.
- As a result, household spending and corporate profits are squeezed. Layoffs rise at the core of the global economy.
- Standard economic model applies – the recession required to bring wage and price inflation down is already underway in Europe and takes place through the second half of next year in the US. The S&P index slumps to 3800, but begins to recover into year-end.
- Inflation tumbles to below 2% in late 2024 and the Fed ends up cutting rates by more than is currently priced in by the markets.
- These eventually set the stage for a meaningful recovery in risk assets – but not until 2025.

In this scenario the US economy remains robust into early 2024, causing inflation to pick up again and forcing the Fed to re-start the hiking cycle in H1 and/or the market to price in such higher level of interest rates. That triggers a mild US recession, mid-year and into H2. Chinese disinflation continues to weigh on goods prices globally, but services inflation proves sticky across developed markets. Tight labor markets and expansionary fiscal policies, most notably in the US, support aggregate demand in the short term. But with labor supply constrained and wages continuing to grow at rates above those consistent with 2% inflation, the upshot is higher underlying inflationary pressure in the next 6 months. That could force both the Fed and the ECB to hike again and keep policy restrictive for longer than investors currently anticipate.

Things are made worse by a tightening of credit conditions. Higher refinancing costs for fixed-rate mortgage and fixed-rate corporate paper hit hard in 2024. Excess savings are exhausted, and higher rates on short-term debt such as credit cards also take their toll. Other economies slow too: recession in the euro area and UK, together with a resumption of a property-led downturn in the China, weaken global demand. This could be exacerbated by a sudden oil price spike amidst geopolitical uncertainty, which would trigger a widening of corporate credit spreads and a downdraft in equities as both corporate and consumer defaults accelerate.

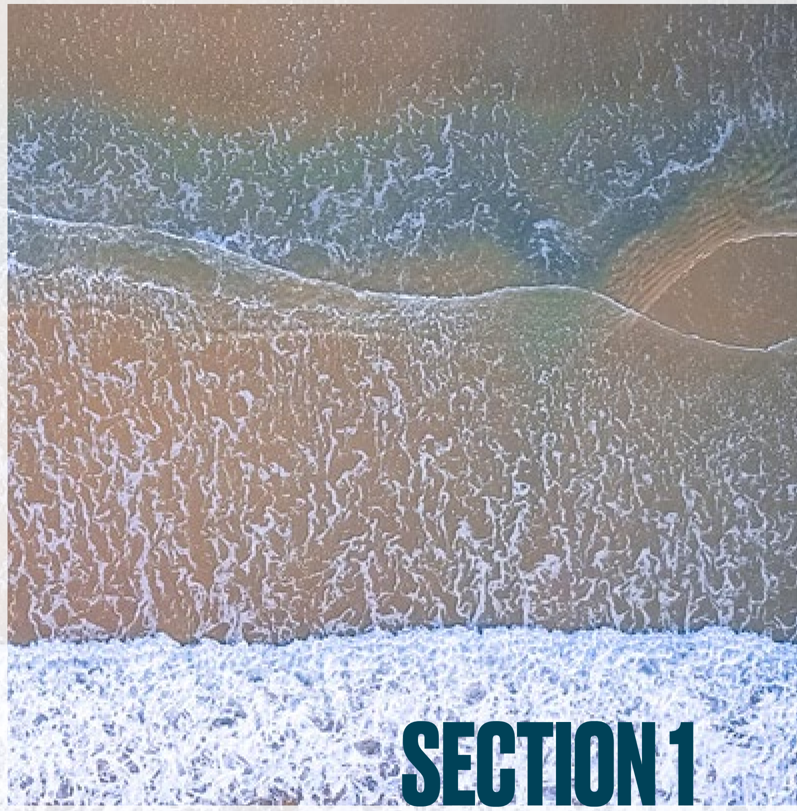
PROBABILITY

10%

Scenario 3
Immaculate disinflation

- A new paradigm
- Policy credibility has been restored, and disinflation occurs largely through falling inflation expectations, rather than the usual mechanism of substantial economic slack.
- Rates have peaked, and normalization begins around the middle of 2024.
- AI-enthusiasm fuels multiples expansion, which combines with 10% earnings growth to deliver a strong equity market rally.
- Wage growth and the headline inflation rate decline into the Fed's comfort range.
- Stabilizing real wages (adjusted for headline inflation) sets up a timely buffer against dwindling excess savings and high real rates.
- US GDP hews to its long-term trend, allowing the Fed to gradually cut rates from H2 '24 in line with market expectations (by ~100bps).
- The USD softens, global financial conditions ease; these impart greater strength to the U.S.' main (demand deficient) trading partners.
- Risk assets stage a significant rally with the S&P reaching well above 5000 by end 2024.
- In the same time frame, IG and HY spreads compress, respectively, to below 100bps and lower than 300bps.

In a 'goldilocks' scenario, all chips fall into place perfectly. Supply side shocks to goods and services production reverse, with supply chain reallocations and energy price fluctuations not proving overly disruptive to global economies. Headline inflation eases sustainably, and sticky core inflation continues to decelerate enough to make central banks comfortable to cut rates accordingly. Ongoing immigration, falling vacancies and a lower quit-rate allow the US labor market to loosen benignly, with softer wage growth. Large-scale layoffs do not materialize. Stabilizing real wages offset the exhaustion of excess savings. In all, improving supply-side conditions are sufficient to lower inflation to global central banks' ~2% objective. Both the Fed and the ECB therefore feel comfortable to step away from restrictive policy stances, resulting in easing global financial conditions. In the meantime, China growth stabilizes without major negative financial stability spill overs from the government's deleveraging efforts. Investor confidence in global growth momentum allows the US Dollar to weaken, further aiding its main trading partners.



SECTION 1
WHAT WE THINK

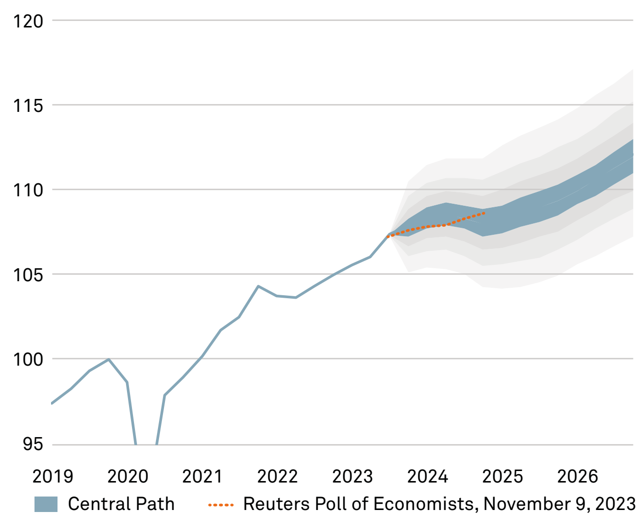
Section 1

WHAT WE THINK: FORECAST SUMMARY

Core inflation has passed its peak across most major economies, with this more persistent measure of price pressures falling steadily over the past three months, not just in the US but in Europe too, leading to a growing conviction among financial market participants that the central bank tightening cycle has come to an end. The way the disinflationary process is unfolding varies considerably from country to country. In Europe, growth has slowed, with output broadly flat for much of this year. In the US, by contrast, economic activity has accelerated, with GDP increasing at an above-trend pace since the middle of last year, and by an annualised 4.9% in Q3, according to the advance estimate.

It is, to a large degree, differences in the behaviour of households as they were confronted by a period of falling real incomes for much of last year and into this year that explain differences in the pattern of growth. US households have dipped into the savings pots that were built up during the pandemic, fueling consumption. But in Europe households have, if anything, been saving a greater proportion of their incomes than before the pandemic – perhaps a sign that they are less confident about the macroeconomic outlook. In the past, the recovery from double-digit, or near double-digit inflation has almost always been accompanied by a recession, everywhere. The chances of a different outcome this time around seem much greater in the US then they do in Europe. In this edition of Vantage Point, we have raised the weight we

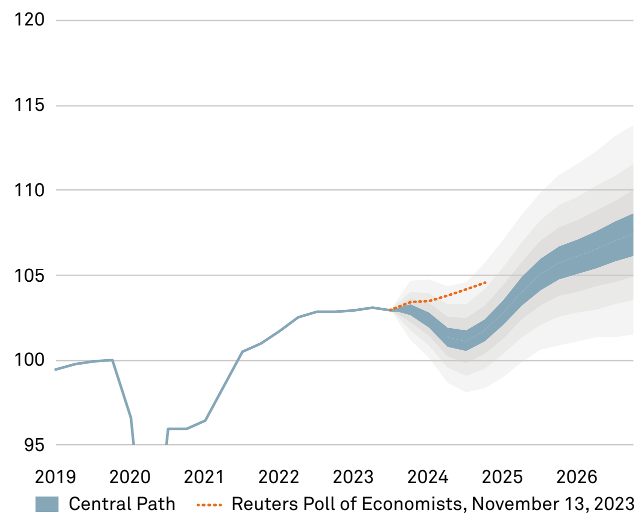
CHART 1: US GDP
INDEX, 2019 Q4 = 100



Source: Refinitiv Datastream/Fathom Consulting.

Key Takeaway: Reflecting our upgraded growth outlook, we see growth broadly in line with consensus near-term, at a low but positive rate, albeit with a downside skew in the latter part of 2024, reflecting the impact of the 'Unavoidable Recession' scenario possibility.

CHART 2: EURO AREA GDP
INDEX, 2019 Q4 = 100



Source: Refinitiv Datastream/Fathom Consulting.

Key takeaway: Euro area GDP expected to decline notably in 2024, and below more optimistic consensus outlook due to tightening policy and financial conditions.

Forecasts begin in Q1 2024 and were calculated as of November 15, 2023. Source: BNY Mellon Investment Management and Fathom Consulting. The "central path" (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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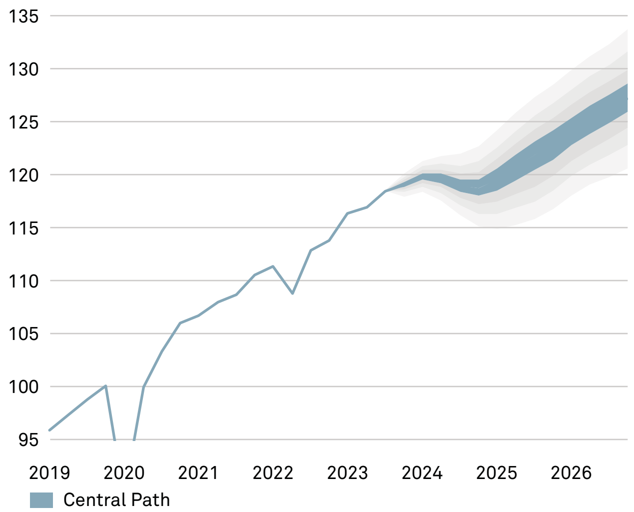
attach to scenarios where the US avoids recession from 50% to 60%, but we have cut the weight attached to scenarios where Europe avoids recession from 20% to 10%.

Our assessment of the range of possible outcomes for GDP in the US, the euro area and China is shown in the first three fan charts. In the US, the mean path for economic activity through next year is now one of stagnation, rather than the outright contraction that we had envisaged three months ago. Weighting up possible outcomes for the euro area, a recession is still very much on the cards. As an emerging economy, China's trend rate of growth is higher than that of both the US and the euro area making outright contractions in GDP less common, nevertheless, our fan chart shows there is a material risk of a period of falling output in China, which faces the threat of a recession in Europe, one of its main trading partners, in addition to its own domestic imbalances. Looking across the three GDP fan charts, the odds of a technical recession, defined as two consecutive quarters of falling output, in the first half of next year are around 10% in China, 15% in the US and 50% in the euro area.

The pace at which inflation has fallen to date has been dramatic, particularly in the US. Nevertheless, some commentators have warned of the prospect of a second wave of inflation, perhaps triggered by a rebound in energy prices against a backdrop of rising geopolitical tensions, and we too are mindful of that risk. Indeed, we see a rebound in inflation,

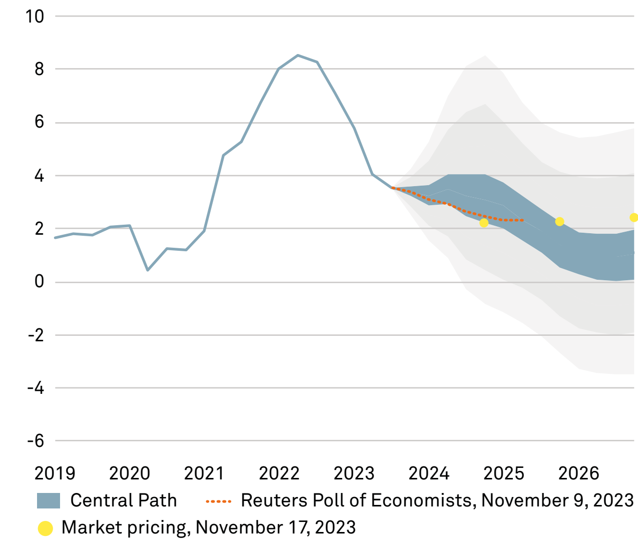
CHART 3: CHINA GDP
INDEX, 2019 Q4 = 100



Source: Fathom Consulting.

Key Takeaway: China GDP also poised to remain softer than trend on its property sector woes and weak private sector confidence. Deleveraging process meaningfully stymies growth.

CHART 4: US CPI
FOUR-QUARTER PERCENTAGE CHANGES



Source: Refinitiv Datastream/Fathom Consulting.

Key Takeaway: We remain more pessimistic than the market about inflation in 2024, but the upside skew to our forecast has come down sharply, as only one scenario ('Unavoidable Recession') envisions reaccelerating inflation. Considering the possibility of a second inflation wave keeps us moderately above consensus near-term.

Forecasts begin in Q1 2024 and were calculated as of November 15, 2023. Source: BNY Mellon Investment Management and Fathom Consulting. The "central path" (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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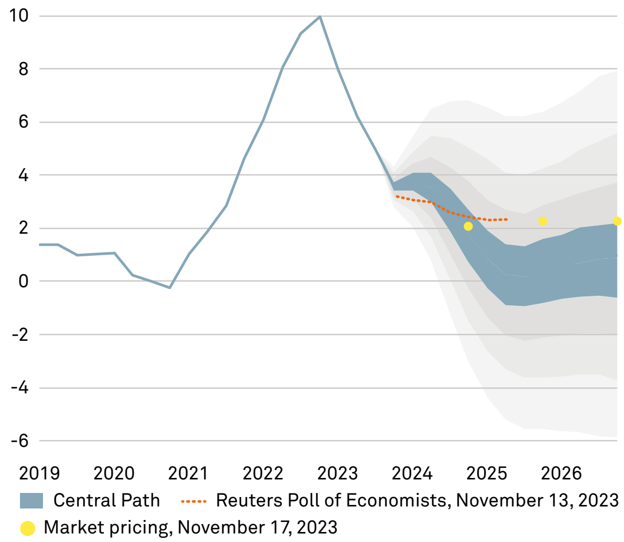
followed by a further material tightening of monetary policy, as one of the most likely paths by which the US economy slips into a recession. The weight we attach to this scenario accounts for the upward bulge in our fan chart for US CPI inflation through next year. While our single most likely scenario of 'International Divergence' sees US inflation move steadily towards 2% through next year, perhaps even dipping a little below with weakness in China and in Europe keeping a lid on commodity prices, the risks lie decidedly to the upside. Averaging across all possible outcomes, our mean forecast for US inflation lies above both market pricing and the consensus among other economists, as surveyed by the Reuters Poll. With a strong likelihood that Europe is either in, or about to enter recession, the fan chart for euro area inflation is more clearly downward sloping. In contrast to market pricing, which sees euro area inflation at or close to target from late 2024, through 2025 and into 2026, we see a close-to-evens chance that, faced with a mounting degree of economic slack, the single currency bloc suffers a period of deflation before the end of the forecast period.

Our fan chart for the US Federal Funds rate is best understood in the context of our fan chart for US inflation. The possibility of a resurgence of inflation accounts for the upward bulge in our policy rate fan chart from early next year. While it is close to an evens bet whether the next move in the US Federal Funds rate is upward or downward, there is positive skew to the near-term outlook, with a rapid tightening through next year

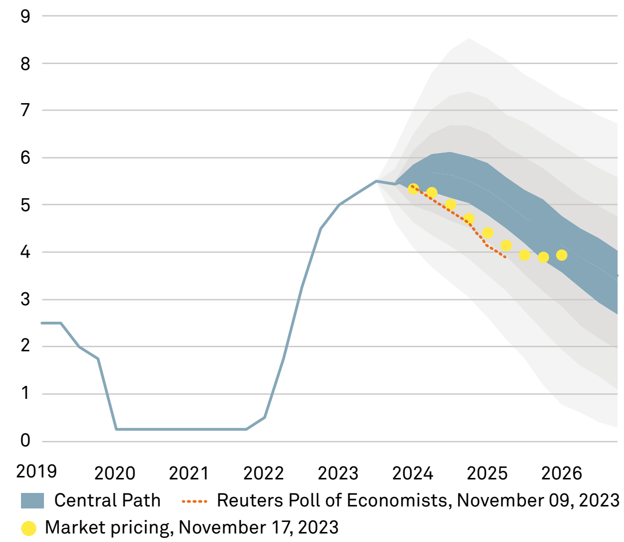
CHART 5: EURO AREA CPI
FOUR-QUARTER PERCENTAGE CHANGES



Source: Refinitiv Datastream/Fathom Consulting.

Key takeaway: Euro area inflation seen above consensus in 1H of 2024 but declining rapidly by mid-year as recession takes hold and demand slumps, and ultimately falling below target by year-end.

CHART 6: US FEDERAL FUNDS RATE
PER CENT



Source: Refinitiv Datastream/Fathom Consulting.

Key takeaway: We see a higher likelihood of further tightening near-term than a rapid loosening of Fed policy. As a result, we see a more moderate decline in the Fed Funds Rate through the year compared to consensus and market pricing.

Forecasts begin in Q1 2024 and were calculated as of November 15, 2023. Source: BNY Mellon Investment Management and Fathom Consulting. The "central path" (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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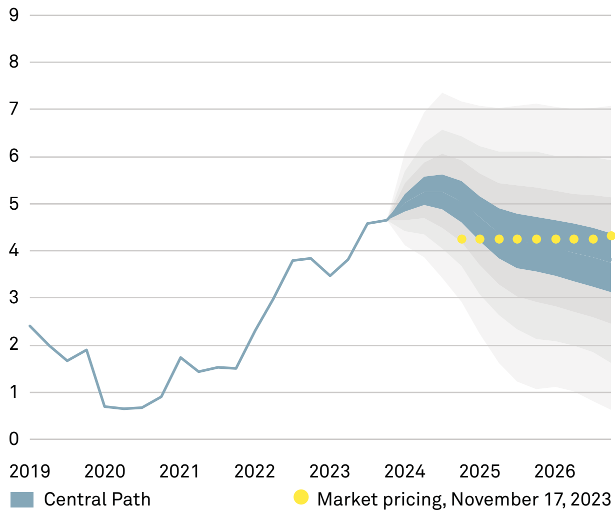
more likely than a rapid loosening. Averaging across all possible outcomes, our mean path for the policy rate of interest now has a more modest downward slope than at the time of the previous Vantage Point reflecting, in part, the lower weight we attach to scenarios that involve a US recession, combined with the likelihood that, towards the end of our forecast horizon, the neutral real rate of interest is on an upward trajectory.[2] Understandably, our fan chart for ten-year US Treasury yields has a similar shape to our fan chart for the US policy rate. Averaging across all possible outcomes, and in contrast to market pricing, we see yields rising through the first half of next year, before falling back through the second half of next year to around 4%. Risks around the mean path are substantial, and this is reflected in the width of our fan chart.

Our fan chart for US equities is similar in shape to the one we presented in our previous Vantage Point. Near-term risks remain to the downside. By the middle of next year, we see around a 15% chance that the S&P 500 has dropped below 3,500, but less than a 5% chance that it has moved above 5,500. Looking further ahead, we see a somewhat better-than-evens chance of a material improvement in P/E ratios, as investors look to increase their exposure to AI stocks still further. This combines with healthy growth in earnings to deliver strong returns to US equities, pulling our mean path for the S&P 500 substantially above market pricing by the end of our forecast horizon.

[2] For more detailed analysis of long-term interest drivers, see our recent paper "Tidal Forces: Dissecting the interest rate equation", which can be accessed on our public website at the following link: https://im.bnymellon.com/us/en/individual/articles/fixed-income/tidal-forces-dissecting-the-interest-rate-equation.html

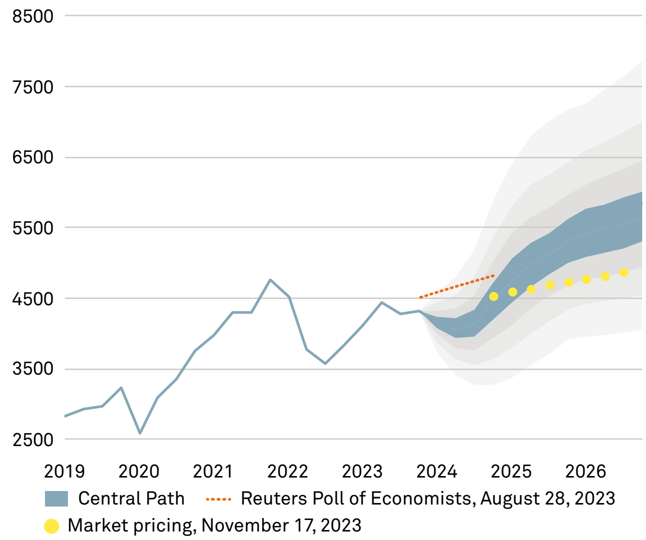
CHART 7: US TEN-YEAR GOVERNMENT BOND YIELDS PER CENT



Source: Refinitiv Datastream/Fathom Consulting.

Key Takeaway: Given our expectations around the Fed's reaction function, we see moderate upside risk to yields in the first half of 2024 but declining during the second half to around 4% either due to growth-saving emergency cuts or policy normalization to maintain stable real yield levels.

CHART 8: US S&P 500 INDEX



Source: Fathom Consulting.

Key takeaway: Equity outlook constrained over the near-term by rich valuations, higher real rates likely to stay elevated and a slowing economy hampering earnings growth and risk appetite. But prospects improve sharply from 2H '24 onward on policy cuts and potential AI enthusiasm catalyst in medium-term.

Forecasts begin in Q1 2024 and were calculated as of November 15, 2023. Source: BNY Mellon Investment Management and Fathom Consulting. The "central path" (i.e., blue bands) represents the central 20% of outcomes based on a mean or probability-weighted average forecast across all three scenarios. The light gray bands show progressively less likely outcomes covering a combined 60% of the forecast distribution. The width of the fan chart shows the level of uncertainty and when the bands below the central path are wider than those above, this shows the balance of risks lies to the downside.

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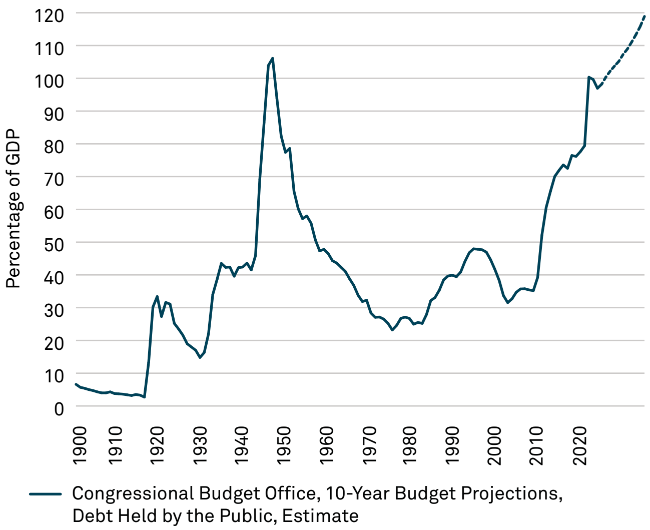
CHART 9: CBO PROJECTION OF DEBT HELD BY THE PUBLIC
% GDP



Source: Macrobond, BNY Mellon Investment Management U.S. Congressional Budget Office (CBO). Data as of Wednesday, October 4, 2023.

US Treasury yields have risen substantially since the summer of 2023. We see three key reasons for the rise: higher supply, lower demand, and expectations for higher rates and rate volatility. On the supply side the US government current and projected funding needs have increased due to fiscal initiatives, baby boomer retirements, and higher interest rates, which lead to higher interest payments. Congressional Budget Office (CBO) estimates that federal debt held by the public sector will reach 118% of GDP by 2033. Federal debt could grow to over 130% of GDP if policymakers extend various expiring policies. However, we caution that other market indicators point to relatively muted concerns of US debt sustainability thus far. On the demand side, as the Fed continues its balance sheet run-off and the Bank of Japan (BoJ) adjusts monetary policy, foreign official demand may wane. In addition, US banks arguably require fewer additional Treasury holdings. As interest rates rise, the cost of balance sheet for banks rises. The market may not be able to absorb as many cash bonds quickly due to balance sheet availability by banks. Indeed, for regulatory reasons, banks may prefer to shed Treasury securities to avoid losing higher margin loan balances. As the Fed and other investors step away from the Treasury market, and Treasury increases supply, projected holdings by the public rise, according to CBO. Finally, investors appear to expect US rates to stay higher over time, pricing out the possibility of policy rate returning to the zero lower bound.

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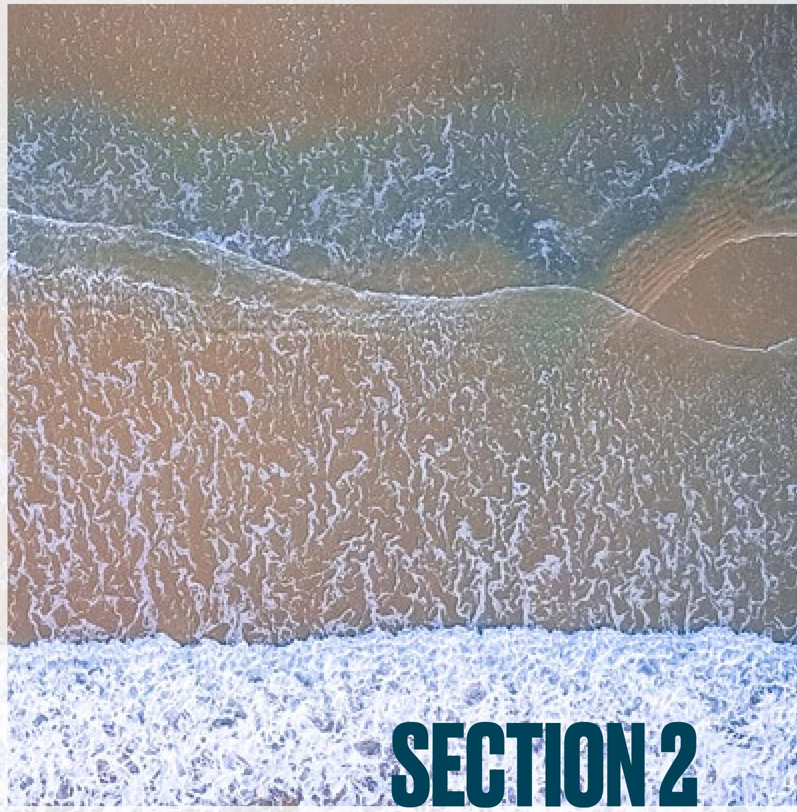


SECTION 2
WHAT THE MARKET THINKS

Section 2A

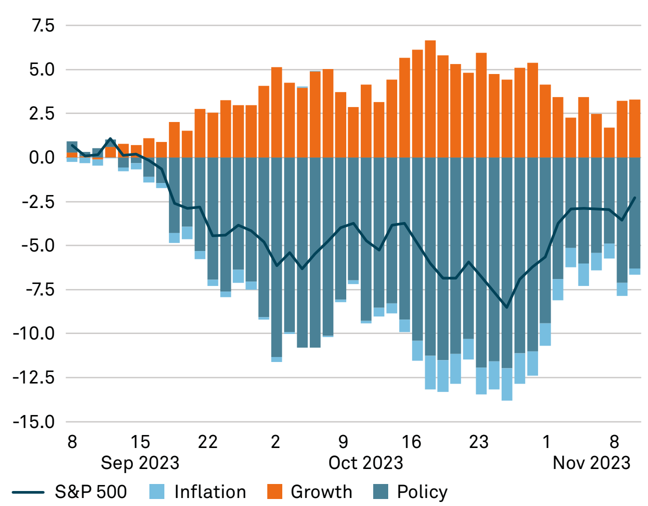
WHAT'S PRICED IN

Summary: The market remained very volatile since we last published, but not out of line with what is seen in periods characerized by rising real rates of interest. Overall, current market pricing remains most consistent with a tale of 'Immaculate Disinflation,' where inflation is expected to stabilize at 2%, growth remains positive yet moderate, and interest rates fall smoothly to neutral levels (i.e., neither restrictive nor stimulatory). This interpretation remains broadly true even if we account for the distortions created by the handful of companies most exposed to the Artificial Intelligence theme, for which the market is pricing in very elevated earnings growth for the foreseeable future. Option markets reflect a limited probability of large (upward or downward) moves in equities or bonds, suggesting that investor expectations are relatively aligned to the prevailing 'Immaculate Disinflation' narrative. We believe the likelihood of more extreme scenarios remains higher than what is priced in. For instance, we see elevated risk that the continued resilience in the economy and the consumer may trigger a more hawkish repricing of US real rates, e.g., if inflation proves to be stickier than expected or central banks judge that slack is needed to bring inflation back to target sustainably (i.e., not in a transitory way), leading to a markdown in growth expectations further into the future. Conversely, advancements in AI could again surprise investors, lifting equity valuations further in the near term.

Growth: Global growth expectations priced in by the market remain positive and at healthy levels, as reflected in the relative performance of equities to bonds, cyclical equities vs defensives, and other market-implied growth proxies, including our own proprietary measure of global growth expectations priced in by the market. This is in contrast with the recent decline in the global composite PMI, a variable usually highly correlated with market-implied growth expectations. Over the quarter, volatility in growth expectations was elevated, with declines seen up until the end of October and a marked improvement over the remaining period, but the level of expectations remained broadly unchanged. In the near term, the market is most positive on US growth (~8% EPS growth in 2024 for the S&P 500 equal weighted), and more tepid on European prospects (~1% EPS growth in 2024 for the MSCI Europe), suggesting that some divergence in growth paths is already priced in, but recession in Europe is not seen as very likely. The level of risk spreads (equity, credit), and narrow option-implied distributions, also signal that the probability of recession priced in by the market is low. In the

Since September, equity prices pushed and pulled in different directions, by combination of positive growth news, but also by expectations for tighter monetary policy

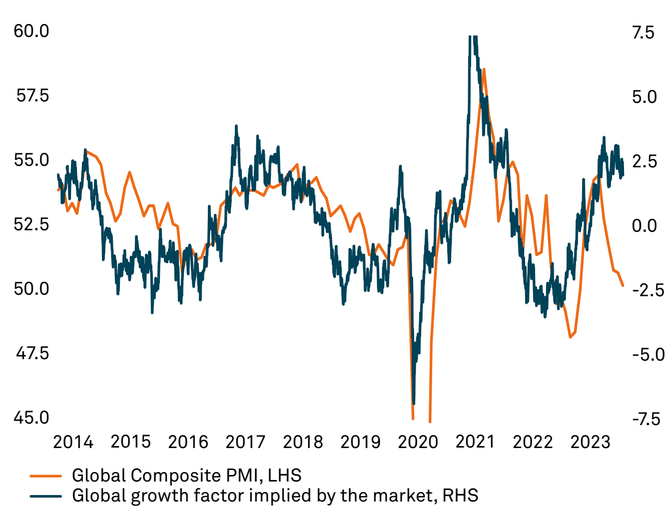
CHART 10: CUMULATIVE CHANGE IN S&P 500 INDEX DECOMPOSED BY MACRO DRIVERS



Source: BNY Mellon Investment Management, Macrobond. Data as of November 20, 2023.

Market expectations for global growth are more optimistic than what suggested by leading indicators of growth

CHART 11: GLOBAL GROWTH FACTOR AND THE GLOBAL COMPOSITE PMI



Source: BNY Mellon Investment Management, Macrobond, JP Morgan. Data as of November 20, 2023.

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US, the spread between the S&P 500 earnings yield and 10-year US interest rates has moved to levels not seen since the early 2000s, indicating that the market is placing increasing weight on the likelihood that AI will lift the long-term growth outlook for US corporate earnings.

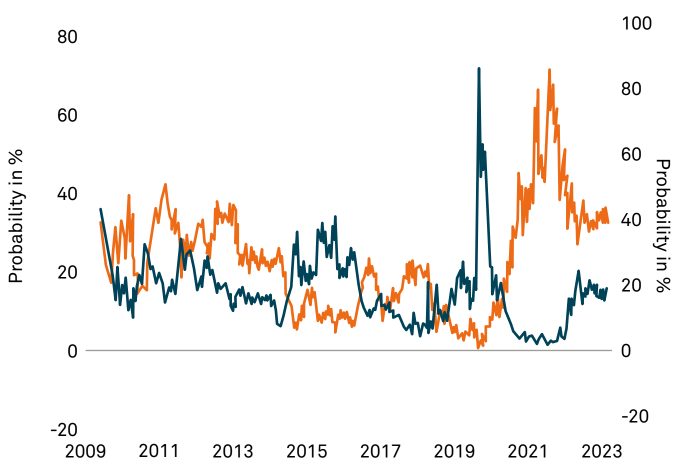
Inflation: In line with the decline in actual inflation seen in recent months, market inflation expectations declined somewhat over the quarter, but broadly speaking the market view is consistent with a speedy return of inflation to target in most advanced economies. There is divergence across regions, however. US market-based inflation expectations remain healthy and at the target. Broadly the same can be said for the euro area, where inflation is seen as stabilising at levels consistent with 2%. In contrast, expectations for Japanese inflation remain deeply below 2%, despite the Bank of Japan's best efforts to reflate the economy. And the market sees inflation in the UK as stablizing about 1 percentage point above target for many years to come, suggesting doubts about the Bank of England's willingness to restore price stability. Option markets still see a relatively high probability of inflation averaging above 3% over the next 5 years, suggesting a shift away from the below target inflation regime that dominated markets after the Global Financial Crisis and until the pandemic.

Rates: With central bankers stressing the data dependence of their future policy decisions, the market remained highly volatile, moving sharply on news about inflation and growth, as well as communications from central banks around the outlook for interest rates. The quarter started with the market pricing in a 'higher for longer' environment, with around one additional rate hike expected from the Fed and the BoE in the near term. It is now expecting 3-4 rate cuts by end 2024. Real (i.e., inflation expectations adjusted) interest rates continued rising overall, particularly at long-term maturities. While it appears that the market is pricing in a high level for the 'neutral' real interest rate going forward, the move in US real rates was also driven by increased worries around the long-term outlook for fiscal sustainability. Consistent with this explanation, the US real interest rates curve steepened sharply, driven by a rise in the term premium,[3] while the curve in the euro area and the UK flattened.

[3] The compensation that investors require for the risk that future interest rates may turn out higher than currently expected.

The market is suggesting the end of the post-GFC below target inflation regime

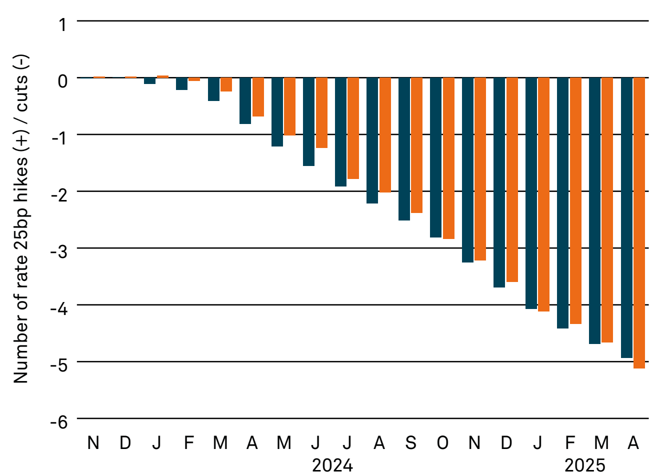
CHART 12: MARKET PROBABILITY FOR <1% AND >3% US INFLATION OVER THE NEXT 5 YEARS



Source: Federal Reserve Bank of Minneapolis. Data as of November 20, 2023.

The market is expecting the beginning of a fast monetary policy loosening cycle in early 2024

CHART 13: NUMBER OF IMPLIED RATE CUTS FROM THE FED AND THE ECB



Source: BNY Mellon Investment Management, Macrobond. Data as of November 17, 2023

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Section 2B

MARKET SENTIMENT

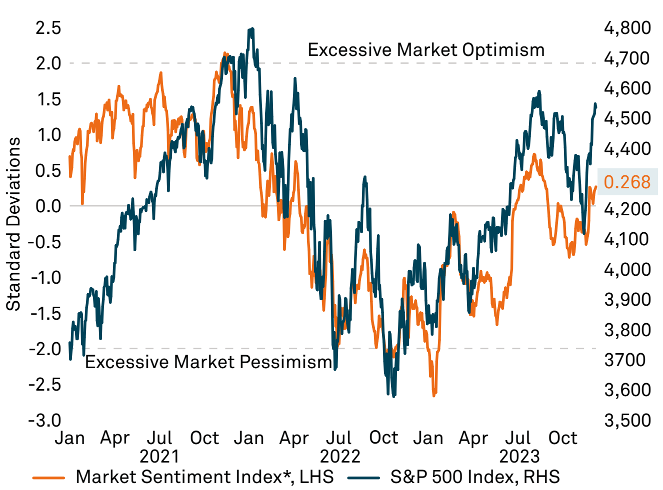
After three months of declines through October, equity markets charged back as they entered the final months of the year. Unsurprisingly, market sentiment broadly improved as expectations that the Fed was finished hiking firmed and yields sharply fell after rising from August through October. By an aggregate measure of market sentiment, based on market-based metrics of risk appetite and investor surveys, the peak occurred in mid-July and subsequently dropped below average in mid-August but has since recovered. Historically, excessive sentiment in either direction, too much optimism or pessimism, has been a contrarian indicator of a potential inflection point in the market. After the markets charge in November, sentiment improved markedly to move in line with the long-run average (see chart). By this measure, sentiment does not currently appear stretched.

Interestingly, a measure of business/consumer confidence, which aggregates results from consumer and business surveys, remains quite low, albeit recovering from this year's trough at the end of May (coinciding with the US debt ceiling deal). The readings suggest "recession-like" pessimism remains prevalent. When juxtaposed with the market's more upbeat sentiment, this suggests there is a disagreement regarding how this tightening cycle will eventually end. Put simply, whether it ends in tears (recession) or cheers (soft landing).

In fact, the markets performance seems similarly in disagreement when one looks under the hood. While at first blush, it has been a "good year" for US stocks, the details paint a far more complex, and less rosy picture. A few of the largest US stocks underpin nearly all of this year's return. Whereas the "average" stock in the S&P 500 has a return in

Market sentiment gained into year-end, moving in line with long-run average

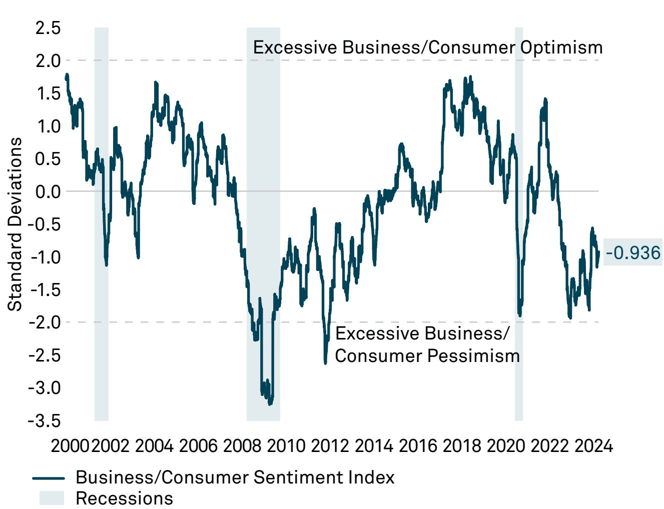
CHART 14: MARKET SENTIMENT INDEX*



Source: Macrobond, BNY Mellon Investment Management.
*Standardized equal weight index comprised of CBOE Volatility Index (VIX), CFTC CME Non-Commercial Long/Short S&P 500 E-mini contracts, S&P 500 Index Consumer Discretionary vs. Staples Ratio, CBOE Equity Put/Call Ratio, and AAII Sentiment Survey Bull-Bear Spread.
Data as of Tuesday, November 21, 2023.

Business/Consumer sentiment similarly improved, but remains at "recession-like" levels

CHART 15: BUSINESS/CONSUMER SENTIMENT INDEX*



Source: Macrobond, BNY Mellon Investment Management.
*Standardized equal weight index comprised of Conference Board's CEO Confidence Survey, NFIB Small Business Optimism Index, University of Michigan Consumer Sentiment Index. Conference Board Consumer Index, and San Francisco Fed Daily News Economic Sentiment.
Data as of Tuesday, November 21, 2023.

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

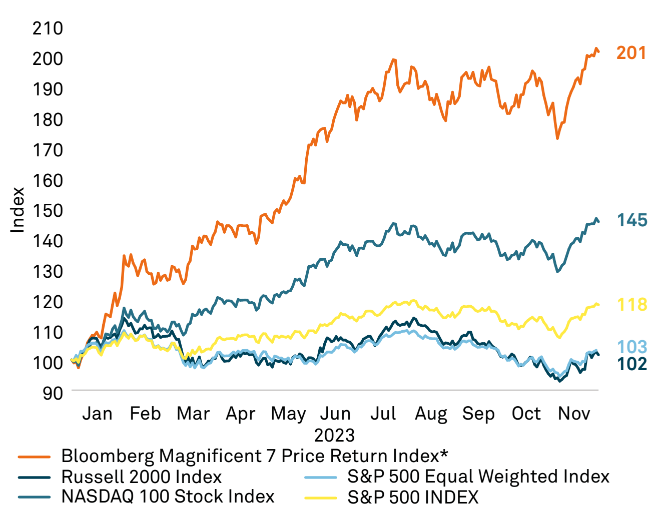
the low single-digits. At the top of the market, a handful of mega-cap names have shrugged off restrictive monetary policy and charged higher on Artificial Intelligence (AI) enthusiasm. Meanwhile, the rest of the market appears hampered by the cold hard reality of much higher cost of capital and tighter financial conditions (i.e., growth prospects are dimming). Small caps especially have suffered as many of these companies are more vulnerable to higher capital costs. The Russell 2000 Index has multiple times this year flirted with negative YTD returns.

Meanwhile, institutional investor surveys suggest that weaker growth is expected in 2024, however, the majority also believe that soft landing is the most likely outcome. Curiously, despite this view, the surveys suggest sentiment remains at bearish levels albeit having risen throughout the year on improving growth prospects. This is likely explained by the fact that macro uncertainty remains elevated. Notably, surveys suggest much higher conviction of lower inflation and rates in recent polls.

As described above and seen in our fan charts, we're unconvinced that soft landing is the end game of this tightening cycle globally, though we give decent odds to the US. Overall, our fan charts suggest a challenged but dynamic outlook for risk assets in 2024. As economic fortunes diverge around the globe, this may present opportunities for investors. Regional indexes have recently been moving in near lock step, but our forecasts suggest a higher probability of decoupling ahead due to varying degrees of recession risk across regions. Where do we see these opportunities across regions and asset classes? In the final section, we pull it all together and layout our tactical and strategic views.

US equity performance heavily concentrated in a few stocks, leaving behind the rest

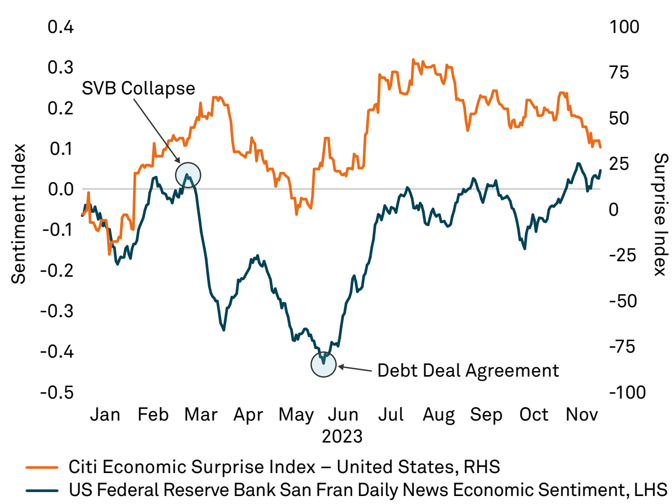
CHART 16: US EQUITY PERFORMANCE YEAR-TO-DATE



Source: Macrobond, BNY Mellon Investment Management.
*Bloomberg Magnificent 7 Index is an equal-dollar weighted benchmark consisting of a fixed basket of 7 companies: GOOGL, AMZN, AAPL, META, MSFT, NVDA and TSLA.
Data as of Tuesday, November 21, 2023.

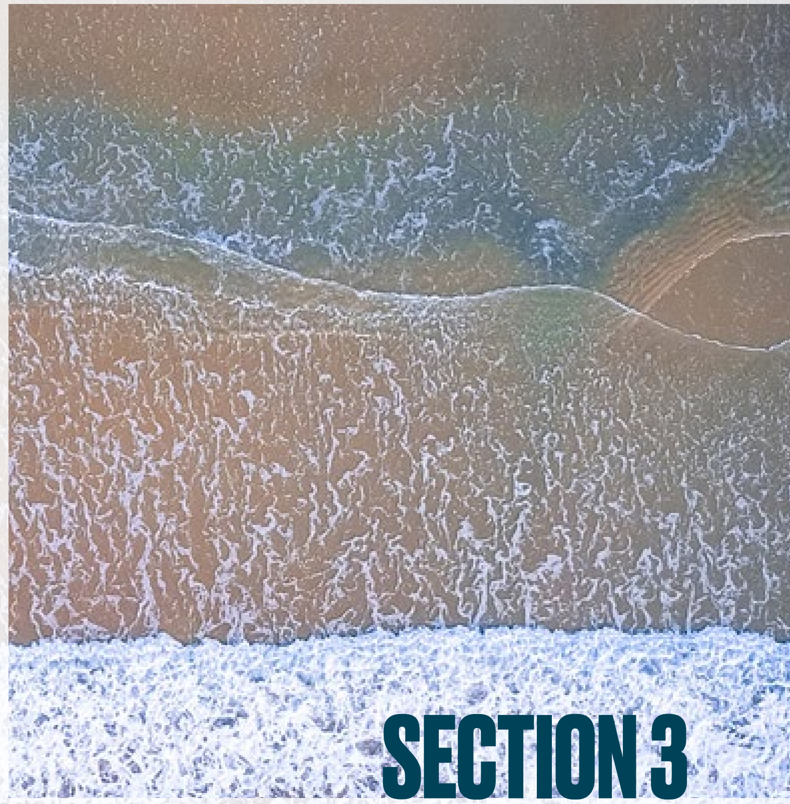
Economic surprises and news sentiment are both trending lower, albeit surprises still positive for now

CHART 17: DAILY NEWS ECONOMIC SENTIMENT AND ECONOMIC SURPRISES



Source: Macrobond, BNY Mellon Investment Management.
Data as of Tuesday, November 21, 2023.

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



SECTION 3
INVESTMENT CONCLUSIONS

Section 3

INVESTMENT CONCLUSIONS

Summary

Completing another lap around the sun, markets were kinder to investors than most expected coming into the year. It's fair to say that against the expectations, 2023 was far better-than-feared for risk assets. In the US, dodging a recession and declining inflation, coupled with enthusiasm for stocks exposed to the generative Artificial Intelligence (genAI) theme, was sufficient to lift the market's multiple (e.g., price to earnings ratio) over the course of the year (despite rising real yields). Aggregate earnings failed to grow, but critically avoided a collapse thanks to resilient consumer demand. 2023 was a "soft landing" year and this increases the likelihood that 2024 could also be one. However, there's a significant caveat.

While, as our scenario probabilities suggest, recession risks have diminished somewhat, especially for the US, it is difficult to fathom that they aren't still higher than during a typical year due to ongoing restrictive monetary policy. The "higher for longer (rates)" mantra creates an environment where financial conditions are likely to slow economic activity, and possibly to the extent that growth contracts and jobs are lost.

Our macro-outlook suggests risk asset returns may be uninspiring during the next orbit of the sun. While there is a path to a solid year of returns, the trouble is that there remains an elevated chance that the downturn that was feared but avoided in 2023, was instead simply delayed by a year. That said, recession probabilities are diverging, which indicates opportunities to add value through regional and asset class diversification.

One must also acknowledge the high level of macro uncertainty that persists. The pessimistic reading of the data may be overdone, especially considering how well the US economy has so far endured the historically rapid tightening cycle. Other economies, notably Europe, show more visible signs of the stresses of higher rates on economic activity.

On a tactical basis, the outlook for risk assets faces headwinds from elevated recession probabilities, monetary policy reaction functions, and what's already priced in. The outlook for the US has improved thanks to cooling inflation and a softening labor market. However, a backdrop of restrictively high rates (real and nominal terms) makes it challenging to justify elevated valuations and the robust consensus earnings outlook which projects +10% earnings per share growth in 2024. Our fan charts indicate that we see policy rates moving lower in 2024 more slowly than consensus, which means short-dated real yields are likely to rise (as inflation declines more speedily) and this in turn may limit multiples expansion.

Admittedly, the potential for sooner-than-expected easing monetary policy (conditional on avoiding a recession) may yet support higher multiples while validating the optimistic earnings outlook. The US equity market is "high duration", such that in a genuine soft landing paired with "goldilocks rate cuts", it could mean a relatively moderate decline in real yields spurs a strong rally. If concurrently enthusiasm for AI reignites, this would turbocharge the rally. We capture this possibility in the "Immaculate Disinflation" scenario and incorporate some aspects of it in 'International Divergence' where US outperforms.

The table below shows the potential paths for the S&P 500 using estimates of P/E and EPS (price/earnings and earnings per share, respectively).

International Divergence		**Year End Values**	
	2024	**2025**	**2026**
EPS Estimate	235	254	275
Earnings Growth	7%	8%	8%
Price/Earnings	22	22	21
Approximate Level	5,179	5,593	5,766
Annual Return Estimate	14%	8%	3%

Unavoidable Recession		**Year End Values**	
	2024	**2025**	**2026**
EPS Estimate	202	243	267
Earnings Growth	-8%	20%	10%
Price/Earnings	18	20	20
Approximate Level	3,643	4,858	5,343
Annual Return Estimate	-20%	33%	10%

Immaculate Disinflation		**Year End Values**	
	2024	**2025**	**2026**
EPS Estimate	242	269	290
Earnings Growth	10%	11%	8%
Price/Earnings	23	23	22
Approximate Level	5,566	6,178	6,382
Annual Return Estimate	23%	11%	3%

Forecasts were calculated as of November 21, 2023. BNY Mellon Investment Management GEIA.

Based on our probability weighted scenarios, we derive risk-adjusted return estimates across assets, and in the tables that follow, we lay out our tactical (2024) and strategic (multi-year) views. Late-cycle macro headwinds keep us (at best) cautiously optimistic on equities overall, though we see diverging probabilities across regions as an opportunity. We have modest preference for EM over DM for tactical exposure, but expect that within DM, US equity has better odds of delivering strong returns, conditional on avoiding a recession, easing monetary policy, and AI enthusiasm catalyst.

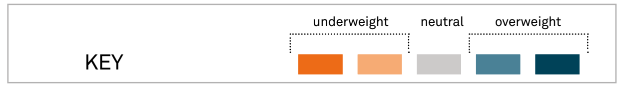
On the fixed income side, we continue to believe high quality bonds offer attractive risk-return profiles in this environment.

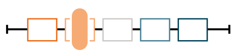
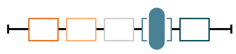
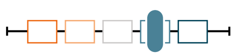
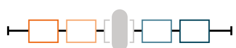
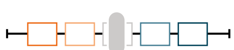
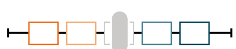
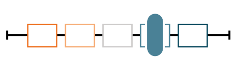
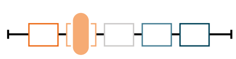
Moreover, the increasing likelihood that hiking cycles are over means the risk of extending duration too soon is lower while the reward is high due to rates remaining elevated. As we've argued for some time given our higher recession risk probabilities and the difficulty of precisely timing a downturn and rates moves, we think it's better to be too early than too late when adding duration exposure. We favor exposure to developed market sovereign debt (slight preference for European sovereigns over US Treasuries stemming from relative recession risks), and up-in-quality Investment Grade credit. We moderate our tactical view on cash and cash-like bonds (money markets) as we see reinvestment risk as material over the next 6-12 months.

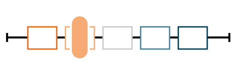
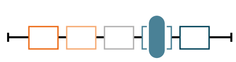
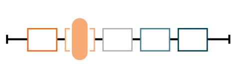
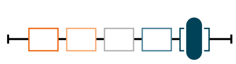
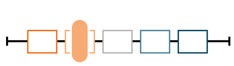
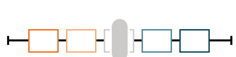
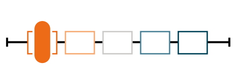
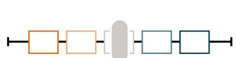
We maintain the view that boosting exposure to the quality factor is a practical way to hedge against drawdown risk but limit sacrificing upside potential. Keep in mind that increasing quality exposure may be achieved through reducing exposure to lower-quality corporates (i.e., companies with weaker profitability and greater leverage). Large caps are preferred over small given the macro backdrop of high financing costs. Sector-wise, we lean defensive, but think more important than picking sectors is identifying names with the right mix of reasonable valuations and quality factor exposure.

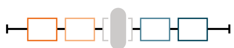
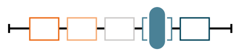
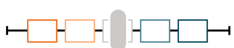
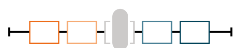
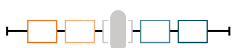
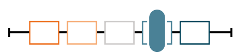
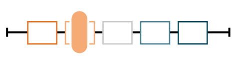
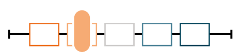
On a strategic multi-year basis, we're becoming more optimistic as our research into the potential impact of AI on productivity encourages us. Although the impact is highly uncertain in the near-term, we assess a high probability that AI will significantly boost labor productivity with benefits accruing broadly across the economy and to shareholders. These developments may support margins and earnings growth sooner-than-expected, and critically, we do not think these benefits are yet priced into the market.

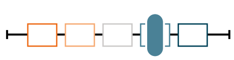
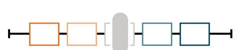
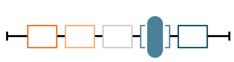
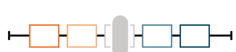
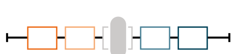
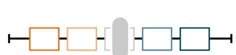
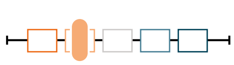
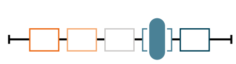
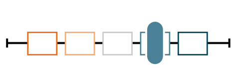
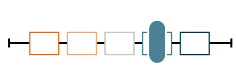
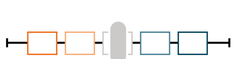
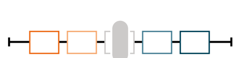
ASSET CLASS VIEWS



Major asset class	Tactical view	Strategic view	Comments
Equities			Late-cycle macro headwinds keep us (at best) cautiously optimistic on equities overall, though we see diverging probabilities across regions as an opportunity. The (still) elevated recession risks indicate it's too early to broadly re-risk because the downside skew is sizable. However, diverging economic fortunes means there are emerging opportunities to regionally diversify and add value by tilting toward risk exposure that face less relative downside skew, and larger potential upside skew via soft landing and AI exposure. We have a neutral view of EM and a strong preference for US and Japan exposure over Europe equity with DMs. On a strategic multi-year outlook, we have a strong preference for US equity based on exposure to AI theme.
Fixed Income			Higher yields across fixed income present buying opportunity as we continue to see extending duration as a favorable risk/reward trade-off in 2024. This view has only firmed as the likelihood that hiking cycles have concluded has risen considerably. Given the difficulty in timing a recession and the associated market moves, we think the risk of being too late in extending duration outweigh those of being too early. Further, with spreads remaining tight, we continue to lean in favor of sovereign debt and high-quality fixed income over lower quality credits that face greater spread risk.
Alts/Real Assets			We have a neutral view on real assets/alternatives, after reducing from an overweight previously. As recession risks moderate, and upside inflation risks have fallen, the attractiveness of assets less sensitive to, and positively sensitive to inflation, similarly decline, especially those with negative carry.
Cash			We moderated our tactical view on cash and cash-like bonds (money markets) as we see reinvestment risk as material over the next 6-12 months. As growth prospects have improved, the relative attractiveness of cash yields has also declined, though we're still favorable in the near-term given current combo of competitively high rates and zero duration risk. We expect it will begin to lose its lustre at some point next year, either in a recessionary environment, or through normalization of monetary policy.

Equity	Tactical view	Strategic view	Comments
Developed Markets Equity			A shifting global macro backdrop will likely lead to diverging developed market equity performance. We capture this most acutely in our 'International Divergence' scenario, but the theme will likely play out across scenarios as monetary policy takes differing paths across countries as warranted by macroeconomic realities. DM equity continues to face headwinds near-term from restrictive monetary policy and weakening demand, especially in Europe. We're considerably more positive on a multi-year horizon, particularly on US equities benefiting from AI adoption, which will likely have positive spill over to international markets.
US Equity			We estimate low single digit returns in 2024 and above average volatility. Returns likely constrained by 1) higher rates staying higher than market expects, 2) valuations difficult to justify at high real rates, 3) questionable earnings rebound given slowing growth expectations/weakening consumer. Yet, US equity has decent odds to surprise to the upside, conditional on avoiding a recession, sooner-than-expected "goldilocks cuts", and an AI enthusiasm catalyst. This holy trinity is possible but insufficiently likely to be favorable currently, given better expected risk-adjusted returns in other asset classes. The strategic most overweight view is underpinned by our research into the possible benefits of widespread AI adoption on a multi-year basis.
UK Equity			Cheap valuations on both a relative and historical average basis remain attractive and imply that minimal less bad news could spur on markets to re-rate. But a poor macro backdrop both domestically and externally (which is critical for larger UK-listed firms) keep us tactically underweight. More positive on a strategic basis.
Europe ex UK			We remain tactically underweight European equities as the economy remains challenged. A recession in Europe remains highly likely, and troubles in China mean that global economic performance ex US continues to struggle. As the asset class is more cyclical, we see a greater downside risk potential, as well as less near-term upside if AI developments surprise positively.

Equity	Tactical view	Strategic view	Comments
Japan Equity			Reflation process remains intact. But headwinds are cropping up. Domestic consumption has been buffeted by a cost-of-living shock brought on by an inflation pick-up but lagging wage growth. BOJ will take more time to normalize YCC. Meanwhile, stable to stronger trend in Yen will stall further FX translation gains of Japanese corporations' offshore earnings. Attractive valuations and structural reforms, however, keep us overweight on a structural basis.
EM Equity			Attractive valuations but dragged down by China and lingering tightness in global financial conditions from higher US rates and a firmer for longer trend in the USD. We stay tactically neutral. Over a longer horizon, China will remain a drag, but improvements in cyclical and financial conditions alongside shifting supply chains and catch-up potential keep us strategically neutral across the EM equity space.
EM ex China			Attractive valuations and the bottoming out of excess manufacturing and tech inventories plus swelling AI-related order books keep us tactically constructive and result in us staying neutral. Sound macro management, economic flexibility and long-term potential make us strategically bullish on EM ex-China.
China Equity			Chinese equities cheapened in 2023, dragged lower by much weaker than expected nominal GDP growth. This reflects a pernicious mix of the downturn in property, excess capacity, and too little stimulus. Late year fiscal policy support doesn't provide the necessary catalyst for us to expect a re-bound anytime soon. We shift to moderate underweight on a tactical basis.

Fixed Income	Tactical view	Strategic view	Comments
US Treasuries			With the outlook for a US economy that remains relatively brighter than elsewhere, and despite the fall in inflation seen so far, the case for going very overweight US sovereign fixed income has fallen, but we maintain a favorable view overall. The high level of nominal yields offers attractive income returns and provides a buffer to short-term price return volatility. Recession risks remain elevated compared to history and higher than priced in by the market. Given the difficulty in timing a recession and the associated market moves, we think the risk of being too late in extending duration outweigh those of being too early.
Intl. Sovereign Debt			We maintain an overweight tactical allocation to developed market sovereign fixed income. With the hiking cycle likely to have ended in Europe, and mounting challenges on growth, we expect favorable risk-adjusted returns over the next 12 months. The potential stickiness of inflation in Europe prevents us going maximum overweight the asset class, but we have a modest tactical preference compared to US Treasuries despite the lower income return offered.
Global IG			Higher quality, better income buffers. But relatively rich spreads imply modest defensive value amidst G2 slowdown. We stay tactically neutral. Over a longer time-horizon, G2 policy easing and better underlying credit quality likely to support healthy returns but unlikely to be exceptional – we stay neutral strategically as well.
High Yield Debt			Sub-investment grade credits resilient so far this year. But spreads have gotten too rich. That also leaves it vulnerable to a macro downturn alongside refinancing stresses in 2024 and causes us to stay tactically underweight. A bounce back once financial conditions begin to ease credit should drive higher expected returns – we are strategically overweight.
EM Local Currency Debt			Well managed inflation fundamentals, a peak in the USD index and, possibly, in US rates should sustain high single-digit total returns in the year ahead (carry plus duration). We shift back to tactically overweight. Over a longer horizon, a track record of economic flexibility and improving policy credibility, despite the drag from China, keep us bullish EM local currency debt.
EM USD Debt			Reasonable yields but combination of G2 and China slowdown, tight spreads and frontier market distress keep us cautious and tactically neutral. Over time, easier global financial conditions to help, but sovereign USD debt issuers' heavier reliance on China and a relatively lower yield, versus local currency, keep us strategically neutral as well.

Source: BNY Mellon Investment Management, as of November 21, 2023.

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DEFINITIONS

Japan (Nikkei 225): The NIKKEI 225 is an index that tracks the performance of the largest 225 companies traded in the Japanese market. **10Y UK Gilt** – Average yield of a range of UK government bonds all adjusted to the equivalent of a ten-year maturity. **Phillips Curve:** An economic theory that inflation and unemployment have a stable and inverse relationship. US **Consumer Prices (CPI) Index** measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rate represents the inflation rate. The **10Y US Treasuries Average Yield** of a range of Treasury securities all adjusted to the equivalent of a ten-year maturity. The **CBOE VIX Index (VIX)** is an indicator of the implied volatility of S&P 500 Index as calculated by the Chicago Board Options Exchange (CBOE). The **Majors Dollar Index (USD)** measures the value of the US dollar relative to a basket of currencies of the most significant trading partners of the US including the euro, Japanese yen, Canadian dollar, British pound, Swedish krona, and Swiss franc. The **MSCI EM Index (Emerging Markets Equities)** tracks the total return performance of emerging market equities. The **S&P 500 Composite Index (S&P 500)** is designed to track the performance of the largest 500 US companies. **Europe STOXX 600** Index represents the performance of 600 large, mid and small capitalization companies across 18 countries in the European Union. **Bloomberg US Corporate High Yield:** covers the universe of fixed-rate, non-investment grade corporate debt in the US. **Bloomberg US Corporate Investment Grade:** designed to measure the performance of the investment grade corporate sector in the US **1-mth. 1-year forward swap:** the avg. interest rate for 1-mth. in 1-year forward. **GDP:** gross domestic product is the total monetary or market value of all the finished goods and services produced within a country's borders over a given time period. **Fed funds Rate:** the target interest rate for overnight lending and borrowing between banks. **Purchasing Managers Index (PMI):** An economic indicator derived from monthly surveys of private sector companies. A level above 50 indicates expansion compared to the prior month and below 50 contraction. Investors cannot invest directly in any index. **Soft landing:** a gradual and controlled economic slowdown, often aimed at preventing a recession or minimizing its impact. **Global Financial Crisis:** The severe economic downturn that began in 2007-2008, characterized by widespread banking failures, a collapse in housing markets, and subsequent global recession.

STATISTICAL TERMS

Skewness in statistics represents an imbalance and an asymmetry from the mean of a data distribution. In a normal data distribution with a symmetrical bell curve, the mean and median are the same. **Kurtosis** is a measure of whether the data are heavy-tailed or light-tailed relative to a normal distribution. That is, data sets with high/low kurtosis tend to have heavy/low tails, or outliers. **Probability-weighted mean** is similar to an ordinary arithmetic mean, except that instead of each of the data points contributing equally to the final average, data points are weighted by the statistical probability for a particular scenario outcome. **Duration** is a measure of a bond's interest-rate sensitivity, expressed in years. The higher the number, the greater the potential for volatility as interest rates change.

Other

QE: quantitative easing. **Fed:** US Federal Reserve. **ECB:** European Central Bank. **BOJ:** Bank of Japan. **BOE:** Bank of England.

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