BNY MELLON

THE ALTA REPORT.

OCTOBER 2023

Welcome to THE ALTA REPORT.

Welcome to the Alta Report, a quarterly compilation of BNY Mellon perspectives derived from ***our unique vantage point*** at the intersection of markets. Touching 20% of the world's investable asset flows gives us insight into key trends, helping you navigate the future arc of markets and macro developments.

Our vantage point comes from:

TOUCHING

20%

of the world's investable assets

SAFEKEEPING

$46.9T

in assets (custody and/or administration) as the world's largest custodian

SETTLING

$12.3T

in U.S. government securities daily

SERVICING

$6T

in U.S. and international collateral

FINANCING

$4.5T

in lendable securities

PROCESSING

$2.4T

of U.S. dollar payments daily

MANAGING

$1.9T

in assets for our asset & wealth management clients

INVESTING

$286B

in client wealth management assets

Data as of June 30, 2023

U.S. Fixed Income

By John Velis
FX and Macro Strategist, Americas
BNY Mellon Markets

INSTITUTIONS BUY LONG TREASURYS

The institutional asset manager flows we track in our custody business indicate that real-money investors are starting to buy U.S. Treasurys at the long end of the curve (10yrs and above). Meanwhile, exposures to the belly of the curve have flattened (5-10yrs) and short-duration exposures (less than 5yrs) are slowing somewhat.

The volume of flows into shorter-dated parts of the Treasury market are still higher overall, in part because T-bill yields are very attractive, but the speed and intensity of flows into long duration are now doubly as fast as flows into short and intermediate maturities. Since the beginning of the year, flows into the 10yr and higher maturity segment of the curve have increased by $18.5bn our iFlow data show.

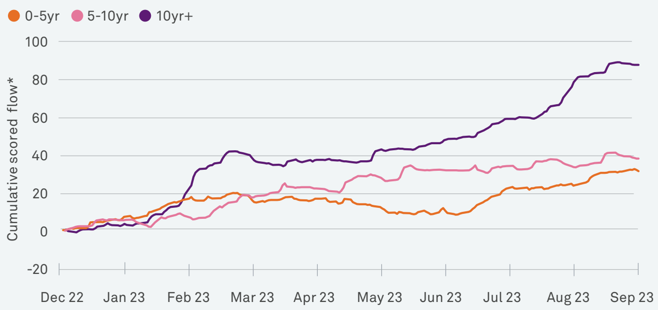
U.S. corporates, endowments, foundations and pensions with greater than $5bn to invest increased their allocations to long-duration Treasurys by 0.17% in June and by 0.21% in July, respectively, our Asset Strategy View dataset shows. Public defined benefit pension funds, which tend to match their assets to longer-term liabilities, are selling large cap U.S. equities and getting into longer duration, too, with plans managing less than $5bn allocating 3.55% more to intermediate bonds in June and downshifting short-duration allocations by 3.88%.

SOME NON-U.S. INVESTORS SELL TREASURYS

Amid plenty of domestic Treasury buying, our iFlow data show that some foreign investors have been liquidating their U.S. cash and short-term asset holdings, after a period of slowly building these positions when foreign-exchange hedging costs became more attractive. The selling was initiated in early June, right on the heels of the U.S. debt-ceiling resolution, and has been pronounced and steady through mid-September.

Cross-border exposure to the U.S. Treasury market is down by more than $1.6bn between mid-August and mid-September alone, likely due to capital losses on these bond holdings as yields have risen. The trend is notable because, even with T-bill purchases becoming less of a concern as the U.S. Treasury refills its coffers, there remains a broader question as to who will buy the longer bonds.

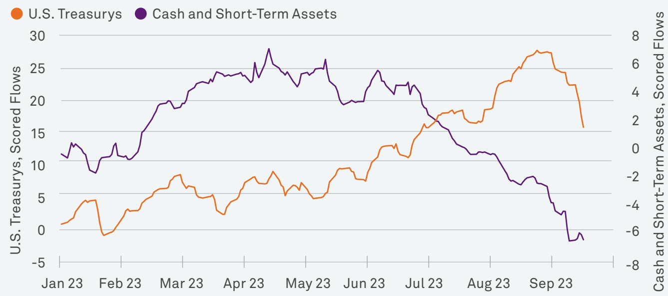
U.S. Treasury Flows by Maturity



*A scored flow is an exponential moving average asset flow, normalized by trailing asset flow standard deviation, where asset flow is daily net aggregate trading (buy/sell)
Source: BNY Mellon iFlow

(Note that our short-end Treasury flows represented here include institutional investments directly into securities like T-bills and not flows into T-bills through money market mutual funds or ETFs.)

Non-U.S. Investor Flows: USTs, Cash & Short-Term Assets*



*All flows are cumulative scored flows (Dec 31, 2022-Sep 15, 2023)
Source: BNY Mellon iFlow

(Note that our short-end Treasury flows represented here include institutional investments directly into securities like T-bills and not flows into T-bills through money market mutual funds or ETFs.)

U.S. Fixed Income

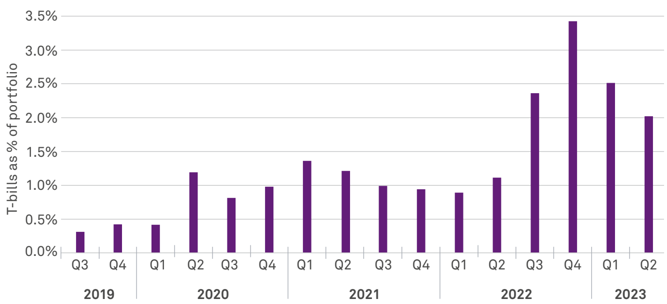
Treasurys accounted for 29% of our cleared fixed income volumes in the first eight months of 2023.

Some 77% of that Treasury volume was in T-bills, compared with 70% in the same period a year earlier. But the shift toward shorter maturities is more pronounced by U.S. retail-oriented broker dealers, as 91% of Treasurys traded by these firms were T-bills, compared with 73% traded by institutional firms.

FAMILY OFFICES ARE FOCUSED ON LIQUIDITY

Data from BNY Mellon Wealth Management's family office business suggests wealthy families are keeping their powder dry for future investing opportunities. As such, they continue to allocate to T-bills for their operating liquidity requirements, taking advantage of attractive yields. At the end of June, T-bill holdings stood at around 2% of those portfolios, double pandemic era allocations. Strategic liquidity allocations for family offices are similarly allocated at present, however they anticipate that as the yield curve normalizes extending duration will be attractive.

T-Bills as a % of Total Family Office Portfolios*



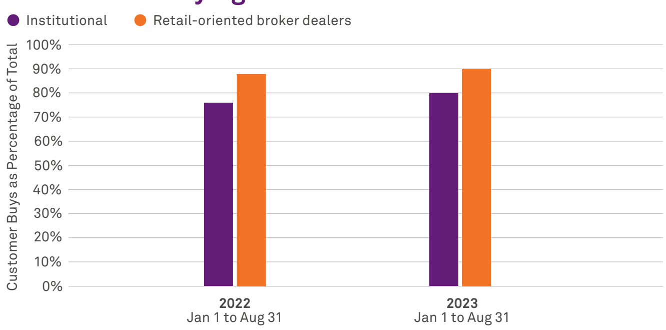
*Source: BNY Mellon Wealth Management, Global Family Office Portfolios

RETAIL MORE ACTIVE IN TREASURYS

Our Pershing clearance platform saw a 99% year-over-year increase in the par value of U.S. Treasurys traded in the secondary market by retail-oriented broker dealers and registered investment advisors (RIAs) for the first eight months of this year ($288bn versus $145bn). The year-over-year increase for more institutional-oriented dealers and hedge funds was only 17%.

Retail also had more of a buying bias. Of the institutional Treasury trades we cleared through August this year, 80% were clients buying (versus 20% selling), and of the retail Treasury activity, 90% were buying (versus 10% selling).

Retail Leads Buying Bias

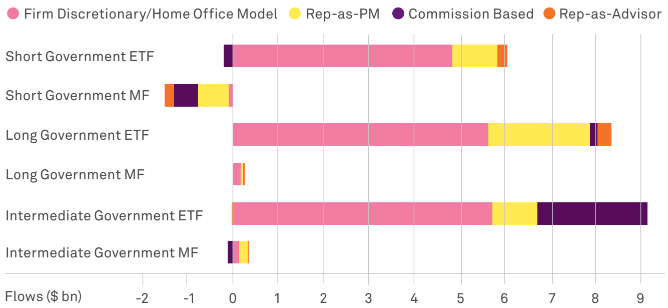


*Data is based on activity of ~400 broker-dealer clients, ~450 RIA clients and ~60 alts/hedge funds who have cleared FI trades via Pershing during the period.
Source: BNY Mellon Pershing Clearance

BROKER CIOs DRIVE RETAIL FLOWS

Fee-based broker dealer home office advisory platforms drove most of the long and intermediate government net inflows by retail investors we tracked over the 12 months ended June 30. In other words, wirehouse chief investment officers (CIOs) and their models are directing a lot of retail client flows into U.S. government fixed income and longer duration specifically, rather than orders from the end clients or their advisors.

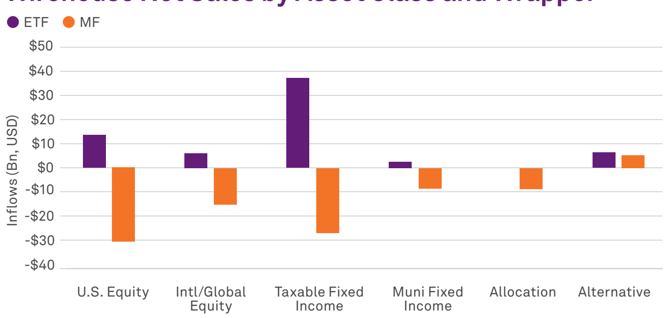
Wirehouse U.S. Government Net Sales Trailing 12Mo*



*Data from Q2 2022 to Q2 2023
Source: BNY Mellon Growth Dynamics

In terms of the preferred vehicle for fixed income investing, our clients seem to favor exchange-traded funds (ETFs) over mutual funds. This bucks the long-term trend, where wirehouse data we get from four major retail broker dealers (our Growth Dynamics platform) show mutual funds have historically been the favorite. Long and short government bond ETFs respectively ranked as the fourth and fifth most popular investment styles tracked by the platform based on net sales.

Wirehouse Net Sales by Asset Class and Wrapper*

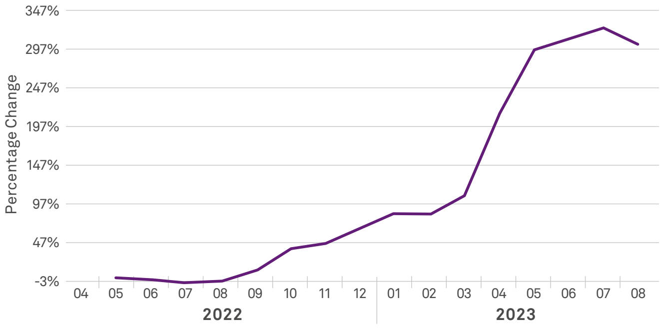


*Data from Q1 2022 to Q2 2023
Source: BNY Mellon Growth Dynamics

SWITCHING REPOS

In addition to cash moving into T-bills, we are also seeing money market funds moving cash from the Federal Reserve's reverse repo program (RRP) into cleared repos that we sponsor into the Fixed Income Clearing Corp. (FICC), where rates to date are competitive. We have seen balances of these cleared sponsored FICC repos rise 300% from year-ago levels ahead of an expected clearing mandate for Treasury-backed repos coming this fall.

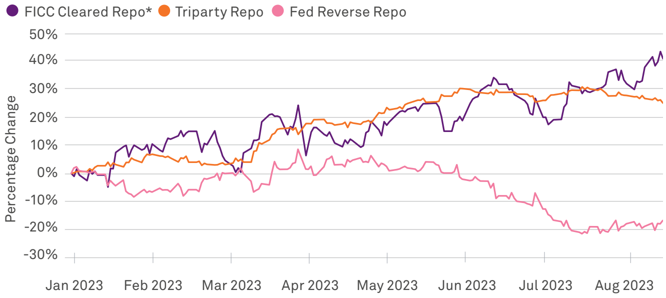
Growth in Sponsored FICC Repo Volumes



Source: BNY Mellon Securities Finance

Our triparty dealer repo volumes, where we act as agent, have also grown by about 25% since the start of the year. This reflects the move into dealer repos away from the Fed's RRP now that rates are comparatively higher in the open market.

Growth in BNY Mellon CCM Repo Balances YTD



*Includes FICC GCF Repo, FICC Sponsored GC and FICC Centrally Cleared Institutional Triparty
Source: BNY Mellon Clearance & Collateral Management

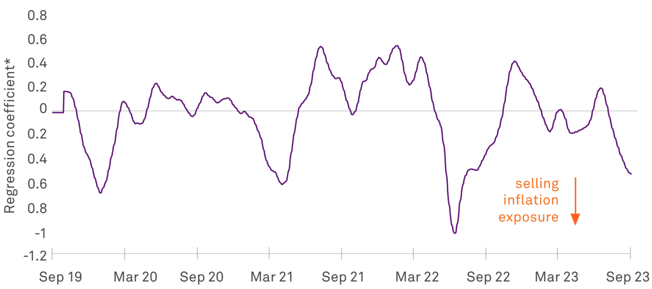
Equities

INFLATION-RELATED FLOWS DECLINE

Flows into equities with a high correlation to inflation have dropped significantly over the past several months, our iFlow data show, indicating that investors are not expecting a resurgence in inflation.

Instead, investors are moving into those equity industry sectors that tend to outperform in lower inflation environments, such as pharmaceuticals, insurance, retail and telecommunications.

Inflation-Related U.S. Equity Flows



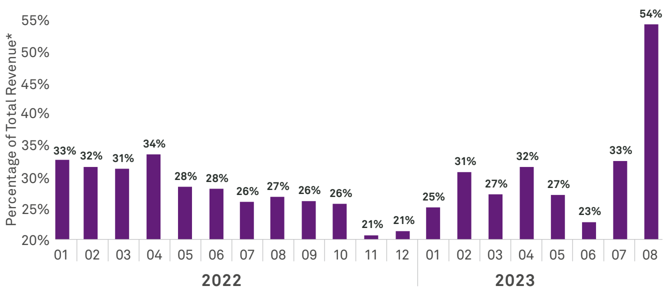
*The regression coefficient describes the relationship between flows and equities that correlate well with inflation.
Source: BNY Mellon iFlow

LONG BIAS IS COOLING

Activity in our agency securities finance book indicates that institutional clients (primarily U.S. asset managers) were lending to a marketplace of borrowers that were heavily short the equities market from 2021 to mid-2023. In May this year, that trend turned, and now many borrowers are long in the equity market, but that long bias was cooling somewhat as of September due to recession fears and the higher-rates-for-longer narrative, according to data from our securities finance platform. As the longs increased, equity specials (those stock loans commanding a yield of more than 200bp) became concentrated in a few red-hot short names.

As of late August, a third of our total U.S. equity agency securities finance revenues were coming from just 10 names (including AMC, KVUE, JNJ and SIRI) out of the roughly 5,000 names we offer, versus a fifth at year-end.

Top 10 U.S. Equities as % of Total Revenues*

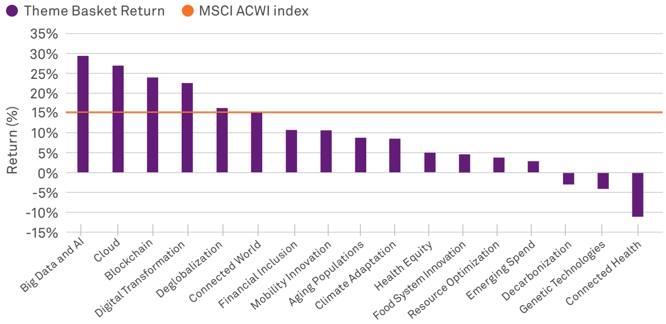


*U.S. Equity Agency Securities Finance Revenues at BNY Mellon
Source: BNY Mellon Agency Securities Finance

AI-DRIVEN RETURNS

Whereas a traditional, sector-based view shows North American technology as the dominant contributor to year-to-date returns in the MSCI All-Country World Index, our multidimensional research platform at Newton Investment Management groups companies by business maturity, providing a unique perspective on drivers of the global equity market. This approach shows that companies exposed to the following secular, thematic stories within technology delivered outperformance during the period we analyzed: big data and artificial intelligence, cloud, digital transformation and blockchain.

Performance of Equity Theme Baskets YTD*



*Baskets managed by Newton Investment Management (data Jan 1, 2023, to Aug 31, 2023)
Source: Newton Investment Management
Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.

International

By Geoff Yu
FX and Macro Strategist for EMEA
BNY Mellon Markets

EMERGING MARKETS READY FOR ACTION

Investors have continued to struggle to allocate capital to emerging markets (EM) given nominal rates in the U.S. are high. But with many of those countries having proactively anchored inflation, some EM bonds are now offering yields well above their domestic levels of inflation.

Despite decent real yields in places such as Brazil and Mexico, iFlow data show there is still a lack of interest in allocating to these markets. For example, quarter-to-date, our clients have net sold $307mn in Brazilian government bonds and $921mn in Mexican government bonds.

China's weak performance is also inhibiting interest in EM markets.

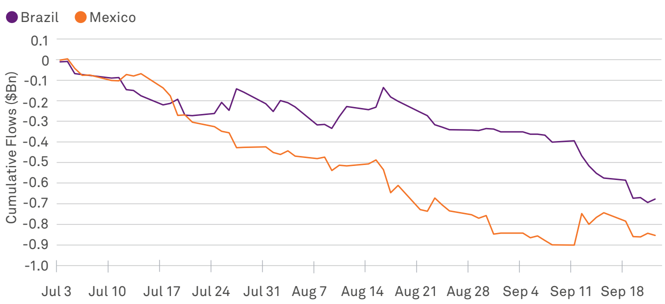
GETTING BACK INTO JGBs

International investors are attempting to buy Japanese bonds again, anticipating improved returns as the Bank of Japan (BoJ) tweaks its yield curve control (YCC) policies, allowing yields on its government debt to float higher.

But there is scant evidence of conviction in the trade. BNY Mellon's iFlow custody data show that two meaningful attempts to wade back into Japanese sovereign debt have been cut short because the U.S. dollar keeps rising and challenging the total return that investors can earn on those bonds relative to U.S. Treasurys. Clients have net sold 330bn yen worth of Japanese government bonds (JGBs) quarter-to-date, according to iFlow.

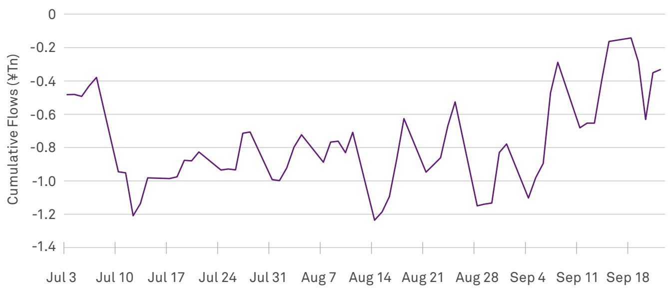
Flows into JGBs rose sharply in mid-May and interest stayed elevated until June 14, just before the BoJ's policy meeting at which the central bank left YCC policy unchanged. But outflows soon followed when official sources indicated that there was a strong market view that Japan's deflationary thinking was beginning to change, and JPY878.8bn left JGBs in the first two weeks of July, according to Flow. Even though the BoJ failed to adjust policy further in its September policy decision, the yen continues to soften.

Emerging Market Flows into Mexico, Brazil Stabilize



Source: BNY Mellon iFlow

Cumulative Flows into Japanese Govt Bonds (JGBs)



Source: BNY Mellon iFlow

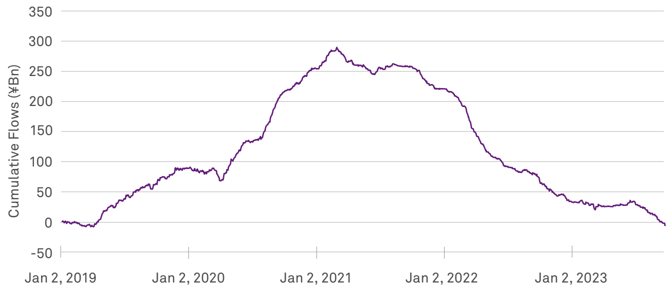
CHINA'S RECOVERY IS STALLING

China's potential economic slowdown will weigh on its major trading partners, perhaps in Europe and APAC more than the U.S. Clients bought 287bn renminbi worth of Chinese government and corporate bonds between January 2019 and February 2021, according to our iFlow data. Since then, the entire holding has been liquidated as investors react to low yields, geopolitics and poor economic data. The bulk of the selling happened between late 2021 and Q1 2023.

But more recently our iFlow data have shown China fixed-income flows as well as equity flows are roughly neutral, meaning there is limited net flow in both directions.

We can see that flows into EM APAC real-estate shares, dominated by Chinese names, strengthened materially in July on stimulus hopes, but reversed sharply as those expectations were not realized. More recently, there has been a renewed stream of statements of support for the sector by Beijing, and flows have stabilized.

China Corp & Govt Bond Outflows



Source: BNY Mellon iFlow

Macro Outlook

By Shamik Dhar
Chief Economist
BNY Mellon Investment Management

Policy rates around the world are probably near their peak. But we think there is potential for a second leg up in rates, not just in Europe but also in the U.S., where we could see one or two more rate hikes if the labor market remains tight. That would add to the impact of previous hikes, which have not yet fully filtered through.

RECESSION STILL ON THE TABLE

The key issue is whether central banks have done enough to bring inflation back to target. That looks more likely to be the case in the U.S. than in Europe and the U.K.

An immaculate return of inflation to 2% in the U.S. is far from certain, however, and some economic pain may be necessary. We believe there is a 50% probability of a U.S. recession during 2024, and if that happens, a global economic downturn would likely ensue. The rest of the world is facing even greater downside risks to growth, particularly in Europe, where we see an 80% probability of recession next year.

While the U.S. is still growing, Europe is drifting toward stagflation and China is still struggling with real-estate problems and below-trend growth. Investors must consider where interest rates will settle once these shorter-term cyclical forces play out. Our latest research suggests a return to an ultra-low-rate environment is not in the cards.

RATES PROJECTED TO STAY HIGH

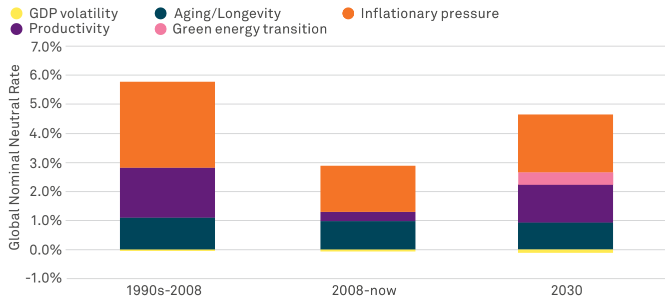
Some economists, including those at the IMF, believe that global nominal rates will return to the 2.5%-3.5% range after the current burst of inflation is resolved. But our analysis suggests that nominal rates will instead settle in the 4.5%-5.5% range over the next decade.

Two factors could put upward pressure on nominal rates. First, persistent underlying inflationary pressures are expected to keep central banks hawkish and benchmark rates higher than they were before the pandemic.

Second, our analysis suggests there have been changes in the fundamental drivers of growth. Secular trends like technology-driven productivity growth and the green energy transition are changing the global economy as they generate higher consumption and investment costs.

Those trends also could push up the real "neutral" rate, which is the rate that theoretically neither heats nor dampens growth. This would result in real rates settling at around 2.5% as we head toward 2030. The income-earning benefits of higher nominal rates could make fixed income assets even more attractive.

Contributions to Global Nominal Neutral Rate



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

View from Washington

By Vincent Reinhart
Chief Economist & Macro Strategist,
Mellon and Dreyfus

BANKS WEATHERING THE STORM

As long as the Fed remains restrictive, we believe banks will continue to feel the squeeze, with the risk of further deposit outflows as customers favor higher yielding cash-like instruments such as Treasury bills. The Fed has left one more rate hike on the table this year, halved its rate-cut expectations for next year and may delay them until the fall of 2024. Yet we feel the impact is unlikely to be as severe for the banking industry as it was in March, when a run on deposits forced the closure of two U.S. regional banks. Financial institutions large and small have had time to find ways to weather the storm, such as offsetting small deposit outflows by paying up for large deposits.

SHUTDOWN AVOIDED...FOR NOW

A government shutdown has been averted for now, but funding is set to run out in November. U.S. sovereign rating downgrades by Fitch Ratings in August and S&P Global Ratings 12 years earlier sounded alarms about the process and path of federal budgeting, with the agencies rightly worrying the U.S. is not organized enough to pay its bills on time. Now only Moody's Investors Service gives the U.S. a AAA rating, which is potentially significant because the complete loss of triple-A status could have a significant impact on the strength of the U.S. dollar.

The potential problem escalates as the federal government's bills mount: net government debt is already greater than nominal GDP, a circumstance previously only seen after world wars.

The Takeaway

With markets digesting higher-for-longer rates, retail and institutional investors are putting their cash to work differently. Conviction about the economic outlook is light, and the range of potential outcomes is wide.

T-bills are still looking attractive to both segments, with their relatively low risk and decent yields. But some institutional asset managers are locking in longer duration in Treasurys in the belief that rates will peak and start to come down. However many seem hesitant to make any bets on asset classes other than cash equivalents until there is more clarity on the macro picture and the timing of policy shifts in 2024.

Other regions, such as Latin America, are further ahead on the path to rate cuts, making them an interesting alternative to U.S. fixed income. Investors are also looking to countries where policy is going to drive more coupon income, such as in Japan. China's economic slowdown could drag on global growth at the same time as the U.S. heads into a potential recession next year, although with the U.S. consumer strong and labor dynamics solid, this may be averted.

Once again, U.S. politics cloud the picture, with Congress potentially impacting the operation of the government and a long election season already underway.

For more information, email:
TheAltaReport@bnymellon.com

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