» INVESTMENT STRATEGY INSIGHTS MAR: 2016

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NIRP MANIA

The idea of negative interest rate policy (NIRP) has now gone mainstream among central banks, but does it work in the real world?

We know that NIRP pushes down currencies, and sovereign yield curves also become negative. Yet NIRP should improve the monetary transmission mechanism and affect the economy, not just markets. Since bank deposits reprice slower than loans do, the banking system has had a long and well-understood history of temporary margin squeezes when rates initially drop, and vice versa. Yet we are learning that banks are reluctant to charge negative deposit rates to their retail customers. This otherwise "sticky" money represents a bank's true franchise, which they are unwilling to risk losing. While retail deposit rates normally follow policy rates up and down, it is unclear how the banking system will be affected when retail deposit rates delink from negatively moving policy rates.

In Sweden's concentrated banking system, after a brief margin squeeze, the cost of NIRP was passed on through higher fees and mortgage rates. Banks' desire to extend mortgages actually rose, and the housing market benefitted as a result. Monetary transmission improved, increasing domestic demand. Unlike Sweden's, the less concentrated banking systems of Continental Europe and Japan have not been successful passing on the cost of NIRP yet. The resulting margin squeeze has driven up funding costs and perversely reduced banks' willingness to lend. In Continental Europe, bank stocks have crashed. The best apparent outcome for these banks is that they migrate their excess deposits away from the European Central Bank (ECB) toward purchasing securities to rebuild their spread. Yet this would end up right back to QE-like effects, with a tendency to stoke asset bubbles and a lack of transmission into the real economy.

Instead of sending the message that central banks are not out of "ammunition," NIRP has had the unintended consequence of steering markets to reprice away from central banks being the market's friend to now potentially being the enemy. The ECB is exploring ways to tweak NIRP to improve its transmission without the collateral damage. Restricting its application to wholesale deposits would help bank margins, yet would result in currency weakness without any favorable impact on domestic demand. Taking a timeout from NIRP and shifting the mix of QE toward buying bank debt would improve bank funding costs and banks' willingness to lend while also helping asset markets. Yet this is tricky with respect to governance.

Meanwhile, given their neighbors' negative sovereign yield curves, the Bank of England had second thoughts about raising rates long before "Brexit" fears surfaced. More recently, the degree of Federal Reserve liftoff has had to be throttled back to avoid a soaring dollar. By shifting the management of the yuan toward a basket heavily weighted by NIRP currencies, China has latched onto NIRP and will end up being more accommodative as well.

NIRP is steering the world's monetary policy toward a more generous global stance than some had intended. Given time, its impact on markets will be seen in a more favorable light. Central banks are still your friend.

THE PINEBRIDGE MULTI-ASSET SERIES:

CAPITAL MARKET LINE
Quarterly five-year forecast of relative risk and return across asset classes.

MULTI-ASSET STRATEGY
Monthly asset class convictions and risk positioning.

DIFFERENCES OF OPINION

THE WHOLE SHALL BE GREATER THAN THE SUM OF ITS PARTS:
PineBridge believes that not only do differences of opinion make markets, but they also foreshadow substantial moves ahead as these differences are resolved. As a multi-asset firm with investment professionals in nearly two dozen countries, we have a special platform to elevate and nurture debate across investment teams and regions. Such debate hones in on our internal differences of opinion in an attempt to develop well-rounded views within PineBridge, seeking an edge on other market participants. The objective of our Investment Strategy Insights meeting is that all our teams will contribute to, and benefit from, the firm's investment strategy ecosystem.

ABOUT THIS REPORT

Once a month, investment leaders from our Global Multi-Asset, Equities and Fixed Income teams meet to share information, opinions and viewpoints. They are joined once a quarter by our Alternative Investments teams. This cross-asset class discussion allows us to learn from differences of opinion.

INVESTMENT VIEWS & CONVICTION SCORE (CS)

Economy

Paul Hsiao, Economic Analyst

CS 2.75 (unchanged)

Faster growth. Our case score remains unchanged; we expect global growth to accelerate to 3.3% in 2016 from 3.0% in 2015. Investors shed risk assets in January and February as if global recession loomed, yet 17 of the 31 economies that have reported fourth quarter GDP actually saw faster annual growth. Meanwhile, global monetary policy divergence is breaking new ground; the Fed is seeking to normalize rates while negative interest rates and quantitative easing (QE) are the policies for the Bank of Japan and the European Central Bank (ECB).

Rates

Amit Agrawal, Senior Portfolio Manager, Government and Inflation-Linked Credit

CS 3.5 (unchanged)

Slight uptick. The 10-year Treasury's recent dip below 1.8% reflects deflation fears and expectations that core inflation soon will turn negative — an outcome even the crises of 2008 didn't produce. Given the stalled dollar rally, wage increases, and robust housing market, plus stable consumer prices over the past 18 months despite headwinds, it's hard to envision widespread price declines. Therefore, we expect the 10-year to rebound to 2%-2.5% for the year, with the recent dip providing an opportunity to lower duration.

Overall, we recommend an underweight portfolio duration and continue to like the four-, six-, and eight-year parts of the curve. We continue to tactically play the 10-year range while overweighting US Treasuries in shorter to intermediate maturities relative to other G3 countries given yield pickup and our expectation of only one Fed hike in 2016.

Credit

Steven Oh, CFA, Head of Global Credit and Fixed Income

CS 2.5 (+0.50)

Continued volatility. Credit volatility has persisted as negative sentiment and selling pressure have spread across all credit arenas, including European financials. Valuations remain attractive, but meaningful tightening will be limited until the market digests the technical overhang of commodities-led "fallen angels" and the default picture comes into focus. After that, credit spreads should tighten and produce strong excess returns. We continue to see the market unjustifiably using oil prices as the gauge for short-term sentiment.

We advocate a balanced approach and continue to favor risk-adjusted returns. Investment-grade spreads near +200 are attractive, and the subordinate bank debt selloff has created opportunities in specific sectors. We favor loans over high yield, but technical trends are deteriorating due to trauma in the collateralized-loan-obligation market. Therefore, we see no catalyst for a rebound unless there are prepayments.

Currency (USD Perspective)

Dmitri Savin, CFA, Portfolio Strategist and Risk Manager, Global Emerging Markets Fixed Income

CS 3.5 (unchanged)

A stronger dollar. We see three reasons for continued dollar strength over the medium term: the likelihood of further gradual downward yuan moves; oil prices staying low due to difficulty in achieving an agreement on sustained production cuts; and monetary policy divergence between the Fed and other major central banks.

For the near term, we favor the euro and yen over the US dollar because of positioning and valuation. We remain bearish on EM currencies due to weak fundamentals and only tentative signs of a reversal.

CONVICTION SCORE (CS)

Investment team views on how portfolios should be positioned for the next six to nine months.

1 = Bullish 5 = Bearish

Change from prior month is indicated in parenthesis.

INVESTMENT VIEWS & CONVICTION SCORE (CS)

EM Fixed Income

Steve Cook, Co-Head of Emerging Markets Fixed Income

USD EM (Sovereign and Corp.)
CS 3.0 (unchanged)

Local Markets (Sovereign)
CS 4.0 (unchanged)

Less volatility. Volatility continued in January as gyrations in China, oil/commodities, and currencies kept risk aversion high. Some stability returned in February as commodity prices rebounded and steadied with market attention moving to developed markets (DM). All EM asset class returns are now positive, with investment grade credits and local markets standing out. While fundamentals remain fragile, multiyear-wide spreads, oversold currencies, and low issuance support the asset class.

EM debt assets performed well versus DM, especially US high yield. Risk assets have traded atypically, highlighting the need to differentiate between US dollar and local currency bonds, as well as US dollar EM investment grade and high yield, as returns and performance vary considerably. We advocate for conservative positioning favoring investment grade over high yield in US dollar credit, and US dollar corporates/sovereigns over local markets.

Multi-Asset

Deanne Nezas, FSA, MAAA, Portfolio Manager, Multi-Asset

CS 1.8 (unchanged)

Growth ahead. China data are mixed, but a credit growth pickup, confirmed by strengthening Total Social Financing (highly correlated to industrial production), leads us to expect faster growth in three to six months. Also, since flat copper and aluminum prices support our contention that plunging oil prices are due to increased supply, not decreased demand, we expect oil to stabilize and rise over our intermediate term horizon.

Our highest convictions remain Japanese equities, which we believe will benefit from expansive monetary policy and increased focus on shareholder returns, and European equities, as we expect the ECB's QE to anchor the euro and support credit growth. We remain underweight EM equity except for Mexico, which we believe will benefit from a modest commodity price recovery, and India. Bank loans, which have low commodity exposure, remain our highest fixed income conviction, and we also like high yield (ex energy) and contingent convertible bonds.

Global Equity

Graeme Bencke, ASIP, Portfolio Manager and Head of Equity Strategy

CS 2.75 (unchanged)

Mixed picture. Earnings downgrades continued through a relatively lackluster fourth-quarter reporting season. In the US this is partly explained by currency values; in Europe, it's the fundamentals. Company guidance suggests capital expenditures continue to fall, but excluding energy the picture appears relatively unchanged. The recent market correction has provided better risk/reward for equities and opportunities in financials and some parts of IT.

Global Emerging Markets Equity

Andrew Jones, CFA, Portfolio Manager, Emerging Markets Equities

CS 3.0 (unchanged)

Trending neutral. We are inclined to decrease risk profiles given structural challenges in China and other EMs, yet feel the market has priced a fair amount of the concern into equity prices. Any People's Bank of China signal that international reserve losses are less bad or manageable could provide a temporary price floor; without that the market will continue to press shorts on equity and currency proxies. Emerging market central banks, which are starting to operate with less "Fed paranoia," have moved to stimulate economies (Indonesia, India) and support currencies (Mexico, South Africa). Valuation on price/book near 2008-2009 levels leads to a neutral view.

We favor health care but disfavor consumer staples. We are positive on Mexico, Central Europe, and India and negative on Colombia, Thailand, and Malaysia.

Quantitative Research

Sheedsa Ali, CFA, Portfolio Manager and Head of Quantitative Equity Alpha Research
Haibo Chen, Quantitative Analyst, Quantitative Research

Deteriorating CS. Our conviction score continues to deteriorate due to wider credit spreads and a flatter yield curve. Credit spread curves continue to widen and become more downward sloped. We position our overall duration for the global yield curve on the short side. Geographically, we disfavor US and Japanese duration, are neutral on UK duration, and continue to like European duration. On yield curve positioning, we favor the Japan short end, US and UK belly, and European long end.