» INVESTMENT STRATEGY INSIGHTS MAY: 2016

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Managing Director, Global Head of Multi-Asset

FOR OIL PRICES, $40 IS THE NEW $30

Commodities have seen a big bounce. The accepted narrative is that, as with other risk assets, this repricing is based on sentiment. But we think fundamentals also played a role. Late last year, global manufacturing faced recessionary conditions even though consumers were fine. Now, inventories have run off, with production converging back toward consumer take-away. Commodities are the nerve center; they bounced first. Yet China also contributed by pivoting back toward credit-fueled growth.

We're most interested in oil. It seems the Middle East needs to liquidate their financial assets whenever oil goes below $40. We view this as one primary cause of today's curious positive – rather than historically negative – correlation between oil and financial assets. Oil is now over $40 once again. Are these prices here to stay? We think so.

As oil touched bottom, reports were rampant that oil was in global oversupply of 1.5 million barrels per day (bpd). Back then, North American shale looked like it could defy gravity. Plunging rig counts were accompanied by steady production. Now US production is finally falling, and has dropped already by 657,000 barrels per day (bpd). This alone has taken out 40% of excess supply. Global supply has also lost 150,000-200,000 bpd from the North Sea, as well as 150,000-200,000 bpd from North Africa, though not all due to fundamental reasons. These add up to almost 1 million bpd. While Iran has been an offset, at what magnitude is hard to pin down. What we do know is that the easiest barrels for Iran to get back onto the market have arrived. From here, the effects of years of underinvestment will show and progress toward boosting production will slow.

Efforts to restrain production will continue to be difficult. Saudi Arabia doesn't want to accommodate Iran, its regional adversary. Irrespective of Russia's public statements, we don't expect a production freeze. Its modus operandi has been to pump full out. Yet even here, Russia risks losing 1%-2% of its production by the second half of this year (or 100,000 bpd) from aging fields and underinvestment. That loss will only grow over time.

A weaker US dollar, given the Federal Reserve's delay in normalizing rates, also helped commodities bounce. As the Fed's July meeting draws near (when we expect the next hike), this tailwind for commodities will dissipate. On the upside, we still expect US shale dynamics to act as a $60 cap on oil prices. Private equity funds have been buying up defaulted shale assets at cents on the dollar, solving the fragility of these capital structures. Also, shale can switch on and off much faster than other sources. North American shale, not OPEC, is the new swing producer. Once prices cross $50 and stay there a while, shale production will return.

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.

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.

INVESTMENT VIEWS & CONVICTION SCORE (CS)

Economy

Markus Schomer, CFA, Chief Economist

CS 2.50 (-0.25)

Strengthening fundamentals. We still expect global economic activity to grow 3.2% in 2016 – in the middle of our central case of 2%-4% – and have more conviction that fundamentals will strengthen over the next six to nine months. The latest batch of purchasing managers index (PMI) manufacturing numbers showed stronger growth momentum from the three largest economies: the US, the eurozone, and China. The many policy measures China has enacted in the past few months are starting to show; a broad set of data points outside the PMI number also reflect China's cyclical improvement. Stabilizing oil prices near $40 per barrel and the likely impeachment of President Dilma Rousseff in Brazil are renewing the prospect of a growth rebound in emerging markets (EM).

Rates

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

CS 3.5 (unchanged)

Repricing ahead? Treasury market volatility, as measured by the MOVE index, has dropped to the pre-December Federal Reserve rate hike level. This widespread market complacency, coupled with dramatically improving financial conditions over the past two months, makes the government bond market vulnerable to repricing on a sudden readjustment of the risk premium. We expect the Fed to strike a more "balanced" outlook at the April Federal Open Market Committee (FOMC) meeting than its current "dovish" tilt but still not commit to a June hike. As a result, we expect a modest rise in real yields across the curve with a continued bias to steepening.

Credit

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

CS 3.00 (+0.25)

Credit momentum continues – reduce risk into strength. Credit market strength has resulted in spreads tightening across many areas to year-end target levels. While credit momentum is likely to continue in the near term, reducing risk levels in May based on current valuations appears to be prudent. Fundamentals have not improved enough to warrant the current enthusiasm, but sentiment has temporarily shifted from fear a couple of months ago to risk-seeking enthusiasm.

Currency (USD Perspective)

Anders Faegerman, Portfolio Manager, Global Emerging Markets Fixed Income

CS 3.00 (+0.50)

Has the US dollar peaked? From our standpoint, fundamentals have not changed much from the January "scare," with global growth still on the back foot, suggesting the US dollar may yet have another leg up. Dovish remarks by Fed Chair Janet Yellen in March will have to be repeated at the April FOMC meeting to support the recent turnaround in the US dollar versus the euro and yen. However, the Bank of Japan (BOJ) and the European Central Bank (ECB) will be unhappy with the market reaction to their dovish actions earlier this year. The battle for the Fed will be whether higher inflation in the short term is a new trend and how to marry this with signals of a further fall in trend growth. Traditionally, the US dollar has had a strong patch in May. Positions have turned short on the dollar, setting up the currency market for whipsawing, particularly if the Fed turns more hawkish again into summer.

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

Improving sentiment. As we anticipated, the risk-on rally in EM debt continued, driven primarily, in our view, by a simple reduction in risk aversion as opposed to anything material from a fundamental perspective. The recovery in commodity prices and Yellen's dovish rhetoric have also helped sentiment toward EM debt. Year-to-date returns in all components have now exceeded 60% of even the most bullish 2016 full-year projections, so we expect a period of consolidation. Overall, spreads (and yields in local markets) are tighter and lower than at the start of the year, and all elements, apart from EM investment-grade corporates, are now trading at levels around our central "cruise along" scenario. Technicals remain strong and fundamentals are virtually unchanged.

USD EM (Sovereign and Corp.)

CS 3.0 (unchanged)

Local Markets (Sovereign)

CS 4.0 (unchanged)

Multi-Asset

Tatsushi Maeno, CFA, Head of Japan Investments, Global Multi-Asset

Resolving disconnections. We continue to expect a global growth bounce within our intermediate-term horizon of nine to 18 months. There are several disconnects: between weak global manufacturing and strong consumption, signs of global economic recovery and still-sluggish financial markets, and resilience in the equity market and the extremely low sovereign rates. We believe these disconnects will be resolved through a recovery of manufacturing, a recovery of financial markets, and a gradual increase of sovereign rates. The Chinese economy is finally picking up, driven by a series of stimulus packages. The US labor market is robust, with wage pressure emerging. Europe's economy continues to be resilient, and oil prices have finally stabilized. Japan, on the other hand, is seeing mostly bad news.

CS 1.8 (unchanged)

Global Equity

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

Looking east. We expect global markets will remain choppy, driven by low growth, low inflation, and central bank uncertainty. The effects of central bank actions, when they come, are increasingly short-lived and highly anticipated. This drives us to focus on trends and companies that we can analyze, and where we can have confidence in our investment vision.

The recent improvement in trade and industrial activity in China, combined with much more attractive equity valuations in much of Asia, are driving us in this direction. A possible "Brexit" in Europe is difficult to predict but may provide excellent opportunities for investment on weakness around the vote.

CS 2.75 (unchanged)

Global Emerging Markets Equity

Andrew Jones, CFA, Portfolio Manager, Emerging Markets Equities

A reprieve. The worst of the China worries seems to be over, but it could be only temporary. US oil production is declining and is supporting crude prices. The European economic recovery appears to be taking hold. Brazil is nearing presidential impeachment. The Russia/Ukraine conflict is holding in a relative low-intensity pattern. These factors are gradually transmitting into positive financial results or, at a minimum, a slowdown of earnings downgrades. Reduced sovereign premiums will also support performance. Some of the recent rallies, especially in materials and in Brazil, reflect investors' reallocation to reflect the newly forming conviction levels. Upcoming EM earnings releases will help determine if the recent optimism is sustainable.

CS 3.5 (unchanged)

Quantitative Research

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

Equity factors. Yield led the factor performance in all regions, consistently outperforming before and after the market bottom in February 2011 in the US in a low and declining rate environment. Value outperformed in all regions except Europe. Momentum sold off in all regions, especially in the US and UK. In the US, quality lagged in March but outperformed in the first quarter, and factor correlations with value are extreme.

Fixed income factors. Our US Market Cycle Indicator (MCI) improved for the first time since June 2015, driven by both tighter credit spreads and a steeper Treasury yield curve. On corporate credit, both investment grade and high yield spreads have tightened back to levels seen in the beginning of the year and close to long-term averages. On the global yield curve, we expect the yield level to increase across all countries; the yield slope to steepen in the eurozone and Japan but flatten in the US and UK; and the yield curvature to increase, especially in Europe.

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