» INVESTMENT STRATEGY INSIGHTS JUN: 2016

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WILL CHINA'S DEBT BUBBLE BURST?

China is the second-largest economy in the world, with growth more than twice most others, facilitated by its willingness to lever up while others were deleveraging. Last year, China abruptly pulled back its credit-fueled growth, inadvertently slowing its economy far more than desired. The resulting ripples inexplicably weakened economies everywhere. From fall 2015 until March 2016, China reversed course and revived its lending growth to get back into its comfort zone. Can it be sustained?

China's all-inclusive debt/GDP has now risen tremendously to 250%, equal to that of the US. No warning flag there, yet its interest rates are far higher so its debt service is also higher and rising. Most others have lower and falling debt service ratios. China's is now at a level where some countries, but not all, have run into sustainability issues. Those who did had large foreign ownership of their debt; foreign investors can be fickle. China's foreign ownership is tiny. Outside of China, market participants are worried about the quality of China's outstanding debt, which has overwhelmingly taken the form of bank loans instead of bonds. Nonperforming loans and the number of bond defaults are both rising. While China's borrowing probably hasn't gone too far yet, we believe a restructuring lies ahead to keep it that way.

Policy will push a terming-out of loans into bonds, in our view. Extending duration will lower debt service, resulting in a much larger debt market and smaller loan market. When your interest rates are higher than the rest of the world's, and policy actions connect your bond market to the outside, your interest rates are prone to coming down. The mutual recognition of Hong Kong and Shanghai registered funds will enable such connectivity. For those who can get comfortable with the yuan's stability versus a basket of currencies, in today's yield-starved world, inflows into China's bond market should lower its rates as well as its debt service. If China's bond indices become recognized in global indices (a current lobbying effort), this too will help connect its bond market. State-owned enterprises will also be encouraged to issue equity in Hong Kong and bring back those funds to pay down debt. The country cannot maintain rapid debt growth forever – but it can for several more years.

One also needs to consider whether debt is being incurred for consumption or to enable investments: If you generate a return on those investments above the cost of debt, your debt is inherently more sustainable than consumption-driven debt binges. Today, China is trying to bridge its old economy to carry enough growth until its newer economy becomes large enough to pick up the baton. We think the new consumer, services, and higher-technology industries will be strong enough three to five years down the road to do just that. In our eyes, China is building a bridge to a pier, not a bridge to a cliff.

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 (unchanged)

Slow and steady. Our conviction score remains at last month's 2.5. We expect global economic activity to grow 3.1% in 2016 — in the middle of our central case of 2%-4%. On balance, global growth numbers were encouraging in April, and we may see faster growth in China and other emerging market (EM) countries in the coming months. Oil remains the best indicator of global appetite for risk assets. We expect oil prices, now near $50 per barrel, to rise slowly for the rest of the year. Political risk seems to have decreased; the impeachment of Brazilian President Rousseff is progressing, "Brexit" seems increasingly unlikely, and the US presidential primaries are winding down. We lean toward a score upgrade but await an improvement in growth expectations from the International Monetary Fund forecast or through stronger Purchasing Managers' Index (PMI) numbers before doing so.

Rates

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

CS 3.5 (unchanged)

Staying low. Recent Fed warning of an imminent rate hike has had limited impact on longer-dated Treasury yields. In fact, lower net supply and a surge in foreign demand have pushed 10-year Treasury real yields into negative territory for only the second time in the past ten years. Any rise in 10-year German bund yields or continued firming of oil prices could make longer-dated Treasuries vulnerable to repricing on a sudden readjustment of risk premia. However, given the unlikelihood that the Bank of Japan (BOJ) or the European Central Bank will abandon their negative rate policies anytime soon, any rise in US real yields likely will be modest. We expect a 1.75% -2.25% range for the 10-year Treasury for the remainder of 2016.

Credit

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

CS 3.00 (unchanged)

Time to lower risk. While an argument can be constructed for credit risk to continue to outperform in a risk-seeking environment, we should not overstay our welcome and believe the appropriate action is to reduce risk. At current fair valuation levels, barring a continued increase in energy prices that drives up the commodity segments and index returns, the best outcome is a steady state, so risks are tilted more to the downside in coming months.

Currency (USD Perspective)

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

CS 3.00 (unchanged)

Stronger dollar. With rate differentials remaining wide, further Fed tightening is likely to push the dollar higher — an example of monetary policy working as predicted, for a change. Prospects for the Chinese economy remain unclear, with the government emphasizing structural reforms over credit injection, spelling further, albeit gradual, depreciation of the yuan. Stronger oil prices increase inflation risk in the year's second half, but more important for the longer-term outlook is the labor market. So far, low growth has dampened wage pressures. Despite less concern about Brexit, political risk continues, with Brazil, Turkey, and South Africa likely to stay in the headlines. The elephant in the room remains the US elections in November.

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

A little less conviction. While the strong risk rally of the past three months slowed in May, month-to-date performance remains positive for emerging market corporate dollar assets, flat in EM sovereign dollar assets, but sharply lower (-4.47%) in EM locals. EM spreads and yields are now firmly in our central "cruise along" scenario, but current EM fundamentals are actually closer to our "bear on a leash" scenario. Arguably, the market is somewhat ahead of itself in terms of valuation and we need EM/global macro fundamentals to catch up. Technicals are now more neutral; issuance has picked up but remains materially below prior years' levels. Overall, with the growth trajectory still uncertain, we feel such strong year-to-date performance in EM dollar assets warrants a modest downgrade in our conviction score to 3.50.

USD EM (Sovereign and Corp.)

CS 3.50 (+0.50)

Local Markets (Sovereign)

CS 4.0 (unchanged)

Multi-Asset

Hani Redha, CAIA, Portfolio Manager, Global Multi-Asset

Modest change. We lowered our CS to 2.0. While we expect China to continue its credit-based stimulus into 2017, support appears to be front-loaded, which would make future support marginally lower relative to our previous expectations. Concurrently, the Fed's rate-hike resumption will raise market volatility and pressure commodity and EM markets. June's Brexit referendum is another source of market uncertainty. We expect the BOJ to ease alongside a significant fiscal package from the Abe government. Europe continues to be one of the most attractive markets, with improving credit growth and employment supported by low commodity prices and a relatively competitive currency level. Bank loans remain our highest conviction in fixed income, yet we are allocating more to fixed income alternatives, such as spread-based and market-neutral hedge fund strategies.

CS 2.0 (+0.20)

Global Equity

Rob Hinchliffe, CFA, Portfolio Manager and Head of Sector Cluster Research, Global Equities

Cautiously positive. This continues to be a stock-picker's climate in developed markets, where first-quarter results showed weak revenue and earnings, and in emerging markets, where sentiment drivers remain stimulus, politics, and currency. Against a backdrop of easing in other markets, the Fed appears committed to rate hikes, which the market continues to discount in terms of likelihood and impact. Given the uncertainty, portfolio balance is a priority. Lending data suggest that fundamentals may be improving, though liquidity-driven valuations offer little upside. We remain cautiously positive on the US, although we continue to look for new investment opportunities, with Asia favored over Europe.

CS 2.75 (unchanged)

Global Emerging Markets Equity

Andrew Jones, CFA, Portfolio Manager, Emerging Markets Equities

Caution over China. Flattening and softening macro data and the digestion of the first quarter's large loan surge have raised China concerns. The Fed's talk of US rate hikes has reversed the year-to-date resurgence in most EM currencies and commodities. Declining US oil production is supporting crude prices, as are supply disruptions in Nigeria and other locations. In Brazil, the impeachment is over and Acting President Temer has appointed some very market-friendly ministers. We now look toward progress in the Brazilian Congress on the urgent fiscal challenges.

CS 3.5 (unchanged)

Quantitative Research

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

Spread tightening. The US Market Cycle Indicator continues to improve, driven by tighter credit spreads. Both investment-grade and high-yield spreads have tightened to the long-term average, and we continue to underweight corporates as a whole under the current risk-averse environment. Within corporate, we favor basic industries and energy; we dislike financials. In global rates, we expect yield levels to increase across all countries; the slope to steepen in the European Union and Japan, but flatten in Great Britain; and curvature to decrease in the US but increase in the EU. Dividend yield continued to outperform against a backdrop of macro uncertainty and low interest rates. Performance as measured by cyclical value (price/earnings) has diverged from deep value (price/book) measures largely driven by the energy sector's underperformance. Momentum extended its selloff. The macro risks of style strategies are high.