2016 MIDYEAR GLOBAL ECONOMIC OUTLOOK

A TIP OF THE SCALES?

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- We are tentatively optimistic that global fundamentals will improve later this year and that a stronger growth trend will emerge in 2017.
- While oil prices have risen from their dramatic fall, a broader rebound in commodity prices is necessary to achieve the growth acceleration we are forecasting for next year.
- Though "Brexit" dominates the headlines, parliamentary elections in Spain this summer pose a much bigger risk for Europe if a more left-wing, anti-austerity coalition takes power.

In the first half of 2016, the global economy faced the effects of three major shocks: the collapse in oil prices, slower growth in China, and rising policy rates in the US. These have prevented a stronger underlying growth trend from emerging. And while economies will continue to deal with the fallout, we think the starts may be beginning to take hold.

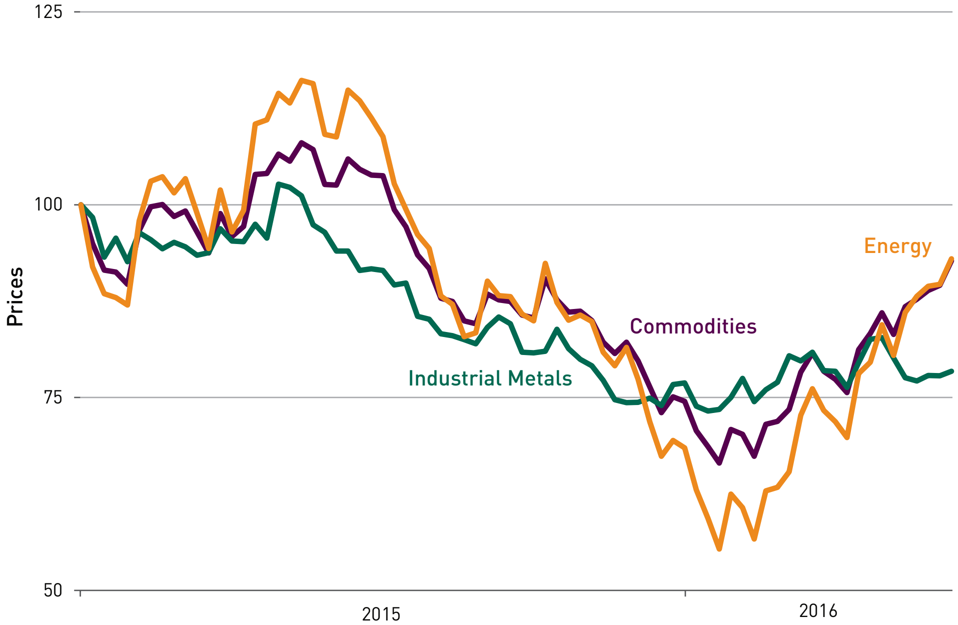
Growth in the world economy slowed to just 3.1% last year, well below the nearly 4% average in the five years since the recovery started in 2010. The weakness stemmed mostly from emerging markets, where the three shocks caused more serious economic damage. We don't foresee a noticeable improvement this year. The world economy should advance to 3.2%, on par with 2015. However, we are still forecasting stronger growth in the next two years as the adjustment to these shocks fades.

The dramatic decline in oil prices has started to unwind. Since bottoming in February, the price for a barrel of West Texas Intermediate crude has nearly doubled. While that's good news for oil producers, rising prices haven't spread to other industrial commodities. The S&P GSCI commodities index is up 20% so far this year, yet the industrial metals component had barely any positive performance through the first six months. A broader rebound in commodity prices is a necessary condition to achieve the growth acceleration we are forecasting for next year.

However, more shocks may be in store in the political arena. The UK's "Brexit" referendum over the country's continued membership in the European Union is grabbing much of the headlines. But we believe Spanish parliamentary elections this summer pose a much bigger risk. Polls show a more left-wing, anti-austerity coalition could take power from the current conservative-led government. Spain could add a louder voice to the as-yet unsuccessful challenge to the European fiscal austerity consensus.

PINEBRIDGE INVESTMENTS

While Energy Prices Are Rising, Industrial Metals Prices Remain Subdued



Source for S&P GSCI Index: Thomson Reuters Datastream, Bloomberg, PineBridge Investments calculations as of 9 June 2016. Prices data rebased 100 = 1 January 2015.

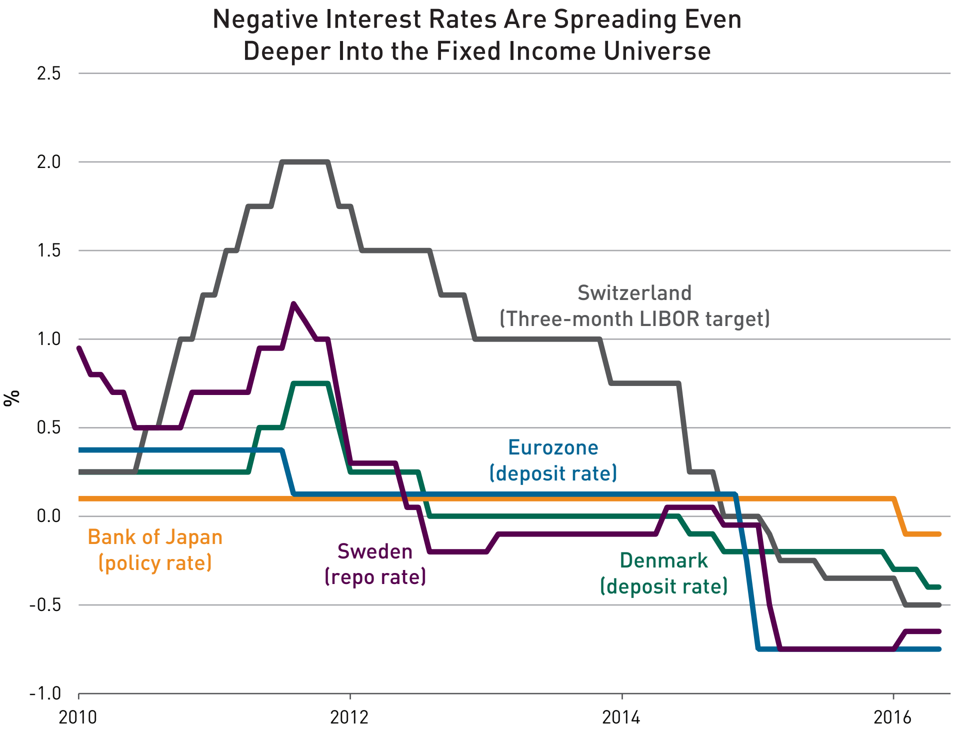
Central banks will continue to prop up markets

Global monetary policy is set to remain accommodative this year, despite the start of the Federal Reserve's gradual rate hike cycle.

Economic volatility at home and abroad has constrained the Fed's plans to normalize policy rates as the US economy normalizes. Low inflation has afforded the Fed the leeway to adjust the pace of rate increases. However, that may change once US inflation picks up more noticeably by the end of the year. By then, the decline in commodity prices will have fallen out of the year-on-year comparison and the recent rebound in oil prices will make itself felt.

At the end of May, oil prices were still down 18% year-over-year, helping to hold down annual US inflation. Even if prices remain unchanged for the rest of the year, by December oil prices will be up at least 33% and contribute to push inflation above the Fed's 2% target in 2016. We continue to forecast only one more Fed rate hike this year, but three such moves in 2017.

The Bank of Japan and the European Central Bank (ECB) are the main reason negative interest rates are spreading ever deeper into the fixed income universe. Negative interest rate policy has been effective as a defensive tool to prevent currencies from appreciating – that's why Denmark, Sweden, and Switzerland adopted it. However, it has failed as an active tool to weaken the yen in Japan or stimulate lending in the eurozone.



Source: Thomson Reuters Datastream, Bloomberg, PineBridge Investments calculations as of 9 June 2016.

Large scale asset purchases are also still ongoing, and the pace will increase even more than last year. The amount of bonds trading at negative yields has increased to nearly $9 trillion, or 20% of all outstanding bonds in the Barclays multiverse index. That's up from just 8% at the end of 2015. With another major bond-buying program just beginning in the eurozone, Sweden and Japan still likely to increase their QE, and Norway on the brink of adopting negative interest rates and QE, global monetary policy will remain supportive for financial markets.

Consumers lead growth in the US

In the US, presidential elections are already producing plenty of noise. While it's too early to assess who will win in November, it's easier to predict that Congress will remain gridlocked, with no significant legislation likely to pass in the coming years. So, from an economic perspective, the US elections are not that consequential. However, the noise may already be a source of market and macro volatility affecting consumer confidence and business investment decisions.

The US economy is suffering from recurring first-quarter weakness. Since 2010, GDP growth has averaged just 0.8% in the first three months but 2.6% in the subsequent three quarters. We expect a similar growth reacceleration this year following another disappointing 0.8% performance in the first quarter. The Fed looks at the US economy in a similar way, attributing some of the first-quarter performance issues to measurement problems.

The main driver of a growth reacceleration is the US consumer. Robust real income growth is generating sufficient purchasing power to maintain the 3% growth rate in real consumption we have seen in the past two years. Housing activity is picking up again, buoyed by low mortgage rates and gradually rising house prices. This signals enough excess demand to stimulate more construction activity in the coming years.

What is holding back a more positive outlook is the persistent weakness in US manufacturing. Excess capacity in some industries is weighing on expansionary investment spending. US capacity utilization is nearly five percentage points below the average of the previous business cycle. And companies' profit recession didn't help last year. Reported profits declined 3%, the first full-year loss since the Great Recession. After an excess of share buybacks and mergers and acquisitions in the past few years, we expect to see a return to productivity-enhancing investment spending, which would lift current GDP growth and future corporate profitability.

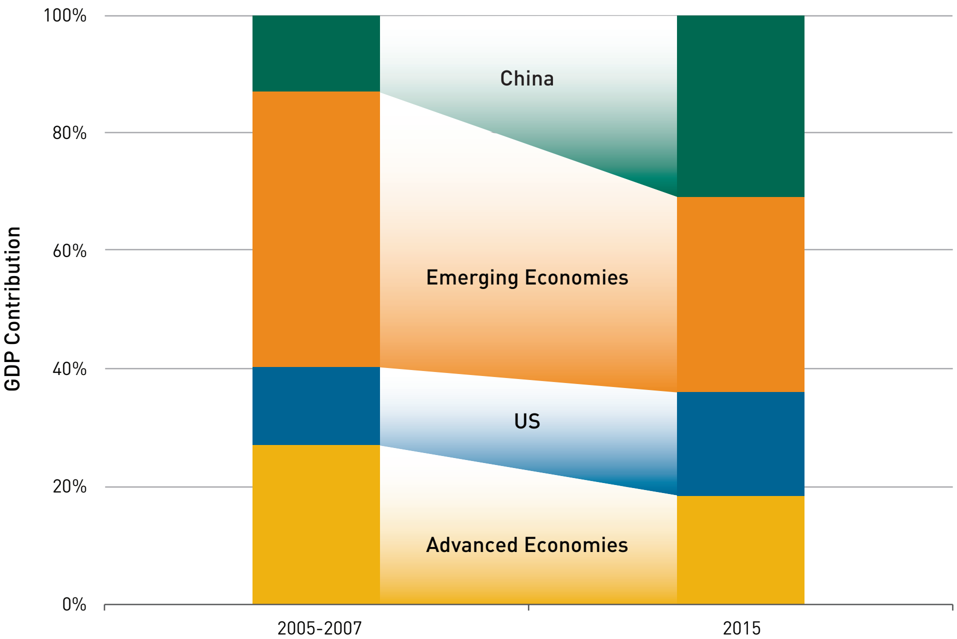
Finally, a correction of excess inventories has, on average, shaved 40 basis points off GDP growth in the past three quarters, accounting for nearly 60% of the deviation from the previous recovery average. We expect annual US GDP growth will pick up to 2.4% by the fourth quarter.

China engineers growth, but only short-term

Like the US, China also had a weaker-than-expected start to the year. GDP growth slowed to an annualized rate of just 4.5% in the first quarter – the worst performance in more than seven years. To hit the government's 2016 growth target of 6.5%, the economy needs to expand at an annualized rate of 7% in the remaining three quarters. Predictably, the government has turned to all-out stimulus to engineer the required growth acceleration.

For the past six months the underlying trend in aggregate social financing, a measure of credit supply to the economy, has been pointing higher. China's budget deficit is expected to double this year, representing a significant increase in fiscal spending, and measures to boost home sales are pushing up house prices, which should boost consumption. China's credit dependency weakens the economy's longer term growth potential and may accelerate the structural slowdown. Yet the combined monetary and fiscal stimulus should boost economic growth in the second half to make the official 6.5% growth target.

While China's Economy Is Slowing, It Remains a Key Contributor to Global Growth



Source: IMF, Thomson Reuters Datastream, Bloomberg, PineBridge Investments calculations as of 9 June 2016.

Monetary policy reaches the limit in Europe

Stronger-than-expected GDP growth in the first quarter highlighted the broadening recovery we expected for the eurozone this year. Falling unemployment rates are triggering cyclical recoveries in a growing number of member states, similar to what the US experienced in the past few years. What stronger growth has not achieved so far is a rebound in inflation. Despite rising oil prices, eurozone headline inflation has remained stuck at 0%, prompting the ECB to unleash another round of policy easing in March, including even more negative deposit rates, the extension of QE to include corporate bonds, and another round of targeted longer-term refinancing operations that, if fully utilized, could grow to €1.5 trillion.

Yet the ECB has little to show for all its activism. While growth has rebounded, bank lending remains anemic. Monetary policy seems to have reached its limits. The interference in the government and now corporate bond markets, the imposition of negative deposit rates on banks that cannot pass the cost on to depositors, and the financial repression of savers are starting to impose a growing cost on the economy. We expect the eurozone to maintain a 1.5%-2% annual growth rate through the end of the year.

Self-inflicted wounds are slowing Japan's recovery

Japan faces stronger headwinds. In the past few years the US has benefited from a traditional cyclical recovery driven by a rebound in employment growth boosting income and consumption. A similar cyclical recovery based on falling unemployment is underway in the eurozone. Japan's more stable labor markets – unemployment rose only 1.5 percentage points during the recession – mean much weaker cyclical recovery forces than in other developed world economies and a much greater reliance on policy stimulus.

The government has been pursuing structural reforms to increase the labor force participation of women and to improve corporate governance, which should boost Japan's growth potential. However, the economy still suffers from the ill-conceived 2014 consumption tax increase. Since Shinzo Abe's election, Japanese GDP growth has averaged just 0.8%. Purchasing managers' indexes show the economy stagnated through much of the first half of 2016 and inflation has fallen back below 0%.

Japan would greatly benefit from a weaker yen to boost inflation, exports, and corporate profits. That would provide companies with the financial means to increase wages and salaries, a necessary condition for a sustained rebound in inflation. Absent a more stimulative currency valuation, Japan's economy is likely to struggle to exceed 1% growth this year.

Most emerging markets are still dealing with the fallout from the commodity price crash

Emerging markets have adjusted to the collapse in commodity prices mainly through sharp currency devaluations in 2015, which offset the decline in US dollar-denominated export prices by boosting local currency revenues. This year, emerging market currencies are generally stronger against the dollar, indicating investors are expecting improving growth trends.

India continues to accelerate. GDP growth improved to a 7.9% annual rate in the first quarter, making India the fastest growing major economy in the world. Inflation has stopped slowing, but the central bank still has room to cut interest rates and support economic growth, suggesting the current growth pace is sustainable in the near term.

Russia still faces major political headwinds. Western sanctions and lower oil prices have seriously hurt Russia's economy. Yet purchasing managers' indexes point to a tentative improvement in business activity, suggesting the country's already 18-month-long recession may end this year. Monetary policy remained tight during last year's currency weakness. But the more stable ruble suggests inflation may start to slow later this year, allowing the central bank to cut rates and support growth.

Brazil is facing the double onslaught of an economic and political crisis. The latter needs to be resolved before the economy can sustainably recover. The new administration of former Vice President Michel Temer has made the right moves so far, but it's too early for even an initial assessment. If Brazil's policymakers are successful in slowing the country's high inflation rate, the central bank could start cutting rates from the current extremely high 14.25% level to support economic growth.

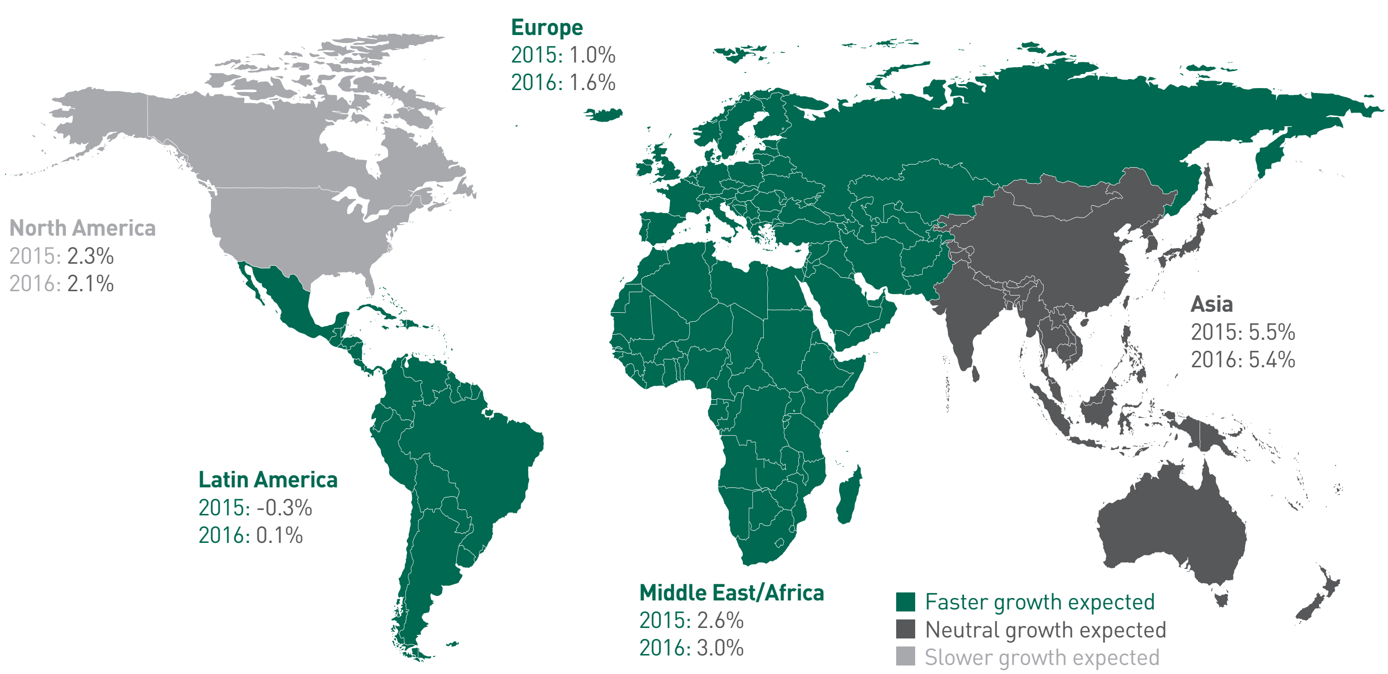
We see upside potential if politics remain in check

We are tentatively optimistic that global fundamentals will improve later this year and that a stronger growth trend will emerge in 2017. Cyclical forces are the most robust in the US and are increasingly evident in the eurozone. Japan faces limited cyclical growth sources and requires additional stimulus. Growth in China should be more stable and commodity prices will gradually strengthen, helping to lift growth expectations in emerging markets.

However, if a combination of the major political risks materializes, markets could quickly plunge back into crisis – but this time without the prospect of aggressive monetary policy support from central banks already pulling out all the stops.

Our macroeconomic outlook for the rest of 2016 is moderately supportive for financial markets. Equity markets have not advanced much this year and have upside potential if global fundamentals improve. Meanwhile, bond yields will likely remain low, anchored by low global policy rates and more QE. Let's hope politics will remain a source of volatility only and not stifle global growth in the next few years.

Global Growth Forecasts



Global GDP Growth: 2015: 3.1% 2016: 3.2%

Source: IMF, Thomson Reuters Datastream, Bloomberg, PineBridge Investments calculations as of 9 June 2016.

About PineBridge Investments

PineBridge Investments is a global asset manager with experience in emerging and developed markets, and investment capabilities in multi-asset, fixed income, equities and alternatives. Our firm is differentiated by the integration of on-the-ground investment teams, providing investors with the combined benefits of global fundamental perspectives and analytical insights. We manage over US$82 billion as of 31 March 2016 for a global client base that includes institutions, insurance companies, and intermediaries.

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