PINEBRIDGE INVESTMENTS

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WHAT HAPPENS IF/WHEN FISCAL POLICY TAKES THE BATON FROM CENTRAL BANKS?

Since the global financial crisis, markets have relied on central banks to address the ensuing growth lull. Fiscal policy has actually contracted since 2010, offsetting much of central banks' monetary stimulus. Where quantitative easing (QE) persisted in an open-ended way until the economy improved (such as in the US), it appears to have worked, albeit with a long lag. Nonetheless, QE exacerbated income gaps between those who were invested in the capital markets and the larger lower income segments who were not.

This, plus the negative effects of global competition on the middle classes in high-income countries, has created a polarized political backdrop, including Brexit in Europe and an anti-incumbent political wave in the US. With each successive dose of QE appearing to offer less stimulus – and negative interest rates invoking uproar from the financial sector – many are calling on fiscal authorities to share the policy burden. Into a world with an extraordinarily high propensity to save, fiscal spending faces no leakage into higher savings and can be used to readdress widening income gaps.

Economist and Nobel Laureate Robert Mundell has pointed out that stepped up fiscal spending merely strengthens one's currency, negating the stimulus, unless accompanied with stepped up monetary stimulus. Where fiscal stimulus appears – and whether it reinforces existing monetary stimulus (market-friendly for capital appreciation assets) or merely replaces it (unfriendly for low-risk assets and factors) – is highly relevant to financial markets.

China and Japan have already entered periods of fiscal expansion. In China, the federal deficit, typically 2%, is already running over 4%. Some see the potential to go as high as 10%, if necessary, to ensure the doubling of per-capita income by 2020 (from 2010). This would be in place of monetary accommodation. In Japan, stepped-up fiscal spending is a given; the question is whether it will accompany or replace continued monetary stimulus. In the US, a Donald Trump presidency would be at odds with a Republican Congress on most issues other than tax cuts. A large tax cut would result. A Hillary Clinton presidency would likely carry the Senate and result in a fiscal thrust focused on infrastructure spending. Either would end the period of shrinking federal deficits and accelerate the Federal Reserve's time frame in bringing an end to the era of extraordinary monetary policy. In the UK, the government is now likely to turn away from fiscal austerity toward a more activist fiscal agenda. And since the emerging markets sat out this period of QE, its gradual wind-down evens the playing field.

All told, a slow-moving regime shift does seem to be in the making, with less monetary and more fiscal accommodation.

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

Paul Hsiao, Economic Analyst, Global Economic Strategy

CS 2.75 (-0.25)

Markets weathered the Brexit outcome in an orderly fashion – British equity markets are now at pre-Brexit levels, for example, and economic data have strengthened globally. For second-quarter 2016, US data point to a pickup, and China posted faster growth. Monetary policy around the world remains accommodative, and we may start to see signs of more fiscal stimulus. A key example of this is Japan's re-elected Abe administration, which announced a fiscal stimulus package that some analysts believe may total JPY10 trillion. This could be just the start of many efforts.

Rates

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

CS 3.00 (+0.50)

The Fed lost credibility by not following through with a June rate hike. So we expect it to follow the market to avoid a "policy error." Currently, markets are pricing in a one-in-three chance of a 2016 hike. Despite better actual inflation numbers, market-based inflation expectations remain very low, and the recent oil price drop complicates the near-term inflation story. In addition, BOE stimulus and a subsequent drop in UK yields to record lows make US Treasuries even more attractive. We expect Treasury yields to remain range-bound with a bias to lower yield during risk-averse periods. Our six- to nine- month range for the 10-year is still 1.25%-1.75%. We like the four-, six-, eight-, and 20-year parts of the curve for attractive roll-down and find five-year TIPS attractive at sub-1.4% breakeven rates.

Credit

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

CS 3.75 (+0.25)

The technical demand for yield is overwhelming downside risk concerns as the market has shrugged off Brexit and other potential flashpoints like the failed coup in Turkey. Valuations are now trading through pre-vote levels, so we are more cautious despite a lack of near-term catalysts to reverse risk appetite. We still consider loans as relatively attractive, but with a barbelled market, repricing risk is increasing. While we believe US investment grade should continue to grind tighter with ongoing international demand, spreads are approaching 130 basis points and are now less favorable to emerging market (EM) investment grade, in our view. Rather than shifting across credit assets, we advocate to reduce risk within credit assets into the current rally.

Currency (USD Perspective)

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

CS 3.00 (unchanged)

The market's extreme pricing out of Fed hikes backed off, but markets continue to believe that the Fed will stay on hold, the ECB will keep buying bonds, and the BOJ will ease. Until that changes, we think major currencies will remain range-bound. The search for yield seems to bypass currency markets: While credit spreads shrank in hard currency markets, the traditional "carry" currencies, in G-10 and EM, barely moved. The impact of Brexit on currency markets was largely confined to the pound, with the euro off only marginally. The lack of improvement in global growth keeps the lid on EM and commodity currencies. Comments from Chinese officials that the near-term devaluation target has practically been reached limit the downside for Asian currencies, in our view.

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

USD EM (Sovereign and Corp.)

CS 3.50 (unchanged)

Local Markets (Sovereign)

CS 4.00 (unchanged)

Steve Cook, Co-Head of Emerging Markets Fixed Income

The risk rally that started in February has maintained its seemingly relentless momentum into July, and nothing seems to be slowing it down. Year-to-date total returns in EM corporates (10.0%-13.3%), sovereigns (11.8%-13.0%), and local markets (14.6%) are attracting even more inflows, rather than being seen as unsustainable and warranting caution. EM debt has outperformed developed market (DM) debt this year, but we are starting to see some value re-established, if only in EM high yield corporates versus the US. Overall, we remain relatively risk-averse but acknowledge that it's tough to fight the market momentum.

Multi-Asset

CS 2.50 (-0.20)

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

Post Brexit, we acknowledge less growth with an offset of greater policy accommodation. Total return is similar, yet we believe less will come from growth and more from yield/repricing of risk. We are positive on Latin American local currency debt and less so on European equities. We don't expect Brexit to have global repercussions: The US continues to show evidence of strength, China is better than last year, and Latin America (with low exposure to Europe) is demonstrating favorable political change. We like select barbelled risk assets that contain either unusually high yield or secular growth that can power through a slower environment. Indian and Mexican equities have such secular characteristics. Local currency debt in Latin America is benefitting from an improved political backdrop (Brazil, Argentina) strengthening local currencies, as well as high coupons. Our currency view still looks for a very gradually strengthening US dollar despite the Fed's cautious reaction function.

Global Equity

CS 2.75 (unchanged)

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

The post-Brexit rally has driven markets to fresh highs. While we believe the UK has the means to navigate this complicated path, we question whether global fundamentals warrant the move given already high valuations. Still, global fundamentals remain stable, and we see signs of improvement. Relative US strength is demonstrated by the Citi Economic Surprise Index and solid loan growth. Europe and the UK have seen little impact from the Brexit vote, and we believe loan growth is set to improve. Japan continues to be supported by underlying structural company changes. EM has been supported by stimulus (China), relative rates, and the reduced likelihood of a Fed hike. We continue to find ample thematic and stock-specific investment opportunities. However, we prefer a balanced investment approach given extreme market positioning, political uncertainty, additional stimulus, and an uncertain Fed hike pace.

Global Emerging Markets Equity

CS 3.00 (unchanged)

Andrew Jones, CFA, Portfolio Manager, Emerging Markets Equities

EM equities have been resilient post-Brexit, despite the gradual weakness of the yuan and questions about the future of the European Union. Support has been based on improving fundamentals in several markets, the appearance of less attractive options in DM equities, and the search for yield globally leading carry-oriented investors to lower EM yields, thus compressing the EM cost of equity. The sustainability of the yield reductions is critical, however. We like consumer discretionary and industrials, plus Russia and the Philippines.

Quantitative Research

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

The US Market Cycle Indicator (MCI) continued on its defensive trend, driven by both a flatter yield curve and a wider spread. In corporate credit, the investment-grade option-adjusted spread was close to the long-term average. Risk-adjusted expected returns turned negative globally, with DM more negative than EM. Within corporate, we favor basic industries, energy, and capital goods and disfavor financials and transportation. In global rates, we expect yield levels to increase across all countries; slopes to steepen in Europe and Japan but flatten in the US; and curvature to increase in Europe and the UK. Our model portfolio is slightly short global duration, favoring the UK and core European countries, while disfavoring the US and Japan. In curve positioning, we favor Japan short end, US belly, and UK and Europe long end.

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