Fasten Your Seat Belts, It's Going to Be a Bumpy Regime Change

MULTI-ASSET OUTLOOK 2017

- Fiscal thrusts are taking the baton from monetary policy, signaling the end of the liquidity trap.
- We expect a bottoming of inflation and interest rates – particularly in the US – to trigger a stronger US dollar, a peaking bond market, and strengthening US stock and residential real estate markets.
- Risks to our outlook include trade renegotiations spiraling into a global trade war, an inflation scare emanating from the US, and China rethinking its faster trajectory.

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Since 2009, we've been in a "glass half empty" world. But it's time to ring out the old. The year ahead marks several simultaneous secular turning points driven by the end of deleveraging in the US, a more vigorous China, re-inflation, a slow onset of tapering, fiscal policy taking the lead, and, of course, the X factor – not Xi this time, but Trump.

While many have bought into secular stagnation arguments, an alternative explanation is that post-financial-crisis periods are always followed by deleveraging and regulatory overkill, during which growth is slow. We are already seeing the initial signs of deleveraging ending in the US, although not yet in Europe or Japan. US banks are back in the lending business. US debt is outpacing nominal GDP growth, and the liquidity trap now has a pin prick, which will be widened by a fiscal thrust. This is following a revival of household formation and the end of a shrinking federal deficit. While China hasn't gone through a similar deleveraging process, it nonetheless discarded its attempt to slow down local government debt buildup, and is now accelerating a new form of fiscal thrust by the central government.

When the two largest economies pivot from slowing to revving up, take notice. Several other simultaneous regime changes are also likely to be fellow travelers.

The geopolitical regime is also turning

Beginning in 1980, falling trade barriers spurred globalization. This led to faster overall growth with rising returns on invested capital. But little attention was paid to the consequence on middle classes in the US and UK from moving labor to select emerging markets (EMs) as well as technological substitution. In these two bastions of free trade, Brexit and Trump mark a turning point. This could be amplified next year as multiple governments in Europe take the populist test. Most have been more nurturing to their middle classes in economic terms and have more experience dealing with fringe parties, yet their electorates are simmering over immigration issues. Uncertainty will continue to build throughout 2017, so we believe the continent should be avoided.

Previously, US politicians had been willing to leave some economics on the table in trade deals in return for political influence overseas. Going forward, this will narrow toward capturing more of the economics for the US middle class. Capital's share of income likely will peak while labor's share could bottom, reversing another 30-year regime. Eventually, this will dig into the global savings glut. We see domestically focused US small-cap stocks, value stocks of all sizes, and large-cap financials as the winners in a rejuvenated US equity market, yet we are cautious on large-cap growth. Selectivity is the order of the day.

It's easy to see all this leading to meaningful geopolitical realignments over time. China is likely to become much more dominant geopolitically in Asia, even if squeezed on the margin economically from trade along with other Asian manufacturers of finished goods and Mexico. Yet China has already pivoted from pumping an unending stream of capital into old industry for export to nurturing higher-value-added technology and services and more investment in domestic infrastructure.

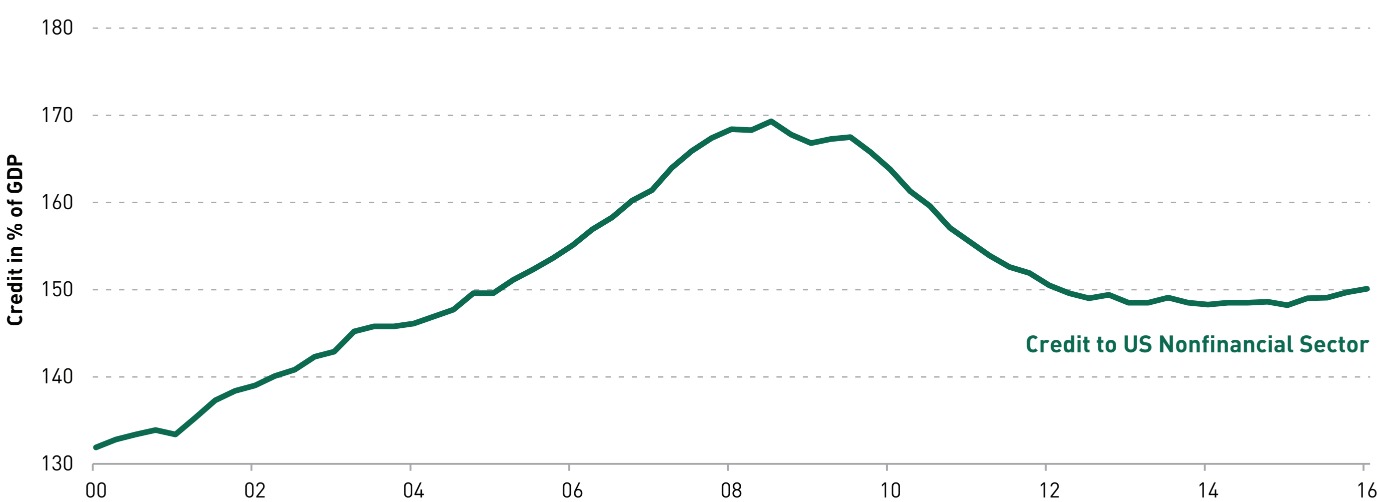
Less "free" and more negotiated trade by the US does not necessarily mean a global trade war. The US will push harder and more narrowly for trade economics, sobered by the lessons of history, but we believe it's likely to resemble more of a "cold" war. In isolation, less trade brings about less global growth, less efficiency, and higher risk premiums. Yet that would ignore the positive impact of Trump's massive US fiscal thrust and regulatory pushback. We see a net plus to global growth, yet with huge uncertainty along the way.

What could go wrong?

It will be a bumpy ride toward a détente on trade. At times it will appear that infrastructure spending and deregulation are hitting speed bumps while trade frictions are spiking. China's new fiscal thrust has resulted in faster growth than last year. Yet after the 19th Congress, China could rejigger the dials used to accomplish this, without the clarity that markets need.

An inflation scare (not an actual spike) in the US could temporarily spook the markets. China has stopped

The End of Deleveraging Begins in the US



Source: Thomson Reuters Datastream as of 19 November 2016.

exporting deflation, and global demand will benefit from fiscal thrusts from the two largest economies. Commodity prices are already rising given China's newfound interest in domestic infrastructure, and the US will join in 2018. Add to that a tightening US labor force and money supply that is beginning to accelerate as John Maynard Keynes' "animal spirits" revive and bank loans accelerate. There is plenty of rocket fuel in the form of pent-up monetary reserves after years of quantitative easing. This is the other bookend to Volcker. A 30-plus-year secular bottom has been put in the US yield curve. But the US is not an island. Sluggishness in Europe and Japan, with negative interest rates and low output gaps, will continue to tug in the opposite direction. Slow and bumpy is the order of the day, segueing toward higher US-led inflation and interest rates.

Finally, the bloom is quickly fading from the rose of favorable illiquidity premiums. While realized returns from private markets will continue to look solid for the next few years, this will be the result of sinking capital in the ground several years ago under more favorable circumstances. Try if you can to latch onto 2011-2014 vintages through the secondary markets, because returns from new vintages in 2017 and beyond for most traditional areas of private markets will look increasingly challenged. Still, some attractive small, midmarket, and niche pockets exist and superior alpha appears more persistent in the private markets.

Where to find opportunities?

While the US equity market previously appeared modestly overvalued, after-tax cash flows will now be worth more if taxes are meaningfully reduced. US GDP should also accelerate from a host of factors. Given US small-cap and value stocks' economic sensitivity, their attractive valuation is now being complemented with improving fundamentals by the second half of 2017, when tax rates should decline.

US financials have also joined this select list as the purest play on the new landscape. Trump will push for aggressive tax cuts, aggressive infrastructure spending, and aggressive regulatory pushback. While the banking system sorely needed higher capital standards, higher capital and tougher regulations forced financials to simplify, derisk, and slow since 2010. From here, properly calibrated regulatory pushback can produce faster growth with rising credit demand, as well as a steepening yield curve, both of which benefit financials. Now it's time to own their equity but not their debt.

We disagree with many that a Trump victory is negative for all EMs. In a slow world, anywhere one can buy growth that is fast, domestically sourced, and accelerating provides a compelling opportunity. India and Indonesia, for example, are not exporters of finished goods, are relatively insular, and are undergoing meaningful reforms. They fit this bill perfectly. Their new governments have also been in place long enough to be hitting their stride, with actual policies and reforms flowing.

Anywhere one can find high real and nominal rates, where monetary policy has been tight and, as a result, inflation is just now cyclically peaking, also is attractive. Take Brazil, where local currency debt is still yielding 12%. Commodities are back, a new government put through a fiscally responsible budget with massive congressional support, and inflation is now falling rapidly. Monetary policy is still very tight at 14% but has begun to ease. While a rising US dollar and interest rates will test this year's recovery of the Brazilian real, firming commodity prices and fiscal restraint are more powerful forces. We expect the latter to ultimately prevail in anything other than an environment where the dollar is soaring and US rates are rapidly rising, which we view as unlikely.

Meaningful change is on the horizon

A net plus to global growth with more meaningful differences to regional, sector, asset class, and factor winners and losers is a healthy backdrop for seeking alpha from choosing beta. More of the world's growth is likely to come from the US. Countries that depend heavily on exporting finished goods to the US are likely to capture less of the global uptick in growth. Commodity producers should be big winners with infrastructure programs working their way through the pipeline. From a market perspective, we look forward to this new regime, despite the likely bumps along the way.

About PineBridge Investments

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