» INVESTMENT STRATEGY INSIGHTS MAR: 2017

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DELAYS AND DILUTION ARE AHEAD FOR US CORPORATE TAX REFORM

While many headlines have attributed the equity rally to the prospect of US corporate tax reform, evidence continues to mount that this reform will be delayed and diluted. However, we do not see this as a cause for alarm: The rally is global, not contained to the US, and began last summer, when most were predicting a Hillary Clinton victory. We believe the rally's true sponsor was the end of private sector deleveraging and the consequent uptick in global nominal GDP growth from below to above stall speed.

What corporate tax reform could do is improve US competitiveness. At 35%, the US statutory corporate tax rate is among the highest in the world; others have statutory rates in the 20s, and some in the teens. But there are some reality checks here, too: Despite the statutory rate, US large cap growth index companies pay average effective tax rates of 13.5%, while small cap pay about 30%.

There is also a big difference between corporate tax "reform" (what the House Republicans are pursuing) and "relief" (President Trump and the Senate's camp). The reform plan is to lower the 35% statutory rate to 20% in a revenue-neutral manner by also culling deductions and credits or introducing the so-called border adjustment tax (BAT). "Relief" – the idea Republican Presidents Ronald Reagan and George W. Bush were able to rally supporters around – is not revenue-neutral, and is fiscally stimulative.

House Republicans can easily pass their tax reform by August. But there is a reason that true comprehensive tax "reform" has not passed in over 30 years. To lower effective taxes for some constituents, you need to raise them for others. The House's BAT tax reform cannot pass in the Senate, certainly not without substantial modifications. And, for maximum leverage, Trump prefers to deal with trade issues one country at a time, not based on general principles inherent in the BAT or in multilateral trade deals.

In the House's BAT plan, many large exporters would end up with negative effective tax rates while large retailers would see onerous increases. The latter would spike consumer prices and gas prices (hurting jobs in Detroit and the airline industry). Eventually, the US dollar would rise enough to provide an offset, yet not without a year of disruption, perhaps even a mini recession. A more likely form of BAT would set a floor on the effective tax rate for exporters and a ceiling for importers. A hypothetical 15% floor and 25% ceiling would greatly diminish lobbying, as well as the impact of the BAT's "stealth" tariff. Watering down lies ahead.

Also, it's almost impossible to get two major things through Congress at the same time when they are as large as repealing/replacing "Obamacare" and comprehensive corporate tax reform. Health care has been prioritized, which means delays in addressing corporate taxes in 2017. Of Trump's "Big 3" economic initiatives – tax cuts, infrastructure spending, and regulatory rollback – the first two need Congress's signoff. So expect regulatory rollback to be his swiftest and most impactful economic stimulant.

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 2.50 (unchanged)

Our global growth outlook remains largely unchanged. In developed markets like the US, manufacturing activity continued to accelerate in January. Stronger business investment, in turn, is boosting Asian exports and is starting to push up commodity prices. However, the upcoming eurozone elections, Brexit negotiations, and turbulence from the Trump Administration are exacerbating uncertainty. Protectionist policies and a trade war could derail the tentative global trade resurgence.

Rates

Roberto Coronado, Senior Portfolio Manager, Developed Markets Investment Grade

CS 3.00 (unchanged)

Ten-year US Treasuries have remained in a tight 2.3%-2.5% range year-to-date, without a clear trend. The market remains short and expects higher rates by year-end. US inflation might have peaked in February, with prices approaching peaks in both oil and soft commodities in year-over-year terms. We think European politics should keep German bunds low in the next few months, providing an anchor for Treasuries.

We remain neutral on Treasuries with a bias for the five- to seven-year part of the curve and recommend caution in the long end given the risk of further steepening. In global bond funds, we continue to recommend long Europe and short US rates. Political risk in France is likely to lead to further support from the European Central Bank (ECB) and bunds. Treasury Inflation-Protected Securities (TIPS) remain attractive versus both nominal Treasuries and non-US inflation-linked bonds over a six- to 12-month period, in our opinion. We prefer the five- to 10-year part of the curve.

Credit

John Yovanovic, CFA, Portfolio Manager, High Yield Bonds

CS 3.00 (+0.25)

The credit market remains bullish, focusing on positive implications of anticipated policy actions and improving economic conditions while generally ignoring potential downside risks. Valuations are tightening in the higher risk assets and quality arenas, though nothing near term is likely to cause a shift in sentiment. Despite the positive fundamental trends, we think valuations warrant a more neutral stance now and perhaps a defensive one in the coming months if valuations continue to trend tighter.

We no longer prefer high yield (HY) bonds over loans and investment grade (IG) bonds. HY spreads have continued to tighten, while loan and IG spreads have remained stable. We expect both HY and IG to provide attractive absolute returns but see better risk-adjusted returns in floating-rate products such as leveraged loans. Within IG, we find less duration-sensitive emerging market (EM) credit becoming more favorable versus developed markets but we remain somewhat cautious until there is more clarity on trade policies.

Currency (USD Perspective)

Anders Faergemann, Senior Sovereign Portfolio Manager, Emerging Markets Fixed Income

CS 3.50 (unchanged)

Potentially slower US growth and a sense the Fed is in no hurry to raise interest rates again have tempered near term positive US dollar sentiment. Yet the wider US yield differential and President Trump's promise of tax cuts keep the stronger dollar outlook alive. Tax reform, including the aggressive BAT plan to stimulate capital formation and employment, would likely further support the dollar. The euro has been remarkably resilient in the face of increased political risks and the potential threat of a breakdown of the European Union. Nonetheless, the ECB has a clear incentive to maintain a weaker euro, and dollar parity beckons.

INVESTMENT VIEWS & CONVICTION SCORE (CS)

We disfavor the euro and yen. In EM portfolios, we favor the Brazilian real and off-index currencies such as India's and Sri Lanka's. We also dislike Central and Eastern European currencies amid increased European political risk.

EM Fixed Income

Steve Cook, Senior Portfolio Manager, Co-Head of Emerging Markets Fixed Income

EM fixed income assets have been resilient. EM may be benefiting from not being Europe or the US, as well as from having a yield cushion, albeit ever shrinking, compared with US Treasuries. February has seen a step up in flows, further improving the technical picture. Valuations are stretched versus only gradually improving economic fundamentals, yet EM issuers seem to be holding up well, perhaps due to a lack of high yield alternatives. Heightened political risk in Europe warrants a cautious approach, and we would not be surprised to see volatility pick up as we approach the French presidential election.

USD EM (Sovereign and Corp.)

CS 3.50 (unchanged)

Local Markets (Sovereign)

CS 3.25 (unchanged)

Multi-Asset

Jose Aragon, Portfolio Manager, Multi-Asset

Slightly higher growth, higher inflation and rates, and more fiscal and less monetary support lie ahead. In our view, deregulation and rising animal spirits will boost growth and profitability, partly offsetting higher costs due to rising commodity prices and wages. Politics will continue to be volatile and erratic, but we expect net-positive outcomes, eventually favoring growth. The main risks are disappointment on the fiscal front and a renewed slowdown in China.

Overall, we favor a combination of equities and cash instruments over credit. We find select equity exposures in the US most attractive, particularly in financial, small cap, and value sectors. Japan remains attractive, in our view, particularly with the recent weakness of the yen. We also like India and Indonesia in EM. In fixed income, we favor bank loans over high yield and investment-grade credit due to rising rates, deteriorating fundamentals, and tightening spreads. We like select hedge funds, listed private equity, and infrastructure for diversification.

CS 2.20 (unchanged)

Global Equity

Graeme Bencke, ASIP, Portfolio Manager and Head Equity Strategy

Equity markets have generally responded positively to fourth-quarter 2016 earnings. The blended earnings growth rate for the S&P 500 is 5%, which marks the first instance since first-quarter 2015 of year-over-year growth for two consecutive quarters. Despite continued uncertainty about the actions of the new US administration and the potential for changes in Europe, investors are bullishly positioned toward the US dollar and have recently reduced their cash positions. Supporting bullishness are rising commodity prices (copper, iron ore) and continued high levels of mergers and acquisitions.

CS 2.75 (unchanged)

Global Emerging Markets Equity

Andrew Jones, CFA, Portfolio Manager and Head of Equity Research, Global Equities

Recent economic data out of China have been positive, leading that market to gains given the fairly low valuations and expectations. Emerging market currencies have been resilient year-to-date, with US dollar strength taking a pause. This foreign exchange trend has also lifted commodities from low levels. Brazilian structural reform appears on track, and constructive social security discussions should progress.

CS 3.00 (+0.50)

We favor financials, technology, materials, Chinese financials, and Indian capital goods and disfavor consumer discretionary and telecoms. We favor Russia and Brazil and disfavor South Korea and Malaysia.

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 parentheses.

Quantitative Research

Peter Fwu, Portfolio Strategy & Risk Analyst, Quantitative Research

The US Market Cycle Indicator (MCI) stayed neutral. On corporate credit, both IG and HY were rich compared with long-term averages. We favor banking, basic industry, and insurance. We dislike REITs, consumer noncyclical, natural gas, and electric. In EM credit, we like Russia, Brazil, and Peru, and dislike Israel, the Philippines, and South Africa.

In rates, we expect yields to decrease in the US and UK, slightly decrease in Japan, and slightly increase in the EU. We believe slopes are likely to flatten in the US, EU, and UK and to steepen in Japan. Curvature is likely to increase in the EU and UK but decrease in the US.