» INVESTMENT STRATEGY INSIGHTS JUL: 2017

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MICRO OPTIMISM VERSUS MACRO PESSIMISM: WHICH IS RIGHT?

The equity market appears convinced that we have entered a healthier stage, seeing a synchronous global expansion early in its upturn. This micro view is influenced by accelerating earnings, stepped-up confidence, prospects for spillover into spending and investment, all coming together after a long holding period. China's reluctant consumers also are coming alive. Just ask Alibaba. Chinese millennials, after allowing their initial decade of stepped-up income to swell savings rates to unheard of levels, now are spending down this enormous pool of funds. Stocks are comforted that central banks are signaling the gradual removal of fragility-based monetary policy, which they see as validating their confidence in the outlook and fortifying future safety nets. Since the last two recessions were caused by bubbles that burst – first in the stock market in 2000-2003 and then in the housing market in 2007-2008 – early central bank tightening should extend the cycle, say the optimists, and thus is a positive.

In contrast, the more macro-focused fixed income markets are riveted on recent dips in inflation, falling prices for iron ore and oil, stagnant wage growth, and a China that once again is throttling back on credit. For them it's déjà vu 2015, with current signals validating their concern that the global economy remains too fragile for central bank accommodation to be removed. The bond market is screaming 'Policy Error' and pointing to a flattening yield curve as predicting rising odds of recession. This validates their concerns.

The micro and macro views cannot both be right.

Central to this great debate is the role of inflation, which after bouncing off a 1% bottom four years ago, is now stuck closer to 1.5%, still stubbornly below most central banks' 2% targets. Yet pushing more money into the system is just swelling markets, not the prices of goods and services. The role of technology, stagnating wages, creative destruction, and how all these interact are cited as the causes of inflation stalling out. How does one reconcile all of this?

First the facts. The pace of nominal growth in the global economy did indeed notch higher last summer after eight years of post-crisis private-sector deleveraging, during which growth was stuck at stall speed. Yet growth is still not fast, just less slow – even if more comfortably above a stall. The Federal Reserve believes that the cumulative impact of its prior quantitative easing lingers, with the system's oversized balance sheet continuing to pull down the medium to long end of the US Treasury curve by 75 basis points. Add that back, they say, and you would see a fairly normal shaped yield curve, with a normal upward slope foreshadowing neither boom nor bust. A growing number of other central banks agree, and feel that maintaining fragility-based policies is increasingly inappropriate. They are beginning to prioritize the normalization of monetary policy, which gradually should remove the distortion in the bond market before it spreads too much into other markets.

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 across the globe, 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, Global Economic Strategy

CS 2.50 (unchanged)

With our balanced view on risks unchanged, our moderately bullish score remains at 2.50. There is evidence of more synchronized growth in developed economies in the form of faster industrial production in Japan and a broad manufacturing acceleration in the Eurozone. In addition, global trade activity remains robust, especially in Asia. Greater demand should have supported higher industrial metals and oil prices, but prices for those commodities fell again in May. While political risk has virtually dissipated in Europe with the election of French President Macron, uncertainty has increased in the US and Brazil, as political scandal threatens any progress on Trump's or Temer's legislative agenda.

Rates

Roberto Coronado, Senior Portfolio Manager, Developed Markets Investment Grade

CS 3.00 (unchanged)

Ten-year US Treasuries have moved to the bottom of their recent trading range despite the Fed's rate hike and its potential start of balance sheet reduction. We think inflation should continue lower given the recent drop in oil prices and lack of rapid wage growth. On the other hand, the market is overly pessimistic on the Trump administration, which should be able to pass reforms that will be positive for growth. The Fed may have a harder time raising rates in September, since another hike could be seen as a policy mistake. The risk to the upside remains Bunds, although they remain stubbornly low. We continue our neutral outlook on US Treasuries, with a bias for the five- to seven-year part of the curve given attractive roll-down, and our positive outlook on Europe, favoring the long end of the curve (20+ years). After the recent retracement, we find TIPS attractive at current levels and prefer the front end of the curve, as we expect inflation to stay just below 2%.

Credit

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

CS 3.25 (unchanged)

With low volatility and tight valuations, credit markets remain a range-bound broken record. Neither the Fed's more hawkish approach in June nor weaker short-term economic data sparked volatility. It is difficult to identify factors that might disrupt current 'treading-water' market conditions. Continuing last month's views, we favor loans over high yield (HY) for portfolio risk reduction, and investment grade (IG) over HY for spreads, while neutral versus loans. We are cautious on European credit due to a potential shift in European Union policy later this year. We continue to favor emerging markets (EM) IG over EM HY due to the current spread premium and the former's generally positive fundamentals; currently there is no effective premium for EM HY.

Currency (USD Perspective)

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

CS 2.50 (unchanged)

Support for the US dollar has dwindled in parallel with a reversal of the "Trump trade," which had pushed yields and the US dollar higher. The Fed expects the first quarter's benign inflation and weaker growth to be transitory, but what will markets think? Fading hopes for tax reform and increased infrastructure spending suggest the US dollar is being propped up only by positive yield differentials vis-à-vis the euro and the Japanese yen. Estimates of the impact of FOMC balance sheet shrinkage suggest that a monthly reduction in the region of US$30 billion continued over 12 months could push the dollar higher versus the yen by three big figures, and the euro higher than the dollar by considerably less. The Fed plans to be "gradual and predictable," which suggests the market impact may be relatively small. Emerging markets currencies benefit from a positive risk environment, a weaker US dollar, and inflows into EM, but investors will have to be selective and mindful of the pitfalls of individual EM countries.

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.

INVESTMENT VIEWS & CONVICTION SCORE (CS)

EM Fixed Income

Natasha Smirnova, Portfolio Manager, Global Emerging Markets Fixed Income

Emerging market debt continues to perform well despite tight valuations and spreads stabilizing within a narrow range. Given the extent of the rally, we think there is much smaller room for outperformance. Robust inflows and a growing prospect pipeline make any attempted correction an immediate opportunity to buy, if not by dedicated EM investors than by cross-over yield-hunters. Idiosyncratic noise and/or geopolitical flare-ups seem to upset markets for a day or two and then are quickly dismissed, perhaps uncomfortably, in the face of strong technicals. Summer carry trade and the absence of major risk events on the horizon may squeeze EM spreads further; longer-term valuations, however, remain challenging at the current level of fundamentals.

USD EM (Sovereign and Corp.)

CS 3.50 (unchanged)

Local Markets (Sovereign)

CS 3.25 (unchanged)

Multi-Asset

Peter Hu, CFA, FRM, Portfolio Manager, Multi-Asset

While China-led growth is topping out, we expect greater growth globally as a result of a cyclical upturn in capital expenditures, rising consumer income, and an expanding US economy. Although US growth has been restrained by a slow first quarter, we're encouraged by the improving picture in capital expenditure — a result of shrinking overcapacity, firming demand trends, and the greater growth potential of a friendlier business environment. We expect US economic activity to pick up in the second half, putting it in the lead of a global growth rotation. In US equities, we continue to favor financials, small caps, and value. We also find Japan equity attractive, as well as Indian and Indonesian equities in EM. In fixed income, we expect rates to rise and spreads to be near their lows; we favor higher quality, floating rate instruments like ABS, investment-grade collateralized loan obligations, and bank loans over credit and duration.

CS 2.40 (unchanged)

Global Equity

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

Solid first-quarter results across most markets continue to power indices, with political developments largely benign. Macro data including consumer spending, capex, and inflation suggest the backdrop will continue, with central banks unlikely to act aggressively. Growth, including tech, has driven much of the year-to-date market performance globally and is trading near historically high valuations relative to value, particularly in the US and Europe. Valuations still weigh on our risk outlook, though we struggle to highlight particular areas of risk that will compress multiples.

CS 2.75 (unchanged)

Global Emerging Markets Equity

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

We continue to favor EM equities, which we find attractive given their fundamental macro and micro improvement, value relative valuation to developed markets, and lower investor positioning. Chinese economic data has been generally in-line over the past month, although we are watching the decline in M2 growth. China's financial sector normalization is proceeding and liquidity injections should soften the process. We are slightly less positive on India, given domestic-oriented valuations after recent market moves, yet our base case still sees growth over the next several years. Brazilian political direction remains uncertain, but economic improvements continue. Given low pairwise correlations, selection will be increasingly important. We favor technology, some of which is consumer discretionary-related, as well as industrials and financials. We dislike energy, consumer discretionary (partially offset by consumer IT), telecoms, and healthcare. We favor Russia, India, Indonesia, and Greece while negative on South Africa and states in the Gulf Cooperation Council.

CS 2.50 (unchanged)

Quantitative Research

Haibo Chen, Portfolio Manager and Head of Fixed Income Quantitative Strategies

The US Market Cycle Indicator continued to trend down due to the flattening curve. In corporate credit, both investment grade and high yield were rich compared to long-term averages. Developed markets credit turned positive from negative, and among sectors we favor technology, electric, utility, and capital goods over energy, basic industry, and financials. We expect yield levels to increase globally, and more so in the UK and Eurozone than in the US or Japan where they should be flat. Except for Japan, we think the yield slope should flatten globally, and curvature should increase in the Eurozone but decrease in US. We favor long global duration, particularly Japan over US and other Euro countries, and Denmark over UK, Italy, and Germany. On curve positioning, we favor 20-year durations over others.