» INVESTMENT STRATEGY INSIGHTS SEPT: 2017

MICHAEL J. KELLY, CFA
Managing Director, Global Head of Multi-Asset

THE FOURTH INDUSTRIAL REVOLUTION

After a prolonged period where companies under-spent depreciation, capacity utilization is still beneath 80%, the rate which normally triggers upswings in capital expenditures. Courtesy of China and others integrating an additional one billion people into the global supply chain, there is still plenty of untapped old-fashioned capacity. Yet get ready for another new, "new norm."

Acclaimed Harvard Business School professor Clayton Christensen's "disruptive technology" concept has finally arrived. Formerly strong business models with well established "moats" are being taken out of the system. Consider the debt holders of many retail and telecom firms, whose business models are suddenly faltering after the long post-crisis period in which their managements bought in stock. And don't forget the new challenges facing Japanese automakers, who built mountains of cash assuming they owned the next 10 years due to their lead in hybrids. Suddenly, an American start-up has launched the first mass-market electric car. Will the global auto fleet even be as large in 10 years if driverless cars and ride-sharing becomes the norm?

Change is in the air. With the slow growth that private sector deleveraging unleashed now behind us, and a reflation of confidence and growth unfolding, a new capex cycle is emerging. It is one in which traditional investment for raw capacity is yielding to new high-tech investments for strategic repositioning purposes. This new investment wave will have both offensive and defensive characteristics. Its intent is to address cost considerations, speed, the ability to customize for an ever discerning consumer, and new demands from ever segmenting distribution.

This stepped up capex in automation, artificial intelligence, and many other technology-based workflow improvements not only will accelerate the global economy, but also widen the gap between winners and losers. First movers investing in advanced tools such as drones and robotic forklifts are experiencing impressive results. One older company in a mundane business, for example, expects to see 33% cash-on-cash return over the next three years. Imagine the pressure on the laggards. In a world where the losers go to zero, investing in index funds makes less sense to us in what we see as a disruptive period ahead.

The sizeable gains in productivity and profitability that high-tech investment is experiencing, however, come at a cost: jobs. Employment cutbacks of as much as 40% from these investments is another aspect of the new, "new norm." While the first industrial revolution ultimately created more industrial and administrative jobs as farm employment plummeted, it is the pace of absorption that matters for political stability. Today, a reflation of confidence and growth is unfolding without inflationary pressures. This eventually will force central banks to choose between old inflation targets and new financial stability risks, such as asset bubbles.

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 2.25 (-0.25)

We upgraded our score to 2.25, which is marginally bullish, on evidence of better global growth. Second quarter GDP reporting from the US, the Eurozone, Japan, and China showed growth accelerating from the first quarter. We expect output gaps in many developed economies to close – or, in Japan's case, to continue exceeding potential GDP – and for much of the second quarter's growth momentum to continue in the second half. We think the biggest risks lie in potential policy errors: a US trade war with China, a sharp change in energy prices, and external shocks such as excessive policy tightening in China or a faster-than-expected return to monetary policy normalization by central banks.

Rates

Roberto Coronado, Senior Portfolio Manager, Developed Markets Investment Grade

CS 3.00 (unchanged)

Ten-year US Treasuries have shown limited volatility in recent weeks and sit in the middle of their five-month trading range (2.10 – 2.40). We expect that range to hold in the near- and longer term, with the upper limit perhaps moving to 2.60. Solid job and economic growth data continue, and inflation remains subdued. Fed watchers haven't changed their expectations, and while a balance sheet reduction will likely be announced in September, we anticipate no rate hikes for the remainder of the year. The only risks are higher bund rates and a geopolitical crisis, in our view. We continue a neutral outlook on US Treasuries with a bias for the five- to seven-year part of the curve given attractive roll-down. We continue to favor Europe in the long end of the curve (20+ years), flat in the US, with most of the exposure in the belly of the curve, and dislike Japan and the UK. The move in TIPS is overdone; we continue to find the front end of the curve attractive.

Credit

John Yovanovic, CFA, Head of High Yield

CS 3.50 (unchanged)

While spreads widened slightly as tensions flared between the US and North Korea, we think credit valuations will remain range-bound at currently tight levels unless a sustained negative event reverses risk appetites. Markets are entering the traditional end-of-summer lull, but with key central bank meetings, the US debt ceiling vote, and other upcoming potential flashpoints, volatility is possible. Within leveraged finance, we continue to favor loans over high yield bonds, although recent high yield (HY) spread-widening reduces the gap. Fundamentals for collateralized loan obligations (CLOs) should support a shift to investment grade (IG), but we think the current technical demand gap for HY results in short-term value opportunity. We are more neutral between IG versus HY, as IG spreads are closer to all-time tights than HY. With strong emerging markets (EM) performance year-to-date and lack of premium over developed markets, we maintain a defensive bias toward EM IG, and favor US over developed markets (DM).

Currency (USD Perspective)

Natasha Smirnova, Portfolio Manager, Global Emerging Markets Fixed Income

CS 2.75 (+0.25)

Disappointment with the Trump tax plan, subdued inflation, and doubts over long-term US productivity make the US dollar friendless. While the US dollar's five-year upward trend looks like it has started to reverse, positioning makes a short-term directional call difficult. The European Central Bank (ECB) is an unwilling participant in the euro's rally and a stronger exchange rate may cap inflation expectations and delay the ECB's tapering intentions. Low popularity of Prime Minister Abe tends to undermine the Japanese yen, but investors use the currency as a safe haven in times of rising geopolitical risk. EM currencies are benefiting from a positive risk environment and a weaker US dollar. The next leg up in EM FX may have to come from an improved EM growth outlook.

INVESTMENT VIEWS & CONVICTION SCORE (CS)

EM Fixed Income

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

Emerging markets debt has remained resilient and continues to outperform its DM peers. Total returns in all components remain firmly positive, with strong technicals still playing a major supportive role. Second quarter earnings for EM corporates continue to beat expectations with credit trends more positive. If this continues, it will help to justify stretched valuations. Sovereign fundamentals also appear strong, although some question second-half China growth. Overall, we maintain our CS as technicals and valuation remain unchanged; we may become more bullish next month if the improvement in fundamentals continues.

USD EM (Sovereign and Corp.)
CS 3.50 (unchanged)

Local Markets (Sovereign)
CS 3.25 (unchanged)

Multi-Asset

Hani Redha, CAIA, Portfolio Manager, Multi-Asset

Improving global financial conditions and China's moderate slowdown provide a supportive backdrop for risk assets. While North Korea has injected some volatility, we maintain our current risk posture, viewing earnings and top-line growth as more positive signs than lagging economic indicators. Although surprised by subdued US inflation, we share the equity market's view that it points to a bullish macro environment where growth translates into strong earnings without margin impact or valuation pressure from rising rates. Despite the absence of policymaking in Washington, we find business optimism and capital expenditure plans encouraging, which are signs of confidence about prospects for end-demand growth. Specifically, we continue to favor US financials, small caps, and value; Japanese equities, and Indian and Indonesian equities in EM. Thematically, we're watching productivity-driven capex and its beneficiaries, primarily focusing on tech sub-sectors that may benefit from rising corporate capex. In fixed income, we expect rates to rise and spreads to remain near their lows. We favor higher quality, floating-rate instruments including asset-backed securities, IG CLOs, and bank loans over fixed-rate assets.

CS 2.40 (unchanged)

Global Equity

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

Strong second quarter earnings and generally solid company commentary support our cautious optimism. This is offset by generally high valuations, the expected shift by central banks to net balance sheet contraction, and geopolitical uncertainty. The prospect of a US tax cut has the potential to generate a market rotation into high cyclical growth stocks from exceptional growth and high stable growth stocks, which have led this year. That said, recent policy failures suggest passage will be a challenge.

CS 2.75 (unchanged)

Global Emerging Markets Equity

Taras Shumelda, Portfolio Manager, Fundamental Equities

Flows to EM equities continued in August helped by evidence of fundamental progress and relative value. Recent Chinese economic data show resilience, albeit with very slight deceleration. Earnings by China's large and mega caps in technology, consumer, and financials generally have exceeded expectations. Similar results were seen in technology and financials in Korea and Taiwan. In contrast, India has seen a decidedly mixed earnings season. In Brazil, the reform process continues at a slower but palpable pace, with lower inflation helping businesses and consumers recover as rates decline. The sluggish Russian economy also shows tentative signs of improvement with tame CPI and rising reserves, although disposable income has been underwhelming. We remain constructive on EM equities given the fundamental macro and micro improvement and believe selection will be increasingly important given low pairwise correlations in Asia and across EM broadly. We like technology, industrials, financials, and consumer staples.

CS 2.50 (unchanged)

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.

We dislike energy, real estate, and healthcare. We favor Russia, Poland, Greece, Brazil, and Indonesia and disfavor South Africa, Turkey, and Thailand. We increasingly find Poland and China favorable while less so on India.

Quantitative Research

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

The US Market Cycle Indicator (MCI) improved slightly as credit spreads tightened. On corporate credit, both IG and HY were getting expensive. The DM credit forecast remained negative, while the EM forecast remained attractive. Among sectors, we favored insurance, banking, and transportation over energy, natural gas, and communications. Basic industry turned from negative to positive. On rates, yield levels were expected to increase in the UK and decrease in the US while remaining flat in the eurozone and Japan; the yield slope was expected to flatten globally except in Japan; and curvature was expected to increase in the Eurozone and the UK but decrease in the US.

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