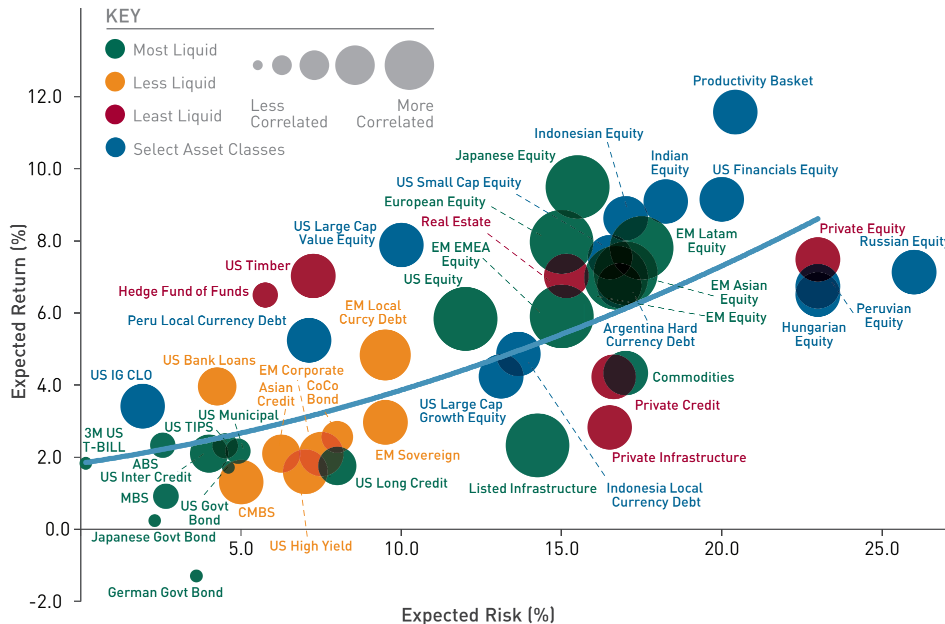
» CAPITAL MARKET LINE 30 SEPT 2017

OPPORTUNITY POINTS TO PRODUCTIVITY-ENHANCING TECHNOLOGY

The global economy's reflationary regime recently turned a year old. We see this slow yet sustainable acceleration of global growth and profitability as primarily the result of the end of private sector deleveraging in the developed markets. Indeed, we have witnessed a rise in confidence, consumption, investment, labor markets, and profitability. Early cycle reflation of volumes within GDP seem to be chipping away at the lingering excess supply that has plagued markets with deflationary forces and sapped investment appetite.

Extraordinary monetary and fiscal policy stimulus also helped the global economy exit stall speed. Now policy support is churning, not being yanked. After the 19th plenum, China will likely take another bite out of the excess supply apple by shutting inefficient, pollution-intensive capacity. While the Federal Reserve is slowly normalizing monetary policy, the combined balance sheet growth by the European Central Bank (ECB) and the Bank of Japan (BOJ) in 2018 will still swamp the minor shrinkage of the Federal Reserve's.

CAPITAL MARKET LINE AS OF 30 SEPTEMBER 2017 (LOCAL CURRENCY VIEW)



Based on PineBridge Investments' estimates of forward-looking five-year returns and standard deviation. The Capital Market Line ("CML") is not intended to represent the return prospects of any PineBridge products, only the attractiveness of asset class indices, compared across the capital markets. Please see Capital Market Line Endnotes. Note that the CML's shape and positioning were determined based on the larger categories and do not reflect the subset categories of select asset classes, which are shown to relative to other asset classes only.

Local Currency

EQUITIES	Return	Risk
US Equity	5.83	12.00
US Small Cap Equity	7.55	16.51
US Financials Equity	9.15	20.00
US Large Cap Value Equity	7.89	10.00
US Large Cap Growth Equity	4.24	13.11
European Equity	7.97	15.00
Japanese Equity	9.49	15.50
EM Equity	6.98	16.70
EM Asian Equity	7.10	17.00
EM EMEA Equity	5.90	15.00
EM Latam Equity	7.80	17.50
Indian Equity	9.09	18.25
Indonesian Equity	8.62	17.00
Russian Equity	7.13	26.00
Peruvian Equity	6.74	23.00
Hungarian Equity	6.51	23.00

FIXED INCOME		
3M US TBILL	1.83	0.15
US Govt Bond	1.71	4.60
German Govt Bond	-1.30	3.60
Japanese Govt Bond	0.24	2.30
US TIPS	2.31	4.50
US Municipal	2.17	4.90
US Intermediate Credit	2.10	4.00
US Long Credit	1.76	8.00
MBS	0.92	2.65
CMBS	1.31	5.00
ABS	2.33	2.55
US High Yield	1.59	7.00
US IG CLO	3.42	1.93
US Bank Loans	3.96	4.25
EM Sovereign	2.97	9.50
Argentina Hard Currency Debt	6.76	16.80
EM Corporate	2.09	7.50
EM Local Currency Debt	4.83	9.50
Peru Local Currency Debt	5.24	7.12
Indonesia Local Currency Debt	4.86	13.65
Asian Credit	2.10	6.25
CoCo Bond	2.56	8.00

ALTERNATIVES		
Productivity Basket	11.57	20.42
Commodities	4.33	17.00
Real Estate	7.03	15.15
Hedge Fund of Funds	6.49	5.75
Private Equity	7.48	23.00
Listed Infrastructure	2.32	14.25
Private Infrastructure	2.82	16.50
Private Credit	4.23	16.63
US Timber	7.03	7.25

THE PINEBRIDGE GLOBAL MULTI-ASSET SERIES:

MULTI-ASSET STRATEGY
Monthly asset class convictions and risk positioning.

INVESTMENT STRATEGY INSIGHTS
Monthly views from our diverse global investment teams.

USD Unhedged

EQUITIES	Return	Risk
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US Financials Equity	9.15	20.00
US Large Cap Value Equity	7.89	10.00
US Large Cap Growth Equity	4.24	13.11
European Equity	9.16	20.66
Intl Small Cap Equity	5.38	15.00
Japanese Equity	7.86	15.90
EM Equity	5.84	17.99
EM Asian Equity	6.01	17.41
EM EMEA Equity	4.69	16.97
EM Latam Equity	6.61	23.20
Indian Equity	7.77	22.91
Indonesian Equity	9.39	17.41
Russian Equity	5.92	26.19
Peruvian Equity	5.94	24.66
Hungarian Equity	5.29	23.52
FIXED INCOME		
3M US TBILL	1.83	0.15
US Govt Bond	1.71	4.60
German Govt Bond	-0.12	12.48
Japanese Govt Bond	-1.40	10.97
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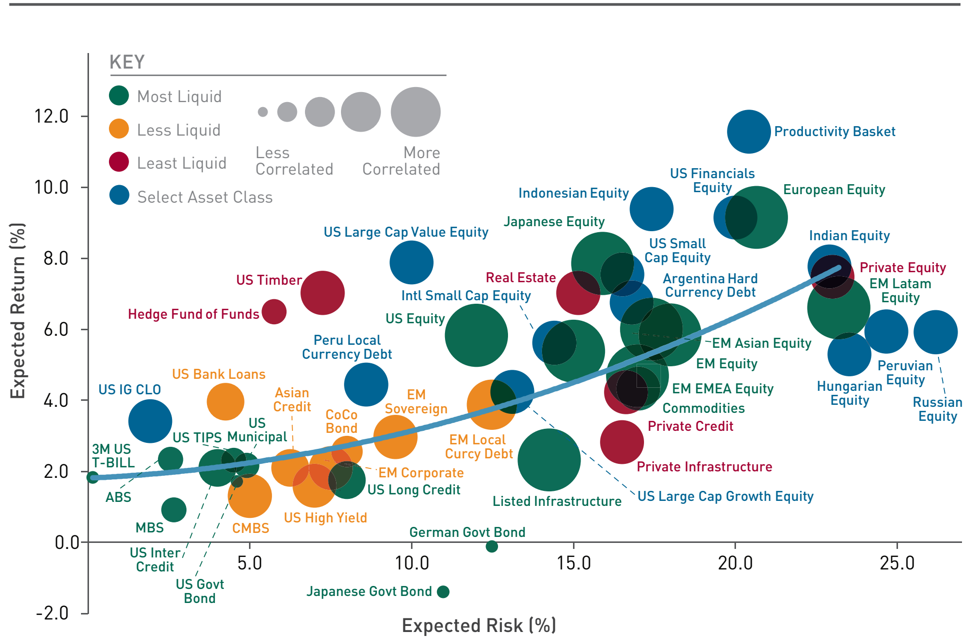
CAPITAL MARKET LINE AS OF 30 SEPTEMBER 2017 (USD VIEW, UNHEDGED)



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Some analysts claim that markets are late in the business cycle and nearing a recession. We respectfully disagree, and point to output gaps, which are conspicuously not late-cycle. Investment activity – which is just awakening – is not overheating. And financial conditions – which are not restrictive – encapsulate gluts in both savings and central bank balance sheets, both of which may take three to seven years to clear. Overconfidence is what ends cycles, and after a lost decade for the global economy, it is tough to spot. Much can change from here; we see a technology-driven, productivity-enhancing investment wave ahead that will not only accelerate growth, but also declare more and bigger winners and losers. This is the opposite of secular stagnation.

Our Capital Market Line (CML) remains positively sloped. Our forecasts for cash flows are accelerating, largely to keep pace with accelerating prices. Dispersion is still high, speaking to the dynamic world ahead as well as the distorted markets from extraordinary policies. All this spells opportunity — not only to select attractive betas, but also to avoid beta "black holes" that will drag down many overdiversified portfolios into lower nominal returns.

INSIGHTS FROM TODAY'S CML

Growth assets lead capital preservation assets. The stall-speed regime was very kind to capital preservation assets as central banks' unprecedented injection of liquidity into markets after the Great Recession generated exceptional risk-adjusted returns. While growth asset prices also benefitted from the precipitous fall in discount rates, the underlying cash flows of these assets grew at a painfully slow pace. Now, the reflationary regime is accelerating the cash flows of growth assets. This is typically the longest part of the cycle, with high earnings growth as the primary driver of total returns. Capital preservation assets, however, will struggle against a slow and steady headwind of tightening monetary conditions, requiring acute selectivity in credit investing.

Markets geared to synchronized global growth will win. While the synchronized global growth recovery will likely fluctuate, we expect global growth to establish a higher baseline. Within the US, certain segments, such as large cap growth stocks, appear to have unrealistic implied growth rates. Yet other segments, including small cap value stocks, are well-positioned to benefit from higher growth while being reasonably priced, in our view. Markets such as Japan and Europe can also be expected to benefit from a reflationary environment with higher corporate capital expenditure (capex).

Productivity-enhancing capex is a structural beneficiary. The focus on productivity-enhancing technology will lead to further acceleration of earnings growth for these technology providers. Over the last few years, the tech sector has outperformed primarily due to consumer-facing internet stocks. Yet our focus is on corporate-facing, productivity-enhancing technology. We are encouraged by surveys of IT leaders indicating that the adoption of this technology has reached an inflection point, and IT spending is due to rise. Priorities include cloud computing, software as a service, and cybersecurity.

Credit markets require selectivity. After benefitting disproportionately from the slow growth environment and enjoying the process of spread tightening and yield compression, most of the credit complex appears fully valued or overvalued to us. Higher rates will be a steady headwind, yet more importantly, we do not foresee much room for spreads to tighten further. This caps the upside and creates a very asymmetric return profile. Additionally, the capex cycle ahead is likely to raise accrual-based earnings yet will squeeze free cash flows and cash-flow-based credit metrics. We therefore advocate moving up the capital structure into floating-rate bank loans, even though that may sacrifice some near-term returns. Robust capital structures such as collateralized loan obligations (CLOs) may also provide opportunities to add investment-grade yield to portfolios while being protected by significant levels of credit subordination.

Private assets are suffering from capital overhang and erosion of protections. The last two quarters have seen a veritable stampede into private assets, as evidenced by record-breaking fundraises. In private equity markets we see all the classic indicators of a weak vintage, including record levels of dry powder, ever-higher entry valuation multiples, and investors' expectations morphing into relative returns as opposed to absolute returns from these allocations. In private credit, we had been seeing competitive pressures leading to erosion of yields, yet credit discipline was being maintained. Not anymore. Investors are now acquiescing to both lower prospective returns as well as erosion of credit protections. We recommend that investors maintain their flexibility to respond to market shocks through allocations to liquid asset classes.

ABOUT THIS REPORT

As our Global Multi-Asset Team's proprietary tool for the management of our multi-asset products, the CML provides a common language and quantifies several key fundamental judgments made after dialogue with our specialists across asset classes.

THE FUNDAMENTALS DRIVING OUR CML

Confidence is developing into an investment cycle. Global synchronized growth made possible through fiscal and monetary policy – and, in the developed markets, the end of private sector deleveraging – is firming and becoming more self-sustaining. We now see clear signs that positive feedback loops are kicking in, leading to all-time-high confidence levels spilling over into capex plans. We are encouraged by the broad-based nature of these emerging capex plans from Europe to China and particularly by the fact that the common focus is on cycle-extending productivity rather than raw capacity. This bodes well for pricing power and a healthier level of inflation.

Productivity-enhancing capital expenditure will extend the cycle. Growth in the previous regime was primarily supported by the consumer and extraordinary monetary policy. The key missing source of growth has been corporate investment. Corporations have been maximizing shareholder returns through a combination of cheap labor, borrowing for buybacks and dividend payments, and low and falling interest rates and commodity prices. The result has been strong earnings through margin expansion at the expense of low productivity and low growth at the macro level. That was then. We now see a sea of change in corporate behavior. Corporate management today is acutely aware of the risks to well-established business models from disruptive technology. They are also seeing the beginnings of a reversal of the interest rate and wage dynamics that boosted their margins. As a result, we are seeing early signs of an acceleration in corporate capex directed toward productivity-enhancing technology. This is a critical development. It can be the source of disinflationary growth and would be another factor helping to prolong this cycle through productivity gains and steadily rising real wages.

The global savings glut and excessive liquidity will be slow to dissipate. Disinflationary forces including demographics in key economies, disruptive technology, and range-bound commodity prices are likely to persist and contribute to a very gradual withdrawal of excess liquidity. Nevertheless, fragility-based monetary policy is no longer appropriate, as the threat of deflation has passed. Therefore, the path for rates is higher, and is generally not being reflected in forward curves. We expect the Fed to proceed with balance sheet normalization and a steady but gradual hiking cycle. The ECB will need to slow down its ongoing massive distortion of European markets, first by slowing its balance sheet growth, then by shrinking it, and finally by removing negative interest rates. It is the BOJ that we expect to remain most accommodative for most of our five-year horizon, only gradually tightening its policy mix in the out years. In aggregate, we think central bank balance sheets will actually continue to grow in 2018, possibly beginning to shrink in 2019 before more quickly moving toward normal sizes in 2020. In a world of global cross-border flows, and a naturally formed global savings glut that will only slowly dissipate, this is a fairly benign rate environment. Rates will rise, but slowly.

Fiscal stimulus should continue to support growth. In the US, regardless of the eventual policy package delivered, it is clear that the fiscal stance will be more favorable than over the last nine years. In China, we are likely to see the fiscal deficit remain relatively wide, though we don't expect it to widen further. Yet the broad undercurrents of populism are still stirring, as recent elections in Germany and the election campaign underway in Japan show. Pressure to loosen the purse strings to support growth that benefits the masses will likely continue for politicians. Fortunately, the higher level of global growth we expect should provide some of the additional revenue base to boost expenditures.

Supply-side discipline will help encourage reflation. Part of the recovery in nominal GDP growth has been due to recent actions in China to reduce production levels and genuinely pursue supply-side reforms. After instituting an elaborate system of production limits in 2016 linked to production costs, China now appears ready to impose more stringent environmental standards. These will likely continue the restraints on production, effectively limiting China's ability to export deflation, thus supporting global reflation. While it is a drag on sheer output, we believe this change in China will be an extremely positive development for global goods reflation and earnings growth starting in 2018.

Unlike inflation, reflation does not pressure valuations. Concern among investors about equity valuations is widespread. Interestingly, we do not hear similar concerns around bond market valuations. This calls for additional caution regarding much of the fixed income complex, in our view. For growth assets, we find compelling empirical evidence that reflation – a rise in inflation from 0%-1% to 1%-3% – is not problematic for valuation multiples. This is due, intuitively, to falling risk premiums as markets move away from the fears of deflation. It is only when inflation rises above 3% in developed markets that reflation morphs into inflation and triggers lower multiples through higher rates. As a result, we acknowledge the lack of potential for valuation multiples to contribute positively to total returns going forward. Yet we believe it is too early to be concerned about meaningful valuation contraction. That comes later with an overheating economy.

The correlation collapse is structural. Since mid-2016 we have witnessed a broad-based collapse in correlations. This has occurred both across asset classes and within asset classes. We see this as driven by the regime shift from stall speed toward reflation; more balanced conditions bring about more muted correlations. Unfortunately, the highly negative correlation between risk assets and risk-free assets also collapses, as bonds no longer benefit from all risk markets panicking at the same time with every negative fluctuation in price. This structural correlation shift calls for a restructuring of investment portfolios.

EM leverage stabilizes and consumption accelerates. We have been concerned about the rapid rise in leverage across emerging markets (EM) over the last few years, expecting it to result in lower forward-looking growth. Now, half of the countries in EM are in a state of passive deleveraging and we have seen these dynamics stabilize over the last few quarters. Credit fundamentals have been improving on the back of stronger growth, leading to a slight easing of underwriting standards. Moreover, we see signs that in Asia, consumption patterns are changing for the better. Urbanization and the growth of the middle class are long-term structural positives for consumption, and we are seeing tangible gains. Savings rates in China are likely to fall as the economy matures, creating a partial offset to the familiar structural slowdown ahead.

ABOUT THE CAPITAL MARKET LINE

The Capital Market Line (CML) is a tool developed and maintained by the Global Multi-Asset Team. It has served as the team's key decision support tool in the management of our multi-asset products. In recent years, it has also been introduced to provide a common language for discussion across asset classes as part of our Investment Strategy Insights meeting. It is not intended to represent the return prospects of any PineBridge products, only the attractiveness of asset class indexes compared across the capital markets.

The CML quantifies several key fundamental judgments made by the Global Multi-Asset Team after dialogue with the specialists across the asset classes. We believe that top-down judgments regarding the fundamentals will be the largest determinants of returns over time driving the CML construction. While top-down judgments are the responsibility of the Multi-Asset Team, these judgments are influenced by the interactions and debates with our bottom-up asset class specialists, thus benefiting from PineBridge's multi-asset class, multi-geographic platform. The models themselves are intentionally simple to focus attention and facilitate a transparent and inclusive debate on the key drivers for each asset class. These discussions result in 19 interviews focused on determining five year forecasts for over 100 fundamental metrics. When modelled and combined with current pricing, this results in our annualized expected return forecast for each asset class over the next five years. The expected return for each asset class, together with our view of forward-looking risk for each asset class as defined by volatility, forms our CML.

The slope of the CML indicates the risk/return profile of the capital markets based on how the five-year view is currently priced. In most instances, the CML slopes upward and to the right, indicating a positive expected relationship between return and risk. However, our CML has, at times, become inverted (as it did in 2007), sloping downward from the upper left to the lower right, indicating risk-seeking capital markets that were not adequately compensating investors for risk. We believe that the asset classes that lie near the line are close to fair value. Asset classes well above the line are deemed attractive (over an intermediate-term perspective) and those well below the line are deemed unattractive.

We have been utilizing this approach for over a decade and have learned that, if our judgments are reasonably accurate, asset classes will converge most of the way toward fair value in much sooner than five years. Usually, most of this convergence happens over one to three years. This matches up well with our preferred intermediate-term perspective in making multi-asset decisions.

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CAPITAL MARKET LINE ENDNOTES

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