» INVESTMENT STRATEGY INSIGHTS DEC: 2017

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WHAT ARE THE RISKS IN 2018?

We have been optimistic about markets since private-sector deleveraging ended and growth and cash flows accelerated. Those factors, plus the lingering global savings glut, a consequence of deleveraging, and the resultant low interest rates, which have lagged rising cash flows, all explain why equities have gone straight up. While the positives continue, we nonetheless should reflect on what could go wrong in the new year.

A flattening yield curve historically has been a reliable forecasting tool. Today's flattish yield curve is flashing a cautionary yellow light. In 2006, when the shape was much like today's, the yield curve foreshadowed the crisis that began in July 2007. But that was the yield curve's finest hour as a forecaster. During a prior flattening in the mid-1990s, the economy and markets roared ahead for another five years before trouble began. In the past, economies and stock markets normally accelerated for 12 months after reaching the current degree of flatness.

One also can argue that today's curve is qualitatively very different from curves in the past. Central banks formerly controlled the short end of the yield curve while leaving the long end to market forces. The shape of the curve, therefore, was really a comparison of the central banks' view of the global economy with that of market participants. Markets proved to be more reliable forecasters than central bankers, thus elevating the shape of the yield curve to star status among forecasters. Yet reaction to the financial crisis changed the yield curve's players. Through quantitative easing (QE), negative interest rate policy (NIRP), and yield curve control (YCC), central banks for the first time sought to control the long end of the yield curve as well as the short end. Federal Reserve studies conclude that the cumulative impact of its past QE is still suppressing the rate on 10-year Treasuries by 50 basis points. Add that to today's yield curve and the yellow light stops flashing. Add the QE, NIRP, and YCC efforts that the European Central Bank (ECB) and the Bank of Japan still are actively engaged in, and which all market participants concede are holding down US rates, and the only question is by how much the entire yield curve is distorted. Whatever the answer, it's likely enough to de-emphasize the shape of today's curve as a warning signal.

China is also cited by many as a primary risk for 2018. New measures are being announced to cull leverage, reminiscent of the 2015 slowdown. But while wealth management loans are being discouraged, consumers now have much greater access to loans at state-owned banks, and on better terms. This time is a more surgical pruning of who gains access to further credit growth, not an attempt to stop it. We are more sanguine that a material slowdown is not unfolding.

Our two chief concerns are a Minsky Moment and inflation. Professor Hyman Minsky is remembered for asserting that periods of stability bring about leverage and carelessness, thus creating ensuing periods of instability. The post-crisis period, while slow in terms of growth, witnessed very stable cash flows and low market volatility. Re-leveraging and rising animal spirits are probably coming, but a Minsky Moment implies more strength to come first, for some time, before a spark can cause danger. Our second worry, rising inflation, would signal that economies were running out of slack and that profits and loose central bank policies were at the end of their run. While we're on the lookout for a Minsky Moment and higher inflation, we see neither on the horizon in 2018.

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 (unchanged)

Robust third-quarter GDP figures and strong manufacturing reports indicate many developed-market economies are on track to exceed growth projections for 2017. As many central banks lean toward normalizing monetary policy, more governments seem to be turning to tax cuts and job schemes to amplify the growth acceleration already underway. But fiscal stimulus is not without risks; increased government spending could equally amplify the negative feedback from rising debt service costs.

Asia Economy

Paul Hsiao, Economist, Global Economic Strategy

CS 2.50 (unchanged)

In China, the slight cooling of credit creation and weaker output conform to expectations of a slower fourth quarter and deceleration in 2018. Decreasing support from Chinese growth is being partially offset by demand from the eurozone, the US, and others. In fact, yearly export growth for many Asian economies remains in the double digits and will probably stay there for a while. Additional monetary accommodation and more optimistic business sentiment due to dissipating deflationary pressures could lead to even stronger nominal growth.

Rates

Roberto Coronado, Senior Portfolio Manager, Developed Markets Investment Grade

CS 3.25 (+0.25)

We have become mildly bearish, expecting 10-year US Treasuries to trade within a 2.25%-2.75% range in the medium term, versus the 2.0%-2.5% range expected since January. US economic growth should continue at its current pace while inflation will likely stay subdued at about 2%. Although we expect tax cuts in 2018, their economic impact should be limited. We see greater risk for Bunds being higher in 12 months as the ECB winds down QE, bringing volatility to rates. In short, we see US Treasuries trading higher a year from now as decent US growth continues while major central banks are less accommodative. But since inflation will not overshoot, we think the Fed will be unable to hike rates faster than expected. We remain neutral 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) and the front end of the Treasury Inflation-Protected Securities (TIPS) curve, although there is limited upside given our inflation view.

Credit

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

CS 3.50 (unchanged)

Despite a recent pullback, particularly in high yield (HY), credit spreads remain near post-crisis tight levels, causing extended valuations on an intermediate-term basis. But since no particular catalyst for the recent spread movement is evident, the retracing of recent tights on a short-term, technical basis is possible. Any US tax changes could affect the sound earnings fundamentals of equities, but we see no material effect on credit markets. While we continue to favor loans over HY over the next 12 months, the recent HY selloff and loan stability may reverse over the next two months, perhaps causing a short-term increase in HY. Spread compression is reducing the advantage of collateralized loan obligations (CLOs) over other credit assets. In developed markets credit we are neutral on US investment grade (IG) versus HY and continue to favor US IG and HY over Europe, but we also favor European loans due to the sterling premium.

INVESTMENT VIEWS & CONVICTION SCORE (CS)

Currency (USD Perspective)

CS 2.75 (unchanged)

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

In its October World Economic Outlook, the IMF shared our optimistic view of synchronized (albeit fairly tame) global growth combined with just a hint of inflation. The outlook for EM growth continues to improve, but risks remain in several areas, such as Turkey, and we remain vigilant, especially given valuations. With tight valuations combined with strong year-to-date total returns across dollar-denominated EM securities, the seasonal volatility we often encounter across fixed income markets in November and December leads us to maintain a cautious stance on risk. Reduced liquidity in December tends to exacerbate price moves, especially negative ones, so caution is warranted.

EM Fixed Income

USD EM (Sovereign and Corp.)
CS 3.25 (unchanged)

Local Markets (Sovereign)
CS 2.75 (unchanged)

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

Despite a possible minor slowdown in China, EM growth has been picking up in recent months, and we remain optimistic on China's growth overall. Gradually improving fundamentals, catching up with fairly tight EM spreads, leave technical factors and external risks to drive EM debt. The Fed-driven September wobble has been replaced by new demand for yield, and EM currencies should benefit from the improving EM growth outlook, supporting our EM currency optimism.

Multi-Asset

CS 2.20 (unchanged)

Peter Hu, Portfolio Manager, Multi-Asset

For the first time this year, we have seen strong corporate earnings growth across all regions and strong confidence in consumer spending and business investment. Due to the party leadership's consolidation of political power and strong consumer spending that will offset the decline in old industries, China is less likely to disrupt global markets, in our view. In credit markets, we expect the yield curve will not move up quickly and that inflation will be lower than expected, all bullish for discounting cash flow. As a result, we favor selected exposure to floating-rate instruments and growth assets, focusing on companies that will likely benefit from greater capital investment in areas that boost efficiency, not capacity. We continue to favor US financials due to releveraging and expected eased regulation; Japanese equities, due to Abe's pro-growth policies; and bank loans and IG CLOs because of our focus on shorter duration and higher quality.

Global Equity

CS 2.75 (unchanged)

Chris Pettine, CFA, Research Analyst, Global Equities

Market strength has continued on greater-than-expected third-quarter earnings. Economic growth should continue to support equities despite some near-term headwinds in the form of heightened valuations, a flattening yield curve, and uncertainties surrounding US tax reform–which could result in a pickup of volatility. Looking into 2018 and beyond, we continue to be positively inclined given improving demand trends and more positive corporate sentiment. At the portfolio level we continue to favor balanced exposure across growth categories.

Global Emerging Markets Equity

CS 2.50 (unchanged)

Gustavo Pozzi, CFA, Portfolio Manager, Global Equities

Flows to EM equities slowed in October over valuation concerns. Overall, however, recent company results have been strong, beating expectations in technology, China, emerging Europe financials, and Brazil. Chinese economic data following the 19th Plenum have been softer than expected, notably in new loans, retail sales, and money supply. Brazilian inflation continues to trend down, which will help businesses and consumers recover as rates decline. We remain constructive on EM equities given the fundamental improvement at macro and micro levels, and believe security selection will be increasingly important given low pairwise correlations in Asia and across EM broadly.

Quantitative Research

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

The US Market Cycle Indicator (MCI) deteriorated slightly as a flatter curve outweighed the tighter BBB credit spread effect. On corporate credit, both IG and HY remained expensive. Our developed markets credit forecast remained negative, while EM stayed positive. Among sectors, we favored basic industry, technology, and insurance over natural gas, communications, and consumer noncyclicals. On rates, we expect yield levels to increase in the UK and Europe and decrease in the US and Canada; the yield slope to flatten globally; and curvature to increase in Europe and the UK but decrease in the US. Our rates model portfolio favored long global duration in Canada, Australia, and Europe. On curve positioning, we favor five- and 20-year key rate durations.

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.