PINEBRIDGE INVESTMENTS

» INVESTMENT STRATEGY INSIGHTS JAN: 2018

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THE NATURE OF GLOBAL GROWTH FROM HERE

Starting in mid-2016, when the long stall-speed regime came to an end, emerging markets (EM) overtook developed markets (DM) as global growth leaders. The growth gap, while still in EM's favor, shrank in the third quarter as DM stocks regained some of their lost ground. The gap appears poised to shrink again when fourth-quarter GDP figures are released. While the growth gap issue is seemingly important, today's global synchronous recovery finds us less concerned about the sheer quantity of growth and more about the quality of that growth and its associated risks in all markets.

Consider China, which vastly increased bank lending in 2009 to insulate itself from weakness elsewhere. After accomplishing that goal, the lending continued during the subsequent sluggish deleveraging of the economies that China exported into. Now, with most of China's export markets growing and re-leveraging again, what many said couldn't be done appears to be happening: China's less credit-intensive consumer and technology sectors are delivering real and rising growth, presenting China with the flexibility to take its foot off the debt accelerator without incurring another 2015-style "thud."

The changing composition of EM economies also changes the nature of the EM/DM growth picture. Impressive increases in the weighting of technology and other less capital-intensive growth sectors have made EM indices much broader measures than the virtual proxies for commodities they once were. Even the oil exporters of the Middle East are in the midst of attempting to trim their exposure to energy. India, which appears to be waiting until 2019 elections are out of the way before considering further structural reforms, is now seeing growth dividends from the painful changes it has already made. And Russia and Brazil have just emerged not merely from stall speed but from outright recessions.

In the DM world, economists quickly labeled the US tax cut as inconsequential; businesses seem to have a different view. When combined with the cessation of the post-crisis regulatory assault as well as the potential for regulatory rollback – particularly in the financial sector through legislation that Mitch McConnell suggests will be introduced in a bipartisan manner in the second quarter – animal spirits are reviving. We suspect expectations are far too tame for US growth in 2018.

But growth does not come worry-free. Albeit slowly, debt now seems to be rising everywhere again, and with that comes risk. Synchronous growth also means that central banks other than the Federal Reserve will begin planning for, and talking about, monetary normalization. And Trump's tax triumph raises the likelihood he will return to trade issues in 2018. In sum, while risk has been pervasive post crisis, central banks were willing to serve as backstops. From here on, growth looks easier to come by, but risk slowly will shift back to the 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:

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

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 2.00 (-0.25)

We upgraded our score to 2.00, signaling greater conviction in stronger global growth over the next six to 12 months. Higher demand has stimulated business investment, which in turn has boosted growth among Europe's and Asia's exporters. Stronger manufacturing also lifted industrial metals prices and growth prospects among emerging market commodity producers. The result is a more synchronized global business cycle. While more stimulative fiscal policy could amplify the trend, there is little inflation risk, which means stronger investment is unlikely to stimulate consumption meaningfully. Furthermore, a broadening global rate-hike cycle and the end of global quantitative easing (QE) in 2019 together with weaker growth in China are likely to create sufficient headwinds by 2019/2020 to slow global growth back to, or below, its long-term average.

Asia Economy

Paul Hsiao, Economist, Global Economic Strategy

CS 2.50 (unchanged)

While China's latest trade, aggregate financing, and manufacturing reports all beat expectations, policymakers are introducing initiatives like the air quality campaign and a new set of asset management product rules that support the narrative of "slower but better growth." In India, stronger third-quarter GDP figures suggest the growth slowdown resulting from the Goods and Services Tax and demonetization has passed. Economic activity is set to accelerate in the coming quarters, helped by measures including the public sector bank recapitalization. Meanwhile, there are convincing signs that regional disinflation has bottomed out.

Rates

Roberto Coronado, Senior Portfolio Manager, Developed Markets Investment Grade

CS 3.25 (unchanged)

We continue to expect 10-year US Treasuries to trade within the 2.25%–2.75% range in the medium term. US economic growth should continue at its current pace while inflation stays subdued at about 2%. Although we expect tax cuts in 2018, their economic impact should be limited. The main risks continue to be Bund rates moving higher as the European Central Bank approaches the end of its QE program, and a policy mistake by the Fed that drives the economy into recession. In short, we see US Treasuries trading marginally higher in January 2019 as the US economy enjoys another year of decent growth while major central banks are less accommodative. Since inflation will not overshoot, the Fed will likely struggle to raise rates three times next year. 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), flat in the US with most exposure in the belly of the curve. We continue to favor the front end of the 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)

Our credit market theme of limited overall volatility and excess demand continues. There are idiosyncratic earnings misses and underperformers, but broad market expectations are positive for the fourth quarter and 2018. Since valuations remain tight amid risk creep, we continue to remain cautious. But it's hard to see what might cause market sentiment to shift drastically. All signs point to coupon-clipping conditions, even if credit rarely returns coupon over the course of a year. We continue to prefer loans over high yield bonds (HY) on a risk-adjusted basis, but ongoing repricing activity in loans and a short-term increase in default expectations, albeit below historical levels, result in a view closer to neutral. Spread compression in the collateralized loan obligations (CLO) market is compressing its advantage over other credit assets. In developed markets (DM) credit we are neutral on US investment grade (IG) versus HY and continue to favor US IG and HY over Europe, but 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

US 10-year yields are flirting with the upper bound of their multi-month 2.10%-2.40% range. More important, two- versus ten-year and ten- versus 30-year US Treasury yield curves are flattening, and the market is debating whether the US yield curve could potentially invert during 2018, adding downward pressure on the US dollar. Accordingly, the positive relationship between higher US two-year yields and the US dollar has broken down. In comparison, steepness in the German curve and the ECB showing no signs of willingness to speed up its tapering translate into the euro remaining supported above 1.1500. Currently, the EUR/USD is caught in a tight range between 1.1690 and 1.1960. Fed behavior, the shape of the US curve, and the wage/inflation puzzle remain the main drivers of the US dollar. Lower US inflation in the first quarter followed by higher inflation in the second could spark volatility, which remains very low. EM currencies retain their resilience, supported by prospects of a wider EM/DM growth differential, subdued EM inflation, and capital flows.

EM Fixed Income

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

Local Markets (Sovereign)
CS 2.75 (unchanged)

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

The outlook for EM growth continues to improve. Nevertheless, we are focused on idiosyncratic risks in areas such as South Africa, Turkey, and Latin America, while remaining vigilant given historically tight valuations. We remain cautious given very strong total returns year-to-date across EM debt and the likelihood of seasonal volatility. Reduced liquidity tends to exacerbate price moves, especially during negative credit events, so caution is warranted.

Multi-Asset

CS 2.20 (unchanged)

Jose Aragon, Portfolio Manager, Multi-Asset

The past year saw strong corporate earnings growth across all regions, strong confidence in consumer spending and business investment, and a tempering of bank regulatory aggressiveness in the US and Europe. China is less likely to cause global economic disruption thanks to the party leadership's consolidation of power, strong consumption, and infrastructure spending driven by the One Belt One Road initiative. We continue to favor: select growth asset exposure and floating rate instruments; active strategies due to the decreased correlation across and within asset classes; companies that will benefit from capital expenditure (capex) focused on productivity/efficiency, not more capacity; US financials due to policy normalization, regulation rollback, and tax reform; and Japanese equity due to support for Abe's pro-growth policies. In fixed income, we favor minimizing duration and focusing on higher quality instruments such as bank loans and IG CLO.

Global Equity

CS 2.75 (unchanged)

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

Healthy third-quarter earnings on solid global growth, favorable central bank policy, and possible US tax cuts have boosted equity markets. Valuations hold us from becoming too optimistic, though companies continue to highlight growth potential, capex plans, and even M&A, despite the drag of high valuations. We expect companies will increasingly discuss their tax outlooks when details are better known. Potential headwinds include labor shortages, wage inflation, and a flattening yield curve. As always, the wild card is politics. Heading into 2018, we look for further market "normalization," which along with improving global growth and technological advancements continues to support bottom-up investment research.

Global Emerging Markets Equity

CS 2.50 (unchanged)

Andrew Jones, CFA, Portfolio Manager and Head of Equity Research, 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.

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

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

Our US Market Cycle Indicator has deteriorated as the yield curve flattened further. On corporate credit, both IG and HY became more expensive. Our DM credit forecast remains negative, while EM stays positive. Among sectors, we favor transportation, consumer cyclical, basic industry, and insurance over communications, consumer non-cyclicals, REITs, and utilities. On rates, we expect yields to increase in the UK and eurozone and decrease in the US and Canada. We expect the yield slope to flatten globally, except in Japan, and curvature to increase in the eurozone and UK but decrease in the US.

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