The Global Slowing – Due to Trade or Something Else?

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While trade frictions attracted the most attention, the primary and outsize drag on global growth in 2018 was the self-imposed slowdown China began in mid-2017. Intended as a gentle cooling, the deleveraging and derisking program overshot; China's private sector — 60% of its economy — iced up.

Since approximately one-third of global growth comes from China, its abrupt chilling spread to economies throughout the world, with an outsize impact on other emerging economies and Europe, just as in 2015. Not helping was that markets already had been losing ground over fears that liquidity was shifting from being a tailwind to a headwind. As clear signs of declining growth emerged, markets looked to the Federal Reserve to adjust its moves to the new, less-encouraging outlook. Instead, Fed pronouncements flip-flopped between talk of data dependency and "auto-pilot," which was stressful for those hanging on by tenterhooks.

China's policymakers' initial response to their too rigorous tightening was slow and timid. But they have picked up the pace, signaling that greater tax cuts and increases in bond issuance by local governments are on the way. While pre-tariff inventory stockpiling must be cleared out in the first quarter, we are becoming confident that China's economy will turn upward by spring. Less certain is whether the Federal Reserve's liquidity draining efforts — incorporating balance sheet trajectories as well as rates — truly shift to neutral. Such a move is likely because it's necessary, but a course change is far from certain since it depends on the Fed's willingness to pivot.

Another question mark for 2019 is business investment. Trade uncertainty held back the unfolding upswing, and that uncertainty continues. Simply put, in the absence of new trade ground rules, it's hard to determine where to invest. While capability and productivity improvements continue, capacity measures are on hold. Still, business confidence remains higher and more resilient than one would think, with company guidance continuing to point to the will and wherewithal to step up investment once there is clarity on trade and the current slowing bottoms.

The good news is that formal negotiations between the US and China over trade and technology recommence in March, and movements on market access appear to be progressing nicely. Intellectual property remains the thornier issue, but initial signs are positive there too. China has stepped up penalties for intellectual property theft and is tip-toeing toward support for the OECD's concept of competitive neutrality — principles that would commit state-owned enterprises to diminishing market distortions.

Healthy markets over the next 12 months require changes by China that would reaccelerate global growth by the year's second half, a shift to neutral by the Fed, and a de-escalation of trade and technology frictions by Washington and Beijing. There is good reason for optimism on all three drivers.

About This Report

PineBridge believes that not only do differences of opinion make markets, but they also foreshadow substantial moves ahead as these differences are resolved. Once a month, investment leaders from our global multi-asset, equities, and fixed income teams meet to share their diverse viewpoints. This report reflects those discussions and debates by providing insight on the topic of the month along with snapshots of our asset class views and convictions across the firm.

Conviction Score (CS) and Investment Views

The Conviction Scores shown below reflect the investment team's views on how portfolios should be positioned for the next six to nine months. 1=bullish, 5=bearish, and the change from the prior month is indicated in parentheses.

Global Economy

Markus Schomer, CFA
Chief Economist,
Global Economic Strategy

CS 2.75 (unchanged)

While we downgraded our CS in November to 2.75 on expectations that further evidence of slower global growth will emerge over the next six to 12 months, our current score reflects a continued expectation that global growth will not decelerate significantly below trend. Our forecast is conditional on the Federal Reserve halting its rate hikes by the summer and China's economy returning to a healthier rate of expansion in the first half of 2019. Although the US-China trade war has not escalated further, a full resolution is not in sight. Europe's growth prospects have deteriorated on the rising risks of a hard Brexit and France breaking EU deficit rules. France's current woes could pave the way for an ultra-nationalist president in 2022, which most likely would trigger an existential euro crisis.

Asia Economy

Paul Hsiao
Economist, Global
Economic Strategy

CS 3.00 (unchanged)

Slower retail sales and exports, and a greater-than-expected decline in industrial production, underscore weakness in China, notwithstanding the 90-day "trade truce." December's closed-door Central Economic Work Conference could signal where economic policy is headed. Upturns in manufacturing and credit growth brighten India's outlook, along with a dovish tilt by new Reserve Bank of India Governor Shaktikanta Das. Many other central banks in emerging Asia, after raising rates throughout the year, are sitting on the sidelines because of greater currency stability and dovish signals from the Federal Reserve.

Rates

Gunter Seeger
Portfolio Manager, Developed
Markets Investment Grade

CS 3.25 (+0.375)

Our overall risk appetite continues to deteriorate. The year-over-year increase in consumer prices has fallen from 2.3% to 2.2%; the latest month showed no gain. US TIPS break-evens have lagged Treasuries by 142 basis points (bps), a staggering reversal. Over the last month, 10-years and 30-years were the best performers. For 2019 we forecast two Fed rate hikes, yields of 3.50%-3.75% by year-end, a lower US dollar, higher European rates, and Treasury issuance between $1 trillion and $1.4 trillion.

Credit

Steven Oh, CFA
Global Head of Credit &
Fixed Income

CS 2.75 (-0.50)

A sentiment shift from risk seeking to risk aversion has resulted in technical selling and material spread widening in developed market (DM) credit. Below investment grade (IG) credit and loans have experienced significant retail outflows, resulting in spreads that should provide more attractive returns in 2019. While the fundamental outlook has deteriorated somewhat, the overall macro environment and earnings expectations broadly support credit risk. Reversing negative technicals, however, will require either a bias shift at the Fed or resolution of trade tensions.
In leveraged finance, we see returns in the 7% area for 2019, with high yield (HY) and loans attractive, but with loans a better relative value despite an earlier HY recovery due to very short-term technical factors. We are cautious on below-IG collateralized loan obligations (CLOs). We prefer US IG over Europe due to better fundamentals and spreads widening to 135 bps. Where we have been overweight EM, wider DM spreads have shifted our bias back to DM.

Currency (USD Perspective)

Anders Faergemann
Senior Sovereign Portfolio
Manager, Emerging Markets
Fixed Income

CS 3.00 (-0.25)

European political woes and weaker Chinese and eurozone growth prospects weigh on the euro, while a further delay in Japanese monetary policy normalization weakens the yen. These forces propel US dollar strength in the short term, although market positioning and long-term valuations suggest the dollar may offer less upside over the next 12 months and may stall rather than strengthen in 2019, particularly if the US economy slows and the Fed becomes less hawkish.
In EM portfolios, we prefer a low risk approach, but look for value in Latin America while viewing Romania, Hungary, and Malaysia as good funders given growing imbalances in their economies.

Emerging Markets Fixed Income

John Bates
Head of Emerging Markets Corporate Research, Emerging Markets Fixed Income

USD EM (Sovereign and Corp.)
CS 2.75 (unchanged)

Local Markets (Sovereign)
CS 2.75 (unchanged)

EM fundamentals remain solid, with Brazil on the mend and China feeling the pinch of US import tariffs but facing no major crisis. Still, we remain cautious due to a low appetite for risk, hinging largely on US economic growth, its inflation outlook, and the Fed's appetite for further rate rises. EM (and especially EM foreign exchange) looks cheap, but most of the value lies in the lower rating categories, which were the biggest winners and losers in 2018. Bond supply remains relatively low, which is supportive for valuations. Being cheaper now than a year ago opens the door for specific tactical and relative value opportunities across EM.

Multi-Asset

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

CS 2.60 (unchanged)

Calmer fixed income markets, increased oil supplies, and signs of de-escalation in US-China trade tensions have moderated the risks that led to us becoming less risk oriented in early October. While the Chinese economy remains worrisome, lending by banks and shadow banks should increase, and other stimulus measures are continuing to ramp up, which should benefit China A-shares. Our CML continues to indicate attractive valuations in other EM equity markets including India, which has secular growth potential, and Brazil, which has potential for structural improvements. We maintain our very low duration profile in fixed income, expecting yields to rise. But because we see the risk/reward of US Treasuries improving significantly as the Fed approaches "neutral," we added duration in early October. Commodities should continue to provide portfolio diversification and we see industrial metals — particularly copper — benefitting from renewed infrastructure spending in China.

Global Equity

Lizette St. Hilaire, CFA
Research Analyst, Global Equities

CS 2.75 (unchanged)

Despite weak global equity markets in the fourth quarter and a particularly dismal December, we observe nothing other than fear to support the greater negative market sentiment. While companies are somewhat cautious, they remain positive about 2019. Still, we expect higher volatility due to lower global GDP growth, rising interest rates, trade tensions, and geopolitical risk. Global markets are now at or below historical valuation levels. With the growth differential between the US and the rest of the world likely to narrow next year, we expect capital to flow toward Asian and Latin American equities. Globally, we remain focused on finding companies making fundamental progress but whose valuations may have been overly penalized.

Global Emerging Markets Equity

Taras Shumelda
Portfolio Manager, Fundamental Equities

CS 2.50 (unchanged)

US-China trade tensions cloud the outlook for the global economy, which is progressing moderately. China's industrial production and retail sales continue to show softness, while foreign direct investment was down 26% year-over-year in December. India is seeing lower inflation and accelerating industrial production, helped by lower oil prices. Despite some signs of a Brazilian economic slowdown, the government's commitment to reforms is encouraging. EM currencies have been weak this year, but the Indonesian rupiah, Indian rupee, and Turkish lira have improved over the past month or so. Company fundamentals — balance sheets, free cash flows, and margins — are quite strong; macro developments are what is leaving asset allocators on the sidelines. We believe that trade tensions ultimately will abate, improving the outlook for individual companies.

Quantitative Research

Haibo Chen
Portfolio Manager and Head of Fixed Income Quantitative Strategies

The US Market Cycle Indicator turned more negative but remained borderline bearish, as credit spreads widened and the curve flattened. Both IG and HY spreads widened significantly, with IG five- to seven-years approaching the long-term spread level. Overall spreads, however, are still rich. We forecast excess returns in EM credit to improve to neutral, while DM continues to be negative. We favor defensive sectors over cyclical. Our rates model projects lower yields and steeper slopes. On a relative basis, the model favors North American over European and Japanese duration. We project US and UK slopes to steepen the most, and expect the yield curve to be relatively more concave in the UK and Europe. Our portfolio's rates view is slightly long duration; we are underweight durations in Europe and Japan, close to neutral in the UK, and overweight in North America. Our portfolio remains overweight five- and 20-year and underweight other key rate durations.

About PineBridge Investments

PineBridge Investments is a private, global asset manager focused on active, high-conviction investing. We draw on the collective power of our experts in each discipline, market, and region of the world through an open culture of collaboration designed to identify the best ideas. Our mission is to exceed clients' expectations on every level, every day. As of 30 September 2018, the firm managed US$90.9 billion across global asset classes for sophisticated investors around the world.

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