Reflation Takes Root

June
2021

The second quarter was a bumpy one for global fundamentals. As it progressed, multiple Covid variants emerged, with flareups causing sporadic lockdowns in countries with lower vaccination rates. In the US, where vaccines were widely available, the recovery was hampered by supply bottlenecks and labor market distortions that slowed growth while causing inflation to spike.

Reopening has been a rougher ride than envisioned. While markets are beginning to price in a slower sequential process, we remain confident that a regime shift will still gather steam over the next several years, even if in fits and starts, pulling the global economy toward reflation and away from "stall speed."

The journey from disinflation to inflation is typically measured in decades, not quarters, and it starts with reflation. We still expect reflationary conditions – which we characterize as price increases rising from an unhealthily slow pace to a slightly faster, but much healthier rate – for most of the next five years. For this to happen we need to move toward more balanced conditions in both liquidity terms and physical terms, with goods and services experiencing less chronic slack than throughout 2009-2019. The latter would manifest in healthier, 2%-2.5% price advances versus the perpetual undershooting of central banks' 2% targets. This appears closer at hand than achieving more balanced liquidity conditions. While we foresee some progress there too, the current imbalance of excess capital relative to uses for it is much more extreme and likely to rebalance more slowly.

After a decade of tepid demand from the private and government sectors, both are on the move, with capital spending sprinting out of the gate unusually early in a business cycle, along with a generational demand for more and newer housing stock. Fiscal authorities are also seeking every opportunity to get their hands on the excess, and in so doing, would be in a position to provide more steering of economic outcomes.

To our eye, none of these trends are at risk from today's reopening wobbles. Over the next five years they should at least arrest the 20-year rise in the global savings rate. Yet to make meaningful progress in reducing the excess, now that fiscal assertiveness has finally stepped up, central banks need to step down, ending their capital markets deluge via quantitative easing (QE). We see this playing out, yet only gradually, over the next few years. To be sure, the firehoses are still going strong despite the extreme surplus of capital relative to usage.

While some suggest that Covid resulted in a flash crash and recovery, with the world now rapidly returning to the conditions of 2016-2019, we see key differences and another path. The imbalances of 2009-2019 were amplified by a policy mix that is no longer in place. During that period, fiscal drags combined with unconventional monetary policy yielded unsatisfactory growth, with the monetary excess merely inflating asset prices and exacerbating inequality, while fiscal drags contributed as well to frustration. The pandemic looks to have served as a tipping point, with the pendulum now swinging toward fiscal assertiveness, particularly in the US, with calls for greater action to address inequality, climate change, and the lingering health care crisis.

We see further large-scale spending plans materializing. Many students of markets are more accustomed to fiscal thrusts that crowd out the private sector, but that may not happen this time around; past injections occurred in eras where capital was scarce, while today they will be attempted in the midst of a savings glut, exacerbated by a QE glut. The new fiscal thrusts being attempted in the US should dampen the 2022

About This Report

The Capital Market Line (CML) is our proprietary tool for the management of our multi-asset products. It quantifies several key fundamental judgments we make after dialogue with our specialists across the asset classes. In this report, we summarize our view of the global markets, provide insights gathered from the CML, and examine the fundamentals driving the CML today.

Contributors:

Michael J. Kelly, CFA
Global Head of Multi-Asset

Hani Redha, CAIA
Portfolio Manager

Steven Lin, CFA
Portfolio Manager

Peter Hu, CFA, FRM
Portfolio Manager

Sunny Ng, CFA
Portfolio Manager

Mary Nicola
Portfolio Manager

Mikhail Johaadien
Research Analyst

fiscal cliff while providing a steady contribution to growth thereafter. The US midterm elections in 2022 will be a crucial test of whether fiscal dominance can sustain itself. Despite the historical precedent of incumbent US governments tending to lose control in the midterms, that may not be the case this time if the public views these new programs favorably.

Timid private sector demand for credit also seems to have undergone a fundamental rethink. Covid exposed many business models' vulnerabilities and supercharged technological adoption, which should act as a deflationary counterbalance together with China's desire to gradually wean itself off leverage. Again, the journey from disinflation to inflation has been measured in decades, not quarters.

While thus far these policy shifts appear to be mainly a US phenomenon, echoes are appearing elsewhere. The Australian government recently made clear its intentions to continue with fiscal thrusts until it can deliver a robust, inclusive recovery. The UK government is not snapping back to austerity mode as it has in the past. And in Europe more broadly, we have already seen a shift in fiscal stance with the Next Generation EU recovery fund. The uptake of this fund will be more of a 2022 than a 2021 event, so no fiscal cliff is on the horizon in Europe. Germany's elections later this year will be an important development, potentially delivering a coalition government that includes a Green Party. Yet the existing government has already taken up the charge on its own. A return to 2009-2019's fiscal drags is unlikely – and removing such drags adds to growth.

The most important exception to this trend is China, where policy support has already peaked and is now gradually normalizing. Prior extremes in carbon emissions and credit expansion to fuel growth require a reset. China's 14th Five-Year Plan continues to shift the focus on growth from quantity to quality. The result? This important engine of growth, particularly for many emerging market (EM) countries, will not be running on all cylinders. And this, along with less vaccine availability and regional sequencing of recovery, will shrink the historical growth gap favoring EM.

One of the implications of the upcoming reflationary regime is higher nominal cash flows, which we have reflected in our forecasts. Yet the reflation of most growth assets' cash flows will likely exceed the reflation of the yield curve. The twin liquidity gluts from private sector savings and central bank balance sheets surged from record high to record high during the crisis and are still growing. Not until the liquidity gluts slow, allowing the economy to grow into them, can the rates curve meaningfully rise.

At the geopolitical level, we believe two key developments will shape the cycle ahead: the rise of economic nationalism, and the intensification of the US-China rivalry. While a faster cycle would add to margins, this growing rivalry goes hand in glove with a less efficient global economy, which is likely to have a restraining impact on further margin appreciation over the period.

The US-China trade war and the pandemic exposed the vulnerabilities of nations to the status quo. A lack of domestic capabilities as a result of hyper-globalization has resulted in shortages of key products such as pharmaceuticals, healthcare equipment, and semiconductors used in a swath of industries. Global powers have already developed national strategic plans to address these perceived weaknesses and will be bolder about intervening in markets to achieve their strategic goals.

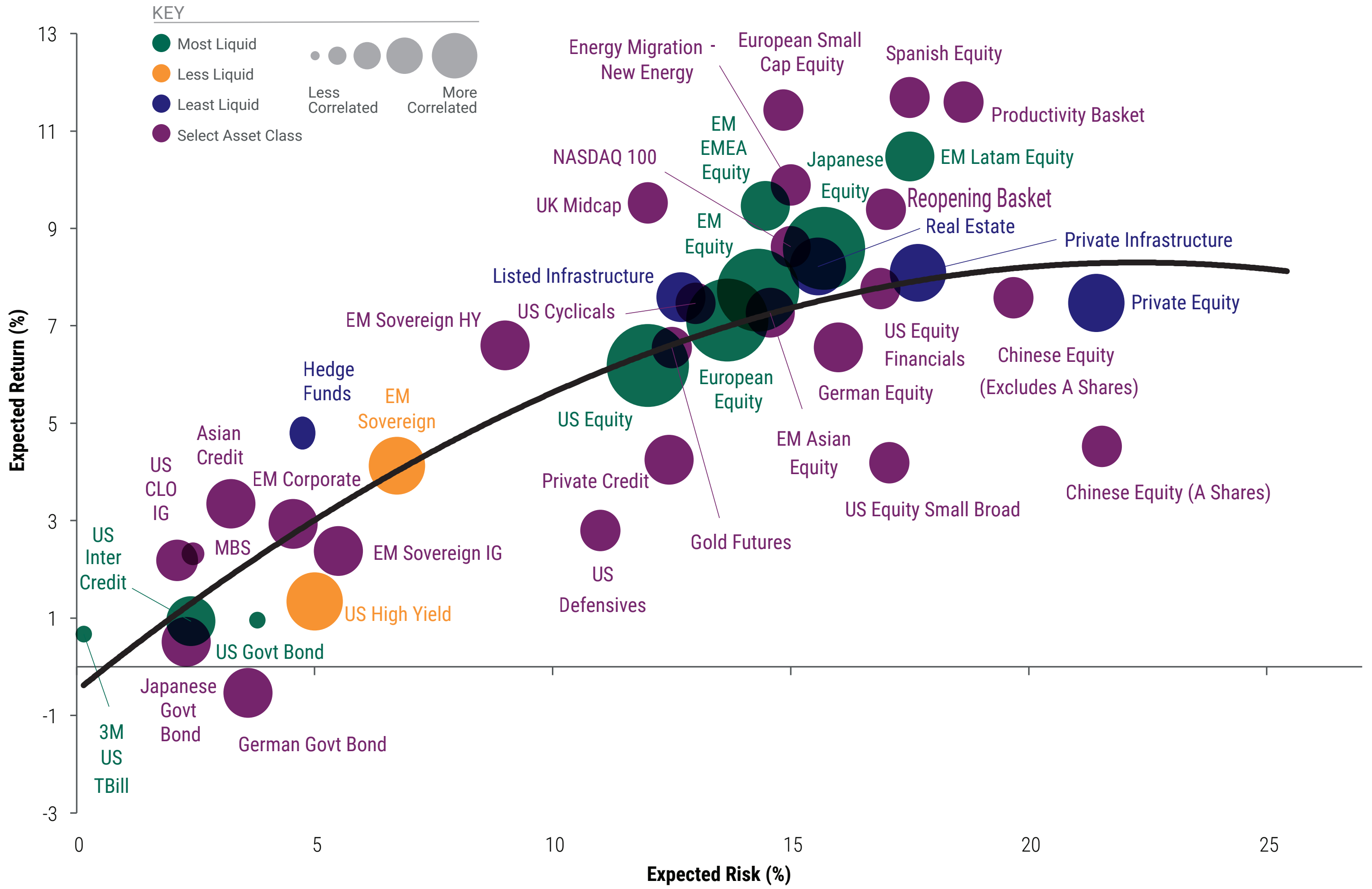
The drive toward decarbonization overlaps with this shift in strategic thinking. Most major governments have now pledged to reduce or eliminate their carbon footprints over the coming decades and are developing concrete proposals to achieve these goals. Thus, for global powers such as the US and China, investing in these technologies is no longer only about "saving the planet." It's also about controlling the global energy cycle, which offers the prospects of becoming more energy independent as well as achieving energy-efficiency gains as the cost of renewables falls below that of fossil fuels. As of now, Europe and China have leadership in certain clean technologies; however, we expect economic nationalism to set off a race to develop domestic capabilities and duplication in major economies, with subsidies and restrictions helping to achieve these strategic goals.

More broadly, the weak pace of corporate investment in the previous cycle has set up the potential for a more vigorous capex environment in the years ahead. Higher nominal cash flows, higher levels of capacity utilization (courtesy of fiscal activism), and several key technological developments all provide impetus for a broad-based investment upcycle. Digitalization remains the overarching theme across most sectors. Yet electrification of transportation and energy networks will also provide opportunities for corporate investment.

Another key motivation for corporate investment will be to shorten supply chains. The recent shocks have revealed the vulnerabilities of stretched supply chains, and we see a growing cross-current toward "localization" of production processes. As a result, globalization appears to have topped out given this backdrop. The incremental investment is being spent in developed markets (DMs), leading to more challenges for emerging markets seeking to attract foreign direct investments (FDI) and to raise productivity.

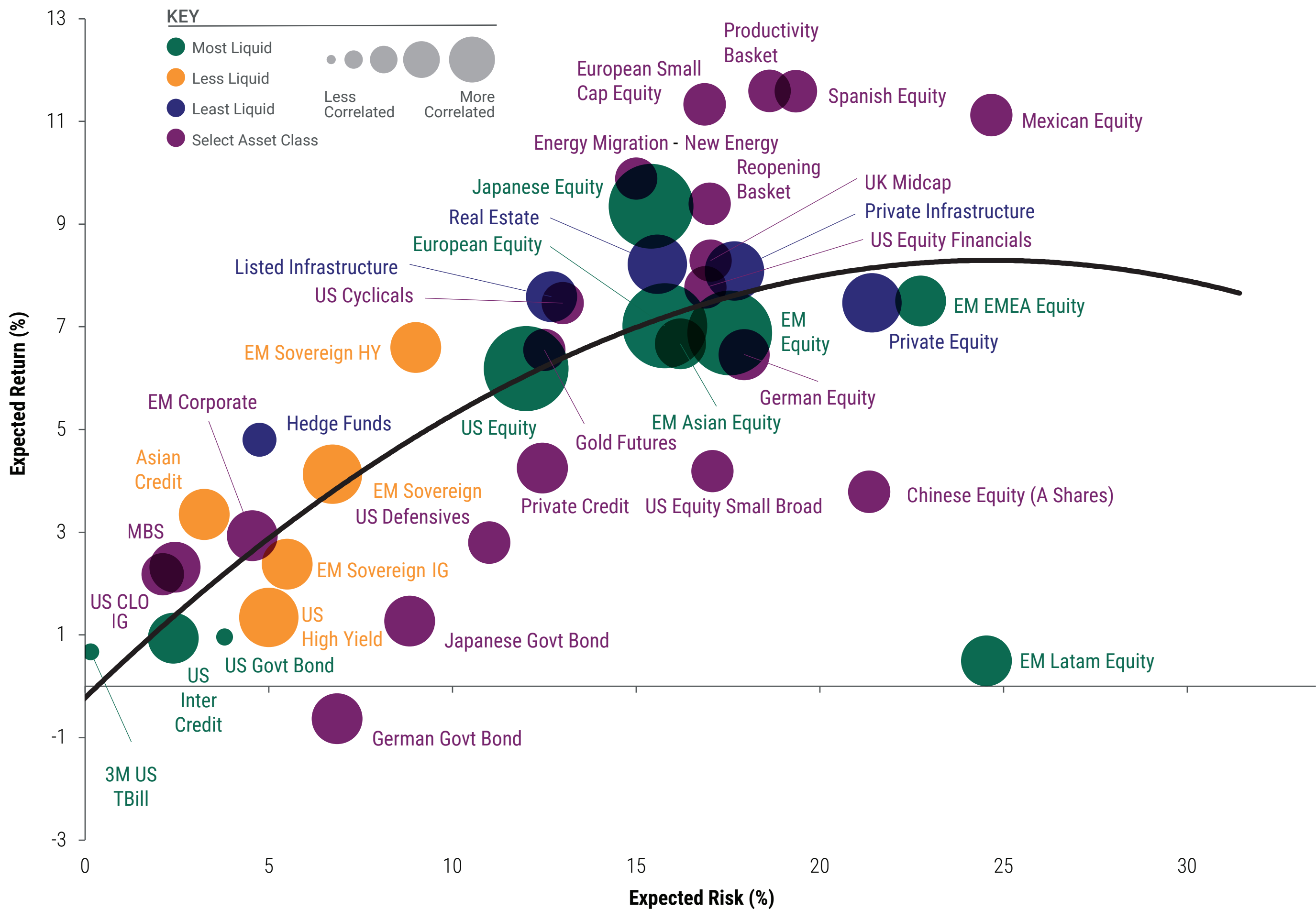
Our Capital Market Line (CML) continues to have a moderately positive slope and a high degree of dispersion, signaling good reward for selective risk-taking. The slope has been flattening of late as a result of risk assets performing well. Risk-free bonds remain challenged in terms of future returns, while EM credit assets continue to provide an attractive real yield. Overall, cyclical and growth equities will be beneficiaries of the healthier growth/inflation environment resulting from the shifting policy mix, leaving defensive equities as underperformers against a reflationary backdrop. Notably, real assets are becoming increasingly attractive as sources of yield and as inflation hedges for those with longer-term time frames.

Capital Market Line as of 30 June 2021 (Local Currency)



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 relative to other asset classes only.

Capital Market Line as of 30 June 2021 (USD View, Unhedged)



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Capital Market Line Endnotes

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Insights From Today's CML

A moderately sloped Capital Market Line (CML) with a high level of dispersion. The slope of our CML continued to flatten over the last quarter, as risk assets performed well. The rally in equities has contributed to this flattening. However, it remains moderately sloped, and in combination with high dispersion, signals decent reward for selective risk-taking. Equities remain the most attractive asset class, with normal risk premiums, while safety assets struggle with initial yield levels that lag inflation.

Nominal risk-free bonds remain unattractive. The twin liquidity gluts emanating from private sector savings and central bank balance sheets continue to grow. While the rates curve should rise slowly from here, the sheer scale of liquidity chasing limited cash flows will cap meaningful rises in yields for many more years. The pandemic has also resulted in a deep level of global slack, yet has activated fiscal thrusts to absorb much of it looking forward. The result will be reflation, not outright inflation, which also caps the level of yields. The forward-looking return on developed market government bonds where QE has been active remains challenged, even after the flow of asset purchases has stopped. The stock of QE will continue to hold down real yields for years to come.

Emerging market debt offers the best risk/reward in fixed income. We expect EM bonds to increasingly be recognized as one of the few fixed income markets to offer a positive real yield. EM corporates, in particular, have achieved remarkable balance sheet management through capital expenditure discipline and

offer higher yields despite lower leverage compared to their DM peers. Within EM debt, China's local government bond market is developing into an interesting diversifier with an attractive current yield. As China continues to mature and structurally decelerate, yields will decline and policymakers will remain committed to connecting its financial markets to global investors.

The reflation regime brings higher nominal cash flows and lower equity risk premiums. The policy mix of the next cycle will support higher nominal cash flows as governments lean on fiscal policy to address societal grievances. We believe that higher costs will be largely offset by higher nominal top-line growth via operational leverage. Equity risk premiums remain average in a world where all such risk, illiquidity, and term premiums remain unattractive. Equity risk premiums are likely to be gradually weighed down as well. This will prevent a sharp de-rating in most equity markets, particularly as bond yields remain low. US equities have dominated the global markets over the last cycle, supported by their predominance in large-cap growth stocks that were the primary beneficiaries of subdued growth in other sectors, as well as monopolistic industry conditions and a significant decline in bond yields. The rise of anti-trust action needs to be monitored closely. A more level playing field, if it occurs, is still a few years out, yet would allow other equity markets to compete more effectively with the US.

Volatility faces opposing forces: Distance from the pandemic should bring it down, while monetary policy normalization would ratchet it back up. The end of central bank asset purchases will launch the policy normalization process and contribute to higher volatility than in the last cycle. As inflation creeps higher, macro volatility also rises, and this too will manifest in asset price volatility. Yet the uptick in volatility will be slow and relatively muted given the stock of liquidity in the system and the pace at which it will be absorbed.

Real assets are increasingly attractive as beneficiaries of higher nominal cash flows. Real assets are likely to benefit from the fiscal thrusts building in many key markets, with higher nominal cash flows only partially offset by the gradual rise in yields. Yet their time in the sun will occur once we have arrived at inflation; for the next handful of years, we will only see reflation. Nonetheless, for those with longer-term horizons, today's pockets of disruption in many commercial real estate and infrastructure markets provide an interesting entry point.

The Fundamentals Driving Our CML

A regime shift toward reflation. The new cycle is highly unusual and accelerated, reflecting the dramatic nature of the exogenous shock that caused it and the unprecedented policy response that short-circuited the decline. To us, a reflation regime is characterized by a healthier balance of economic conditions, manifesting in slightly higher inflation levels. However, it remains a regime drowning in liquidity and therefore yields remain very low, particularly at the global level, where the policy response was less forceful. Correlations will shift accordingly, with less extreme stock-bond correlations and lower correlations between risk assets.

Excess capacity will be absorbed, but excess liquidity will linger. In the last cycle, it took a decade to chip away at the excess capacity that had built up over 2001-2008; substantial progress had been made before the pandemic struck. Due to the exogenous nature of the Covid shock, a "snap back" to healthier conditions is likely, and excess capacity may be fully absorbed within our forecast horizon. The result will be Goldilocks economic conditions for several years: reflation, not outright inflation. In parallel, the twin liquidity gluts of global savings and central bank balance sheets have ballooned due to the pandemic and will likely take over a decade to absorb. It will be difficult for financial conditions to become tight until that happens. The result will be accommodative liquidity conditions, with yields that rise very slowly for many years.

The rise of fiscal activism. The imbalances of the policy mix of the last cycle – fiscal austerity combined with unconventional monetary policy – resulted in unsatisfactory growth and an extreme rise in inequality. And for even longer, policies that pushed labor's share of income to record lows were ascendant. The pendulum is now swinging in the opposite direction, particularly in the US. As populations repeatedly vote for a change in direction, emboldened by governments' seemingly endless capacity to spend, persistent fiscal dominance is a real possibility. The result would be that central banks find themselves with inflation suppression as their primary task, rather than the reverse problem, which they have grappled with for nearly two decades.

A rise in economic nationalism. The US-China trade war and the pandemic have exposed nations' vulnerabilities to the status quo. A lack of domestic capabilities resulting from hyper-globalization has resulted in shortages of key products such as pharmaceuticals, healthcare equipment, and semiconductors used in a broad range of industries. Global powers have already begun to develop national strategic plans to address these weaknesses and will be bolder about intervening in markets to achieve their strategic goals. These developments could dent corporate efficiency and productivity, yet the equivalent of a "space race" would also spur innovation. Geopolitics will also be dominated by the ongoing evolution of China from "vertical integration" to "horizontal competition," and the US appears to be hardening its resolve to compete more actively, likely in concert with its closest allies.

China will prioritize productivity and technological advancement. China's policymakers are well aware of the country's negative demographic trends. Their 14th Five-Year Plan clearly shifts China's focus toward productivity enhancement rather than high levels of aggregate growth. China will accelerate its investments into domestic technological capabilities, ranging from semiconductors to 5G and artificial intelligence (AI). In parallel, China will continue to gradually open its domestic financial markets, and local-currency government bonds will garner growing foreign ownership, lowering its cost of financing. With an increasingly centralized power structure, China's ability to maintain enough private sector confidence to reinvest will be decisive in determining its growth trajectory. A gradual structural slowdown is likely, yet it may be less severe than feared as a result of higher-quality human capital and proven innovation capabilities.

Most emerging markets risk being left behind in the knowledge-based economy. Even before the pandemic, EMs in the last cycle delivered an abysmal growth outcome, far worse than their DM counterparts. Why? A combination of fading population growth and a collapse in productivity. The productivity collapse, in turn, was a result of a drying up of foreign direct investment and a lack of structural reforms. In the era of economic nationalism, emerging markets will find it even more difficult to attract FDI, as companies are encouraged (or coerced) to develop domestic facilities in developed markets. China's shifting growth profile will also generally be less supportive of other EMs, with the exception of Asian economies such as Taiwan and South Korea that can supply higher value-added components to China. Proximity and trade interconnectivity with the US will support economies such as Mexico.

Decarbonization becomes a strategic imperative. Technological progress and a critical mass of sentiment are combining to make decarbonization a strategic imperative for global powers. Clean tech such as solar and wind power have now become cheaper than fossil fuels, and this cost advantage will continue to grow. Most major governments have now pledged to reduce or eliminate their carbon footprints over the coming decades and are developing concrete proposals to do so. Thus, for global powers such as the US and China, investing in these technologies is no longer only about "saving the planet" but about controlling the global energy cycle and achieving energy-efficiency gains. As of now, Europe and China have leadership in certain clean technologies; however, we expect economic nationalism to set off a race to develop domestic capabilities and duplication in major economies, enabled by subsidies and restrictions to achieve these strategic goals.

Digitization will dominate investment priorities. Digitization has been a defining driver of economies and markets for over a decade, enabled by technologies that have achieved scale and disrupted existing business models. Throughout the pandemic, companies continued to press ahead with their digitization plans, and the crisis has only emphasized the importance of this strategic imperative. Economies that lead in this transformation, and tech providers that enable it, will continue to grow and take market share. This theme remains in early days in terms of both consumer- and corporate-facing markets and continues to be most advantageous to the US, given its leadership position in software.

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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