PineBridge® INVESTMENTS

The 21st Century's New Berlin Walls

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

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The world is heading into winter in more ways than one. As economic considerations increasingly take a backseat to social and political priorities in China, the flow of goods, capital, and ideas will likely become more and more constrained – perhaps ending a long summer of freer and more globalized trade and markets. That period began in earnest after the fall of the Berlin Wall, which led to more open technology transfer and integration of the global economy. These trends lifted living standards for hundreds of millions of people globally, and especially those in emerging countries.

Geopolitically, the fusion of government with autocratic leadership — most evident currently in Russia, China, and Iran — is likely to have widespread consequences. While benign autocracies do exist, like Lee Kuan Yew's highly successful reign in Singapore, how does one push out more malignant autocrats, or just bad actors when they become so entrenched? The Russia-Ukraine conflict is the most recent example of how one-man rule combined with military power and mal-intent can go wrong in seemingly irreversible ways.

With the National Congress of the Chinese Communist Party (CCP) concluded, President Xi Jinping has cemented his grip on China's leadership by dismantling the checks and balances put in place by Deng Xiaoping, which had intended to preempt another autocratic era like Chairman Mao's erratic reign. Meanwhile, President Xi continues to strengthen his alliance with Russia, while asserting territorial rights disputed by most international bodies.

This consolidation of power portends more centralized economic decision-making, assertiveness in foreign affairs, and a new inward economic focus, emphasizing self-reliance. The Chinese economy is incredibly large, more sophisticated, and currently more integrated into the global system than any of the centrally directed economies of the 20th century. Setting the ground rules for such a sprawling economy is one thing; directing every aspect of it is something else. Greater state supervision is likely to continue disincentivizing China's private sector, thereby slowing the country's growth and economic dynamism, yet Xi appears firmly committed to the tradeoff. It boosts the odds that he, along with the CCP, never loses control.

In a sense, the world is now likely witnessing the rise of 21st century versions of the Berlin Wall. No longer physical barriers, these new walls are philosophical, ideological, and often electronic encirclements that isolate nations and people. This new world structure has very real costs, as evidenced by the massive write-offs by multinational corporations driven to abandon their businesses and investments in Russia after the invasion of Ukraine. Businesses and their investors will be wary of venturing into areas where the ground rules can too easily be changed.

For investors, this new world means greater uncertainty, slower growth, constrained productivity, and elevated odds of military conflict. After a long summer, many are feeling the chill.

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 3.50 (unchanged)

Stance: After last month's downgrade, our CS remains unchanged, although risks to forecasts remain skewed to the downside; we expect things to get worse before they get better. We are in an incredibly slow-moving slide toward a broad global economic contraction, which could trigger a much bigger financial crisis. A European recession looks extremely likely over the winter, but a Fed pivot early next year could yet prevent one in the US, and China could step up stimulus measures to stabilize its economy. Regionally, our US score holds at a neutral 3 on continued expectations that a more convincing inflation slowdown next year will prompt a rebound in real consumer income growth and rate cuts in the second half. The Europe score is bearish enough to deal with a recession, but also reliant on monetary policy not turning outright restrictive and fiscal policy to provide offsetting stimulus. In China, we await the shape of the economic policy landscape following Xi's reappointment. Our below-neutral emerging market (EM) score is still driven by external and not necessarily domestic concerns, including weaker global growth, falling commodity prices, the strong US dollar, and rising US interest rates.

Outlook: Central banks remain the focus. While the Fed isn't willing to acknowledge a shift in the US inflation environment, greater evidence of that in coming months should change its narrative. Similarly, the European Central Bank soon will have to change its tune on quantitative tightening (QT) and rate hikes before even getting to a restrictive policy stance. Finally, we should also pay closer attention to financial instability events like the ones we saw in the UK in recent weeks, and which are also now appearing in Japan and Switzerland.

Risks: (1) Fed policy error, (2) European political crisis, (3) US fiscal policy misstep.

Rates

Gunter Seeger, CFA
Portfolio Manager, Developed Markets Investment Grade

CS 2.00 (unchanged)

The Treasury market is struggling to find replacements for its largest buyer — the Fed — which now owns more than 25% of the market and one-third of the agency mortgage-backed securities (MBS) market. If the market's current liquidity problems continue, the Fed will have to step in before Christmas. Globally, there have been selloffs in almost every asset class. The UK liability-driven investment fiasco is the first crack exposed on Treasury leverage, and losses in the derivatives market have been staggering. We anticipate that problems in other leveraged strategies (levered Treasuries, shorting the US dollar, and others) should cause a flight to quality. We think it's prudent to be long US Treasury duration at least through the end of the year.

Credit

Steven Oh, CFA
Global Head of Credit
and Fixed Income

CS 3.75 (+0.25)

Recession risks continue to rise in the US due to the Fed's march toward a policy overshoot and any hopes for a policy pivot in China following its Congress have been dashed with the reaffirmation of its zero-Covid policy and saber-rattling over Taiwan. Despite the expected deterioration in fundamental macroeconomic and earnings outlooks, below-investment-grade credit spreads have rallied. While prices and yields are very attractive, corporate credit spreads, other than CCCs and portions of CLOs, are not yet at recessionary levels. Therefore, we have raised our CS toward a more defensive tilt. The differential between high yield (HY) and investment grade (IG) spreads has tightened, with the BB-BBB differential closing to the +120 area, leading us to continue favoring IG over HY. The floating-rate credit spread differential to fixed rate has increased during the month, particularly with CLO mezzanine spreads. With BB CLOs now at about +1.100, buyers can pick and choose among higher-quality transactions that should survive a rising default rate environment, but there is no near-term catalyst to reverse the lack of demand. We remain tilted toward the more defensive US over Europe and EM.

Currency (USD Perspective)

Anders Faegermann
Senior Sovereign Portfolio Manager, Emerging Markets Fixed Income

CS 3.00 (unchanged)

Fed warnings that it will keep raising its policy rate until it reaches a "sufficiently restrictive" level, in combination with sticky US inflation and healthy payroll figures, suggest the strong US dollar will not prevent further rate hikes. This has reduced hopes for a Fed pivot in 2023, supporting the US dollar for the short term. While three key criteria could trigger a reversal of the strong US dollar — a Fed peak, growth bottoming outside the US, and coordinated currency intervention to weaken the US dollar — we believe none of the three criteria is actively in play near-term or over our forecasting horizon. Currently, there is no desire for coordinated intervention to weaken the US dollar, and there shouldn't be until economies outside the US, primarily in Europe and Japan, start to grow faster. Based on reduced expectations of a Fed pivot within the next 12 months, together with upward revisions to our US 10-year rates forecast, we push our US dollar/Japan yen forecast back to 147. We cannot rule out further weakness to the Japanese yen due to a dovish central bank and the country's large trade deficit.

Emerging Markets Fixed Income

Chris Perryman
Senior Vice President, Corporate Portfolio Manager and Head of Trading, Emerging Markets Fixed Income

USD EM (Sovereign and Corp.)
CS 3.00 (unchanged)

Local Markets (Sovereign)
CS 3.00 (unchanged)

Our current central case scenario, with a 60% probability (versus bear cases of a pivot at 20% or stagflation at 10% and the bull case of a soft landing at 10%), can best be described as a "classic" US recession with multiple quarters of negative growth sparked by excessive Fed tightening. Even if a tightening pause comes in first-quarter 2023, the Fed is likely to remain restrictive for the rest of the year, offering little respite to credit markets. Since core inflation will likely remain sticky in meeting the 2% target and the unemployment rate will be slow to react to tight monetary conditions (acting with a lag), US rates will remain high, and a Fed reversal may not arrive until 2024. An ugly global backdrop is likely to weigh on sentiment toward emerging markets and drive outflows, yet EM fundamentals paint a picture of growing dispersion: remarkable resilience among the majority of EM countries with a minority being hung out to dry due to inability to borrow and potentially service debt, creating overly negative headlines. Falling debt/GDP ratios, healthy foreign exchange reserves, and twin surpluses will enable EM to withstand some external headwinds in 2023, and eventually attract inflows once the Fed starts easing monetary policy, whether in late 2023 or early 2024. Defensive high-quality security selection remains our call, with the challenging macro backdrop still influencing total return expectations. Sovereign BBBs are a standout value from the robustness in credit fundamentals.

Multi-Asset

Deanne Nezas
Managing Director, Portfolio Manager, Global Multi-Asset

CS 3.75 (+0.25)

With risks rising, we downgraded our CS from 3.50 to a more defensive 3.75. The Fed now appears to require labor market cooling before it relents. For that to happen, the Fed will continue tightening until resilient US demand dampens and then dents profits enough to stop the hiring. Until then, the Fed appears determined to rein in market rallies with either higher or longer rate rises or faster/longer drainage of liquidity through quantitative tightening. Either way, financial stress will continue to build until something inevitably cracks. Meantime, companies generally remain sanguine. CEOs are still not signaling demand stumbles or imminent plans to cut jobs. While slowing is evident, an outright recession would still take time. In China, we see improvements ahead in the form of dial-backs in zero-Covid policies and their almost complete disappearance by the end of March 2023. This may not make for a vigorous recovery, but even modest sequential improvement is better than the deteriorating growth everywhere else.

Global Equity

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

CS 2.50 (unchanged)

We expect third-quarter earnings to mirror those in the second. A combination of price hikes, cost cuts, strong backlogs, and modest demand elasticity likely will have helped companies manage the inflationary environment successfully. As a result, markets will continue to grapple with fears about the future, which include higher mortgage rates, oil trends, volatility, and war, which "will strain future numbers," according to JPMorgan CEO Jamie Dimon. Market weakness has presented us with opportunities to upgrade the portfolio and invest in advantaged companies at valuations below typically high levels. As always, portfolio style balance remains a key component of our risk management.

Global Emerging Markets Equity

Taras Shumelda
Senior Vice President,
Portfolio Manager,
Global Equities

CS 2.25 (unchanged)

Recent US restrictions on exports of high-end tech to China may affect long-term development of hyper computing in China, while at the same time benefiting local Chinese and Taiwanese R&D players. In the fourth quarter, toll-road fees will be cut to support China's logistics sector. In India, large-cap software companies are reporting strong demand and less margin pressure than the market feared. Commentary from consumer companies is mixed with strong demand for cars and white goods, but soft numbers for mass segment products such as motorcycles. In Latin America, corporations view incoming Brazilian president Lula as a pragmatist who will pursue market-friendly policies. With inflation declining for the third month and GDP accelerating, Brazil is the preferred market for investors. Elsewhere in Latin America, company guidance points to a strong Q3 in various sectors at our portfolio companies. In EMEA, Central and Eastern Europe are still being affected by the war, while Africa and the Middle East are neutral or net beneficiaries.

Management teams in global EM (GEM) have become much more attuned to ESG, with many companies having top ratings. However, there are significant country differences. We continue to engage with management teams to help drive change and ESG improvement. We have kept the portfolio unchanged and continue to view long-term opportunities and the risk/reward balance in GEM as some of the most compelling we've seen in years.

Quantitative Research

Haibo Chen
Managing Director, Portfolio Manager, Head of Fixed Income Quantitative Strategies

Our US Conviction Score slipped to 4.23, driven by a flatter curve, which was down nine basis points (bps) and a wider BBB credit spread (up 21 bps). Our Global Corporate Model remains positive on EM and negative on developed markets (DM). In DM industries, the model favors energy, insurance, industrials, and banking and dislikes financials, REITs, communication, and technology. In EM countries, the model likes India, Indonesia, the Czech Republic, Argentina, Brazil, and Israel, and dislikes Poland, Columbia, Hungary, and South Korea. Among EM industries, the model likes oil and gas, utilities, transportation, and financials and dislikes real estate and diversified industries.

Our Global Rates Model continues to forecast lower yield and a flatter curve. The rates view expressed in the G10 model portfolio is overweight global duration. It is slightly overweight North America and underweight Europe, being neutral on peripheral countries and underweight core countries. In Asia it is slightly overweight Australia/New Zealand and overweight Japan. Along the curve, it still positions for flattening and is overweight 20-year key rate duration and slightly overweight the two-year, largely due to the Italy two-year.

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