GLOBAL DYNAMIC ASSET ALLOCATION

PINEBRIDGE INVESTMENTS

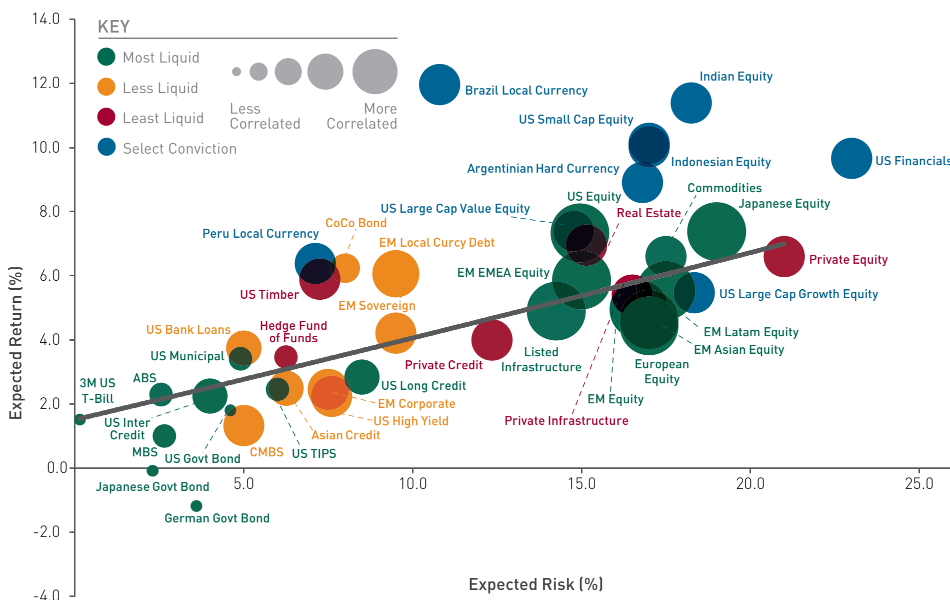
» CAPITAL MARKET LINE 31 DEC 2016

RISING 'ANIMAL SPIRITS' USHER IN A NEW REGIME

Post-crisis regimes result in private sector deleveraging and spikes in regulations, both of which slow growth. The latest post-crisis recovery was no exception. Yet markets did surprisingly well, the result of extraordinary and unconventional monetary policy support that more than offset the slow fundamentals. Then, in 2016, a choppy period ensued, whereby the disinflationary slow-growth, yet favorable market regime ended without being replaced by another. Fortunately, a new multiyear regime appears to be falling into place as we enter 2017, one of faster growth yet less accommodative monetary policy.

At the beginning of 2016, markets began to look through favorable monetary policies. The European Central Bank (ECB) subsequently validated suspicions by tapering its quantitative easing while the Bank of Japan (BOJ) zigzagged toward yield curve control, a weaker form of balance sheet growth. Private sector deleveraging also ended in the US. This alone is a game changer. Yet China also started both a fiscal thrust and

CAPITAL MARKET LINE AS OF 31 DECEMBER 2016 (LOCAL CURRENCY VIEW)



Based on PineBridge Investments' estimates of forward-looking five-year returns and standard deviation. The Capital Market Line ("CML") is not intended to represent the return prospects of any PineBridge products, only the attractiveness of asset class indices, compared across the capital markets. Please see Capital Market Line Endnotes and About the Capital Market Line. Note that the CML's shape and positioning were determined based on the larger categories and do not reflect the subset categories of current convictions or US large cap growth equity, which are shown to provide current positioning relative to the other asset classes only.

Local Currency

EQUITIES	Return	Risk
US Equity	7.33	14.95
US Small Cap Equity	10.13	17.00
US Financials Equity	9.66	23.00
US Large Cap Value Equity	7.39	14.77
US Large Cap Growth Equity	5.47	18.34
European Equity	4.44	17.00
Japanese Equity	7.38	19.00
EM Equity	4.95	16.70
EM Asian Equity	4.64	17.00
EM EMEA Equity	5.87	15.00
EM Latam Equity	5.54	17.50
Indian Equity	11.39	18.25
Indonesian Equity	10.02	17.00

FIXED INCOME		
3M US TBILL	1.51	0.15
US Govt Bond	1.80	4.60
German Govt Bond	-1.18	3.60
Japanese Govt Bond	-0.08	2.30
US TIPS	2.46	6.00
US Municipal	3.41	4.90
US Inter Credit	2.25	4.00
US Long Credit	2.84	8.50
MBS	1.00	2.65
CMBS	1.33	5.00
ABS	2.30	2.55
US High Yield	2.24	7.60
US Bank Loans	3.74	5.00
EM Sovereign	4.22	9.50
Argentinian Hard Curcy	8.91	16.80
EM Corporate	2.46	7.50
EM Local Curcy Debt	6.06	9.50
Brazil Local Curcy Debt	11.97	10.80
Peru Local Curcy Debt	6.38	7.12
Asian Credit	2.49	6.25
CoCo Bond	6.24	8.00

ALTERNATIVES		
Commodities	6.60	17.50
Real Estate	6.95	15.15
Hedge Fund of Funds	3.46	6.25
Private Equity	6.60	21.00
Listed Infrastructure	4.90	14.25
Private Infrastructure	5.40	16.50
Private Credit	3.99	12.35
US Timber	5.89	7.25

THE PINEBRIDGE GLOBAL MULTI-ASSET SERIES:

MULTI-ASSET STRATEGY
Monthly asset class convictions and risk positioning.

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

USD Unhedged		
EQUITIES	**Return**	**Risk**
US Equity	7.33	14.95
European Equity	4.02	22.29
Japanese Equity	6.22	20.09
Intl Small Cap Equity	4.83	17.00
EM Equity	4.77	17.99
EM Asian Equity	4.49	17.41
EM EMEA Equity	5.31	16.97
EM Latam Equity	5.61	23.20
FIXED INCOME		
3M US TBILL	1.51	0.15
US Govt Bond	1.80	4.60
German Govt Bond	-1.60	12.48
Japanese Govt Bond	-1.25	10.97
US TIPS	2.46	6.00
US Municipal	3.41	4.90
US Inter Credit	2.25	4.00
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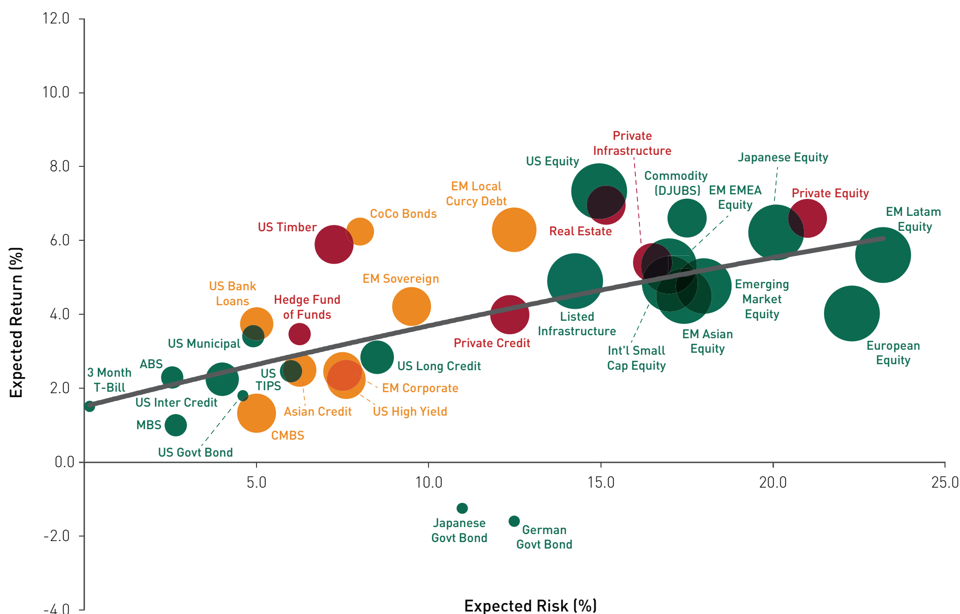
ABOUT THIS REPORT

As our Global Multi-Asset Team's proprietary tool for the management of our multi-asset products, the CML provides a common language and quantifies several key fundamental judgments made after dialogue with our specialists across asset classes.

CAPITAL MARKET LINE AS OF 31 DECEMBER 2016 (USD VIEW, UNHEDGED)



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supply-side management, ending its exportation of deflation and helping to revive global growth. The US election amplified this, with a second fiscal thrust and the beginning of meaningful regulatory push-back.

With balance sheets strengthened and regulatory risks falling, "animal spirits" among businesses are now rising. A sustainable upturn in business investment isn't far behind. Growth, leverage, inflation, and interest rates are all now trending up. A regime change toward the restoration of growth and reflation is in the making, with profound implications for markets.

However, the challenging growth conditions that necessitated unconventional monetary policies also brought about a new era of post-globalization politics. The divergence in prospects between the few meaningful asset owners versus the many stagnating wage earners was blamed on globalization. Brexit and the US election ended unfettered globalization. The US is now beginning to step away from many of the costs (and benefits) of leading the global economic and military security architectures, while others vie to fill the void.

Across asset classes, the post-crisis regime where low-risk asset classes and factors outperformed their higher risk counterparts during a recovery is over. A more conventional period where growth assets outperform capital conservation assets during expansions (and vice versa during recessions) is restored. Yet within asset classes, changing political landscapes, structural changes, tax changes, and asynchronous valuations all point toward much greater selectivity. This is reflected by the unusually wide dispersion in our Capital Market Line (CML).

INSIGHTS FROM TODAY'S CML

Select segments of US equities have become attractive. US equities now present a nuanced picture. An "America first" policy combined with tax reform will be positive for most domestically-focused US equities. In particular, small-cap stocks tend to have the highest effective tax rates, and look to be the primary beneficiaries. The financial sector will benefit from several aspects of the new landscape, including a push-back of regulation, higher rates plus a steeper yield curve, and higher credit growth on the back of rising animal spirits, thus business investment that needs to be financed, in our view. In contrast, businesses with a high proportion of imported value added are at risk of effective tariffs in the form of a border adjusted tax rate.

Japan's reboot is underway. After the US Federal Reserve stopped backpedaling on the timing of interest rate increases, the rapid growth of the BOJ's balance sheet is once again translating into a weaker yen. While Asian-export-centric economies appear vulnerable to coming under trade pressure with the US, Japan might experience less hostility since its business practices are less prone to attack and its monetary policy can be beneficial for US funding costs. Meanwhile, slow but steady progress in improving return on equity (ROE) and shareholder return continues.

We see only a few attractive equity markets outside of the developed world. US trade policy will challenge many economies that rely on global trade. Large economies geared toward domestic consumption, coupled with structural reform, are likely to deliver higher, sustainable growth. Notwithstanding the recent demonetization event and its short-term impact on growth, we continue to view India as exhibiting these characteristics. It is making steady progress on brave and profound structural reform. Indian equities appear attractively valued on our CML and are also less vulnerable to protectionist trade policies.

We see select pockets of value in emerging market local currency bonds. We expect an environment that will likely include higher US rates and a strong US dollar, which will generally be challenging for many local currency bonds. Yet we find attractive idiosyncratic situations where progress toward structural adjustment has already been made, such as Brazil and Indonesia.

Brazil continues to make steady progress toward restoring fiscal credibility. Brazil remains one of the few markets where financial conditions have been tight and inflation high, with clear prospects for this condition to reverse, making its local debt attractive. Indonesia's local bonds have been relatively resilient in the face of an intense rally in the US dollar and rates, demonstrating the extent to which macro stability has been restored over the last few years. We consider Indonesian real rates to be attractive and the central bank's policies as supportive of the currency.

Core yields will be persistently challenged. Our CML has incorporated an expectation for the normalization of rates and flagged developed market sovereign bonds as being particularly overvalued for some time now. This continues to be the case, and as a result we have only fine-tuned our forecasts for yields modestly higher due to recent events. One of the drivers that has contributed to this outlook is the recognition that the ECB will unwind its unconventional policies slightly sooner than previously expected, thereby contributing to a more rapid rise in core yields. The BOJ, however, will make more gradual progress toward achieving its inflation objectives.

Favor floating-rate credit exposure. Bank loans remain one of the bright spots within the fixed income markets, providing floating-rate exposure and an attractive spread even when incorporating relatively high default expectations. High yield bonds are losing their attractiveness as spreads now provide limited scope to compensate for eventually rising default rates and current increases to the risk-free curve. The rise in animal spirits will gradually begin to stretch balance sheets, leaving little room for further spread tightening. Selectivity in credit is becoming ever more important.

Commodity prices are pushing up against a ceiling. After prices recovered significant ground in 2016, further upside remains capped by the extensive availability and flexibility of supply. Moves to deregulate and thereby reduce production costs will only strengthen the cap. At the same time, downside for both oil and metals markets is limited due to the gradual buildup of fiscal-driven infrastructure spending in the US and China, as well as India's infrastructure needs.

Many private assets are becoming unattractive, in our view. We do not expect strong performance from this vintage of most private assets. Institutional investors have been turning to private assets as a panacea for low prospective returns in the public markets accompanied by rising volatility. As a result, flows have been gushing into private markets at a rate that far exceeds managers' abilities to deploy effectively. This does not bode well for the subsequent performance of 2017 and beyond vintage investments. Exceptions to this include US timber and residential real estate, which are set to continue benefitting from a housing cycle that has only recently embarked on an upswing supported by strong fundamentals.

THE FUNDAMENTALS DRIVING OUR CML

Political dynamics will have a persistent, amplified effect on economics and financial markets. The US election result confirms that a secular shift is occurring in the Western political landscape with a decline of centrist policies. Politicians are likely to position themselves to embrace these trends rather than seek to minimize the swing toward them. The result is likely to be a rebalancing of income toward labor. While this would otherwise be negative for earnings, this time it coincides with regulatory push-backs and fiscal thrusts designed to enhance growth. These policies can provide offsets.

US fiscal policy and deregulation are poised to kick in. The US is now set to join China and Japan in pushing ahead with a fiscal thrust through tax reforms (likely in 2017) and perhaps an infrastructure program (likely in 2018 and later). Perhaps even more importantly, we have very likely seen a peak in regulation in the US. Although it is difficult to quantify the impact of regulation on growth, it has become businesses' No. 1 concern, according to PricewaterhouseCoopers' 19th Annual Global CEO survey. The spike in regulation has become a significant economic drag, resulting in a lack of incentive for companies to invest in their businesses. This applies across a broad range of sectors, but perhaps most importantly to financials due to their unique role in enabling economy-wide growth through credit expansion.

The investment cycle is gearing up. Given businesses' low confidence, capital expenditures have been a low percentage of cash flow. Now, regulatory risk is falling and growth prospects are rising. Most firms outside of China are focused on improving margins on the back of slack labor markets and falling interest rates. The regime ahead is likely to see a reversal. Gradually rising growth, inflation, and interest rates in developed markets and their resulting margin pressures are likely to combine with deregulation and rising confidence, leading to investments in productivity.

Expect a lull in global trade. The major political events of 2016, and perhaps those of 2017, look poised to produce a lull in the level and makeup of global trade, creating winners and losers relative to the past. Asia's emerging export-oriented economies are most vulnerable to these trends, along with Mexico. US tax reform, including the possibility of border adjustable tax rates, may be the mechanism through which change is effected, leading to a stronger US dollar. We have been favoring large economies with domestic-oriented consumption, and continue to do so.

India's demonetization policy only adds to our intermediate-term positive conviction. While the implementation of the demonetization has been mismanaged and disruptive for short-term growth, we believe it will enhance India's intermediate and longer term growth prospects. Given the constrained balance sheet of India's government and state-owned banks, availability of capital for infrastructure investment from global investors remains a critical ingredient for increasing India's potential growth. The multitude of local tax regimes are in the process of being harmonized through India's goods and services tax reforms, making the country an easier place for foreign firms to do business. Given these improved growth dynamics, we think Indian equities have become even more valuable due to short-term price movements.

Expect a secular turning point for inflation. A massive amount of bank reserves, combined with the end of private sector deleveraging in developed economies, rising business investment, narrowing output gaps, commodity price stability, and a global rise in fiscal expansion all point to higher inflation ahead. The only exceptions to this trend are some select emerging market economies, such as Brazil and Russia, that are going through intense adjustment and restructuring processes.

Rising rates will result from rising strength. The higher growth/inflation regime ahead has already shocked core fixed income markets. In 2018, the ECB will accelerate the unwind of its asset purchase program. Unfortunately, that is more likely to result from political pressures than from economic conditions, thereby adding fuel to the "bondfire." The BOJ, on the other hand, is likely to maintain its accommodative monetary policy stance for longer. But here, too, we expect to see progress over the coming five years and some degree of policy normalization toward the end of that period. These forces will have some important offsets, like the cumulative impact of years of an escalating global savings glut, which can only go away slowly. Another is the large debt load. While it is easily serviceable with low interest rates, the burden can intensify quickly if rates rise too far too fast.

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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CAPITAL MARKET LINE ENDNOTES

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