Capital Market Line

Quarterly Five-Year Forecast of Relative Risk and Return Across Asset Classes

A Temporary Slowdown Till Spring, and a Steeper CML

December
2018

Many saw Federal Reserve tightening and trade frictions as the primary drivers of 2018's decline in risk assets. In our view, the main culprit was China's decision to de-lever. Like 2015, this was intended to redirect China's economy but nonetheless sent ripples of weakness around the globe. It also sought to remove stimulus put in place prior to November 2017's 19th Party Congress. Only recently have policymakers begun to appreciate the extent to which this self-inflicted slowdown went too far. Since last fall, China has been rolling out stimulus measures practically every week, which will continue until acceptable growth is restored.

Complicating this rebound is the simultaneous overhaul of the global trading system. Outcomes range from more restrictive to more open arrangements. The former, which would hamper global growth, was priced into the market last year. The latter is more likely, and would nurture global growth. An opening up and de-escalation has been trial-ballooned, and hopefully begins its long journey in March. We are encouraged by President Xi's favorable words on "competitive neutrality," the OECD principles by which countries with state-owned enterprises (SOEs), not just China, level numerous playing fields both domestically and internationally so that SOEs do not receive preferential treatment. In retrospect, this should have been in place before China was admitted into the World Trade Organization. If done in an enforceable manner, competitive neutrality offers a less disruptive path to adjusting global supply chains and competing technology ecosystems (one for those aligned politically with China and one for those aligned with the US).

By spring, we expect pre-tariff inventory-stocking to be cleared, tax cuts to be made, access to credit to be more equal, and import duty relief to be in effect, which will allow China's growth to resume. By then, the slow-motion pause by the Fed's draining of liquidity should also be in place. While forecasters see a sharp US slowdown subsequent to this, back to the stall-speed pace of 2% after the supposed "sugar high" of the 2017 tax bill runs its course, we see a more modest slowing and remain convinced that the natural growth rate in the US and Europe was suppressed from 2009 to mid-2016 (which we call the stall-speed period) by classic post-crisis drags, most of which have now run their course. In light of a well-established eight-quarter lag between rising wages and rising productivity, we are now at the point where escalating productivity has begun keeping inflation at bay, offering central banks a conducive backdrop to pragmatism in their monetary normalization efforts, supporting an even longer cycle.

In light of the recent violent action in risk assets, many prices now incorporate 50% odds of a global recession. We think that's way off base, with merely a temporary slowdown ahead until China's growth stimulus and the Fed's pause are given time to gel.

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.

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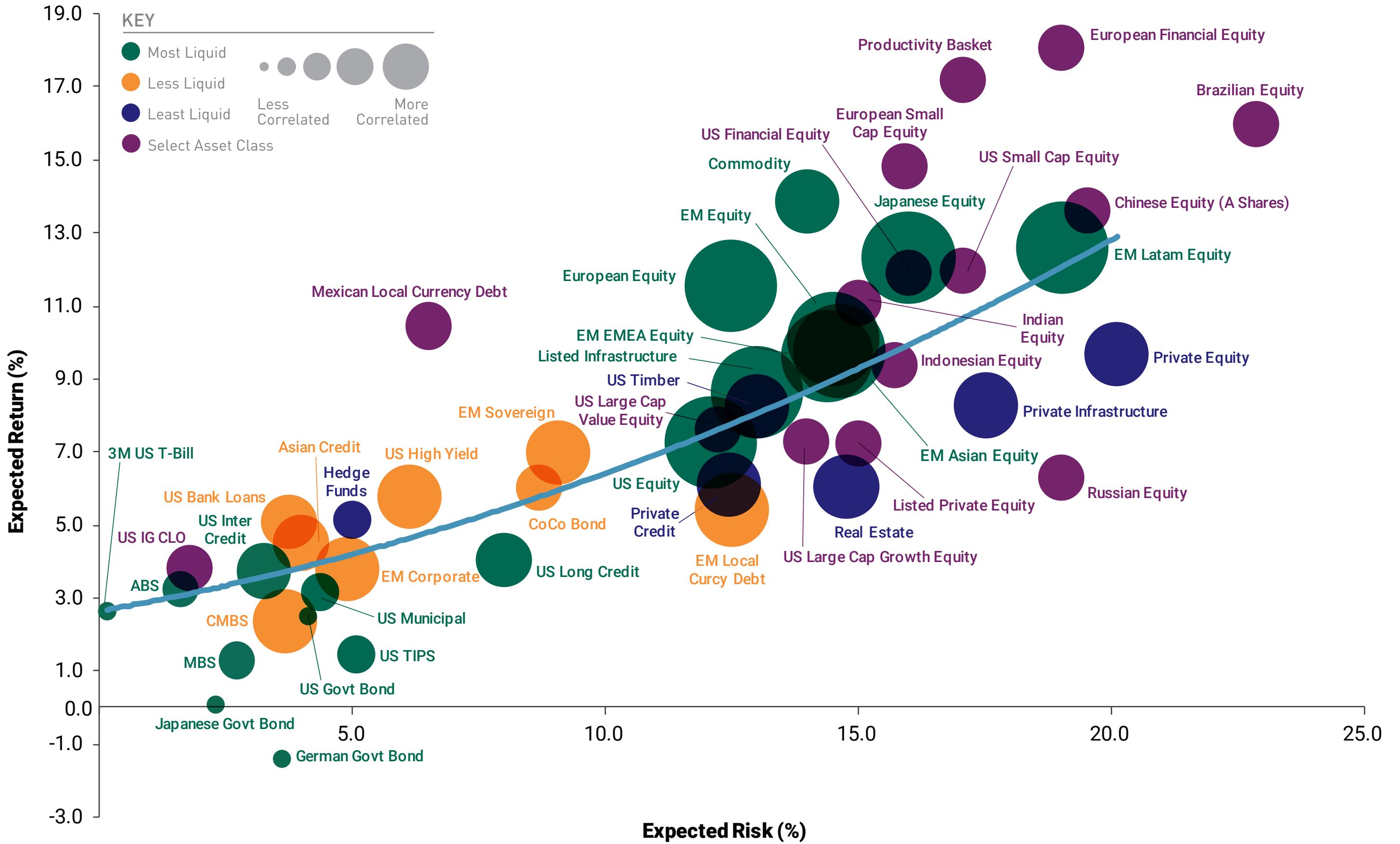
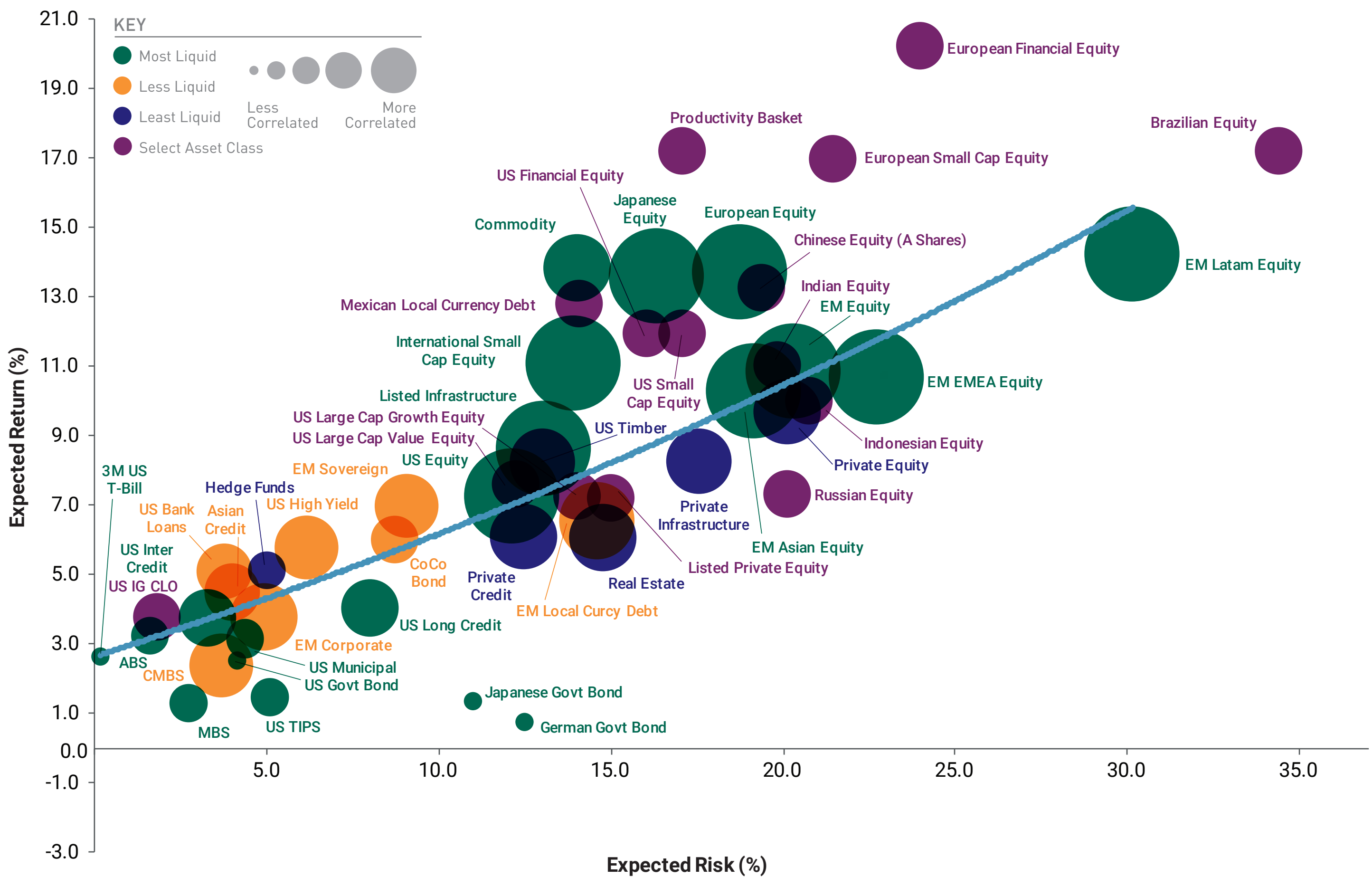
Capital Market Line as of 31 December 2018 (USD View, Local Currency)



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 31 December 2018 (USD View, Unhedged)



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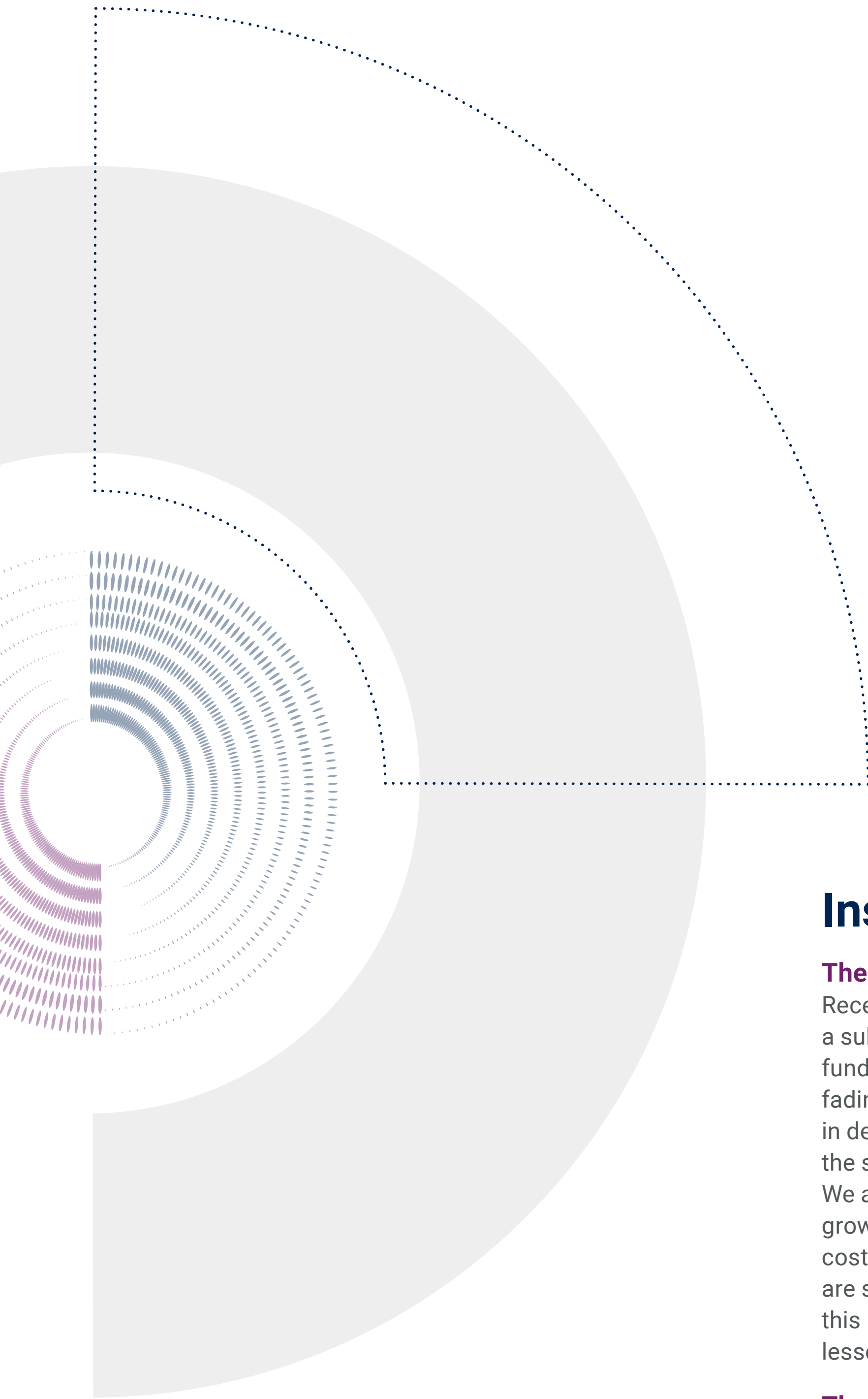
Capital Market Line Endnotes

The Capital Market Line (CML) is based on PineBridge Investments' estimates of forward-looking five-year returns and standard deviation. 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 for each asset class, which, when combined with current pricing, results in our annualized return forecasts for each class over the next five years. The expected return for each asset class, together with our view of the risk for each asset class as defined by volatility, forms our CML. Certain statements contained herein may constitute "projections," "forecasts," and other "forward-looking statements" which do not reflect actual results and are based primarily upon applying retroactively a simulated set of assumptions to certain historical financial information. Any opinions, projections, forecasts, and forward-looking statements presented herein are valid only as of the date of this document and are subject to change. There can be no assurance that the expected returns will be achieved over any particular time horizon. Any views represent the opinion of the investment manager and are subject to change. For illustrative purposes only. We are not soliciting or recommending any action based on this material.



Insights From Today's CML

The Capital Market Line (CML) is substantially steeper. Recent price declines across risk assets have resulted in a substantial steepening of our CML, which is based on fundamental forecasts. These forecasts incorporate the fading of post-crisis drags from private-sector deleveraging in developed markets (DMs), the global regulatory spike, and the shift from an emphasis on monetary policy to fiscal policy. We also recognize the crucial role of productivity and changing growth drivers in China (which affect commodities) in defusing cost pressures. Equally important is that neutral interest rates are substantially lower than in prior cycles, and – crucially – that this is recognized by central banks that have learned important lessons about post-crisis inflation dynamics.

The US risk-free rate anchors the CML at attractive levels. The Fed's gradual hiking has pushed US risk-free rates to attractive levels, gradually elevating the entire CML. Last quarter's CML signaled that US Treasuries were no longer unattractive. This was rewarded by a sharp fall in 10-year yields,

which resulted in the asset class once again falling below the CML's fair-value line. Notwithstanding low neutral interest rates, we expect another leg of gradually higher yields. Other DM sovereigns, such as those of Germany and Japan, remain unattractive, in our view, as their normalization processes largely lie ahead.

Growth assets are attractive in the environment ahead. Wage pressures began slowly rising two years ago. There is a well-established eight-quarter lag between rising wages and rising productivity – déjà vu. Notwithstanding the improved relative value of US safety assets, the nascent investment wave we see developing is enabling firms to offset cost pressures while also benefitting from higher top-line growth. Should central banks be patient and pragmatic, the result should be the restoration of high and resilient margins, as was the case in third-quarter earnings even though that reporting period started with a head fake. A higher baseline level of earnings growth is a great enabler for growth assets. The gradual tightening of monetary policy has contributed to a severe de-rating of equities, including in the US. We believe this will be less of a headwind for future valuations, given the degree to which neutral rates have fallen.

We find exposures linked to the global investment cycle attractive. Although recent data show a pullback in business investment, we believe this to be temporary, due partially to trade tensions and uncertainty, which will likely dissipate as companies accustom themselves to the evolving trade landscape. Since business investment survey data continue to confirm a bias toward productivity-enhancing technology, we find providers of productivity-enhancing technology attractive as intermediate-term investments. Moreover, digitization drives disinflationary growth at the macro level and has several far-reaching effects going beyond process optimization and business improvement. It fundamentally transforms and creates business models, alters value chains, and blurs lines across industries. We continue to see digitization as the single most underestimated and unrecognized driver shaping the cycle ahead and making it fundamentally different from those of previous decades.

Credit market conditions are challenging. For the last couple of years, we have gradually become more cautious about credit, concerned by the combination of deteriorating credit fundamentals and tight credit spreads. The recent selloff in risk assets hit equity much harder than credit, despite speculative-grade spreads widening over 100 basis points. Indeed, high yield is now attractively valued per our CML for the first time in several years as a result of wider spreads and stabilizing credit fundamentals. So entry prices are fine here, yet will exit liquidity exist two to three years from now? We are increasingly concerned about bank loans, where fundamentals have continued to deteriorate as a result of very strong technicals. The next downturn might well emerge from credit markets, given the buildup of leverage in corporate balance sheets and weak underwriting standards that are becoming the norm. Therefore, we continue to find US investment grade credit relatively unattractive.

Private assets continue to experience unfavorable supply/demand dynamics. The insatiable demand for private assets abated somewhat late in 2018. Overall, we find that this cycle is playing out very similarly to previous cycles, albeit over a longer timeframe. Private assets are potentially vulnerable to disruptive technologies in a wide range of sectors. This warrants a cautious approach, particularly in large-cap private credit markets. We recommend "future-proofing" private investments or otherwise maintaining dry powder through a focus on liquid assets until a better entry point is discernable.

The Fundamentals Driving Our CML

We see a global shift toward monetary tightening and fiscal easing. Central banks will continue to gradually tighten since global price levels have recovered from their unhealthy flirtation with deflation. The US will be the first to arrive at its terminal rate, followed by other DM central banks. At the same time, however, the global fiscal stance has shifted from being a significant drag on global growth to a modest positive contributor. This is partly a response to the rise of populism globally as well as today's relatively healthy levels of growth and incomes. The combination of staggered, yet steadily tighter, monetary policy and looser fiscal policy is a mirror image of the stall-speed regime and has important implications for growth, interest rate differentials, and currencies.

Peak US yields are on the horizon, with Europe and Japan in tow. US inflation is well-behaved and provides central banks with room to be flexible; we expect inflation to remain anchored by central bank credibility and productivity gains, encouraging a non-dogmatic approach compared with the past. We have been expecting the Fed's "pause" and continue to see confirmation of a pragmatic approach to monetary policy. This should provide room for productivity trends to build on their nascent upturns, thereby extending the life of the cycle. Beyond the US, slower yet above-trend growth will allow the European Central Bank and the Bank of Japan to continue normalizing rates slowly but surely, keeping their sovereign bonds unattractive.

China continues its slowing, yet avoids a "hard landing." As it approaches its potential growth rate from above, China thus far has successfully managed a glide path toward lower growth, albeit with several mini-cycles along the way. Consolidation of party power in 2017 extends Chinese policymakers' decision horizons, raising the tolerance for lower growth in the near term and emphasizing its "quality." This translates into significant impetus for necessary reforms, including the introduction of "competitive neutrality," protection of intellectual property (IP), and loosening of tariffs and foreign investment restrictions. These changes will be disruptive to the existing model, potentially increasing errors as untested policy tools are deployed, but should lead to more sustainable (albeit lower) growth. China's major challenge is likely to be its access to technology, as trading partners protect their IP, forcing China to innovate at higher cost.

The global trading system undergoes a major overhaul; supply changes create winners and losers. The global trading system is in flux, driven by a sea change in US trade policy. The WTO has been presiding over an outdated model in which tariffs are virtually the only metric for judging "free and fair trade" while nontariff barriers and unfair advantages accruing to certain nations are de-emphasized or ignored outright. It seems to us that the status quo is in the process of a dramatic shift. China in particular has benefitted from the existing system. We see the potential for major trading blocs to fundamentally change their trading requirements vis-à-vis China, particularly with regard to technology. Multiple potential outcomes exist as this transformation ensues, ranging from a global shift to protectionism to a mutual opening of markets. We anticipate the latter, and will keenly monitor global supply-chain adjustments to identify winners and losers.

The capability cycle will fuel a productivity wave. We see clear confirmation from top-down and bottom-up data points that a global investment cycle is firmly underway. Although these investments include traditional manufacturing-related capex, they predominantly take the form of technology-based enhancements of corporate capabilities designed to stave off disruption and become more agile and efficient at delivering services to end markets. This trend is global and widespread, with profoundly positive implications for growth and inflation. The result is likely to be a disinflationary growth burst as technologies conceived 30 years ago now become fully commercialized and adopted on a global scale. Rising productivity is like pixie dust for markets, generating growth while simultaneously dampening inflationary pressure and improving margins.

Faster-growing emerging markets will shrink negative output gaps. Emerging market (EM) assets struggled in 2018 as new trade realities dawned and US rates reset to levels much closer to their final destination. But after sustaining multiple shocks from the commodity price collapse and China's self-inflicted hard landing in 2015-2016, EMs are early in their recovery cycles. As a result of healthier commodity markets, strong DM growth, and the macroeconomic stability of their external accounts, EMs are likely to see growth accelerate. Even if lower Chinese growth acts as a cap, we think EM countries with wide yet shrinking output gaps, such as Brazil, are best positioned to sustain above-trend growth rates over the next few years. Since EMs will be particularly vulnerable to changes in global supply chains, and likely to create a high level of performance dispersion, selectivity will be key.

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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Last updated 6 March 2017.