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

PINEBRIDGE INVESTMENTS

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Why Today's Economic Green Shoots Are Strongly Rooted

Another self-induced China slowdown with a global spillover is coming to an end. Also coming to an end seems to be Federal Reserve forward guidance, which misled markets into pricing in a restrictive phase long before necessary, wreaking havoc. Since markets are always and everywhere about growth and how it is capitalized, we believe that markets this year will come to agree with us that global growth is now more robust and less fragile, and that the liquidity candy jar will not be taken away for several more years.

Since growth has already overcome the disruption of trade frictions, which preempted a step-up in investment, a likely positive outcome from the current US-China negotiations could unleash the next phase of investment-led growth. We have long argued that the trade reset ultimately will result in fewer barriers, not more, and greater trade, not less.

China's current policy response to its slowdown – a leveling of the playing field between large state-owned enterprises and private companies – should be thought of less as stimulus and more as a restorative effort for the private sector. If, how, and when the private sector responds will be the most important driver in setting the trajectory for China and global growth.

The Fed's January pivot appears to have taken the markets by surprise, although it was not surprising to us; we have been arguing that Chairman Jerome Powell has been foreshadowing such a move since his August 2018 Jackson Hole speech. The end of quantitative tightening in late 2019 is also profoundly important for longer lasting favorable capitalization of cash flows, as is the Fed's consideration of "average inflation targeting," which would entail accepting overshoots of its 2% inflation goal for several years to make up for the long spell during which inflation fell short. In market terms, this effectively extends by several years the time when the Fed would become restrictive, thus extending the cycle.

In the face of these deep-rooted green shoots, yield curve inversion and its presumed predictive powers have consumed markets lately, despite the curve's inconclusive causal link to recession. We acknowledge that bank lending may be disincentivized when the curve inverts, which can lead to lower credit growth and economic deterioration. But bankers, not the bond market, call the tune. In the past, only when bankers shared the inverted yield curve's foreboding by tightening lending standards did recession follow. Currently, bankers are not tightening standards and would have to do so for some time for a recession to ensue. Prior US yield curve inversions also occurred before today's distortions were caused by years of financial repression and during an era when the US, not China, was the world's economic locomotive. We caution against assuming a simple repeat of the past.

Today, we believe equities remain the most attractive asset class and are contributing to a relatively steep Capital Market Line (CML). In contrast, most fixed income and private assets remain uninspiring.

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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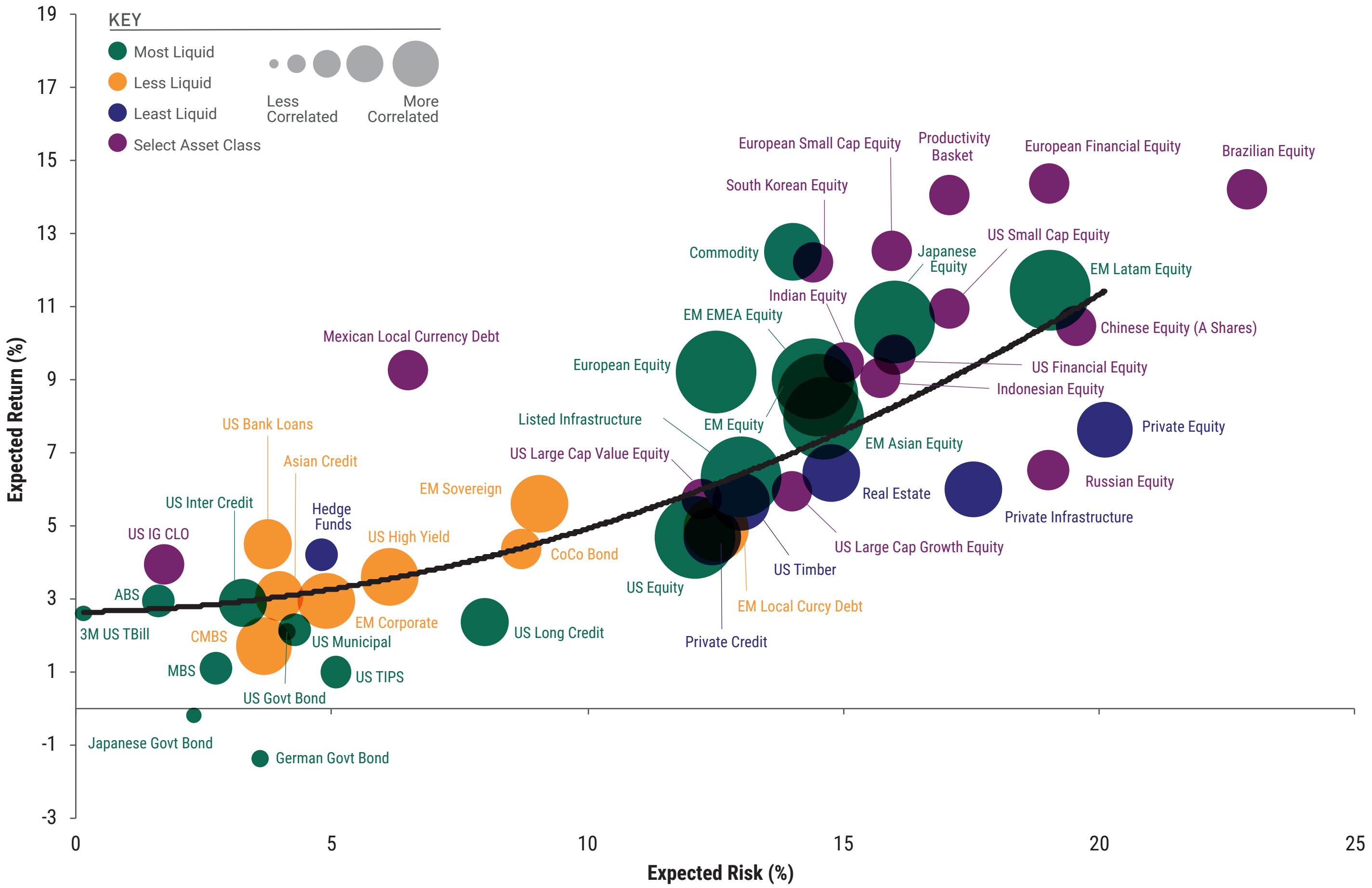
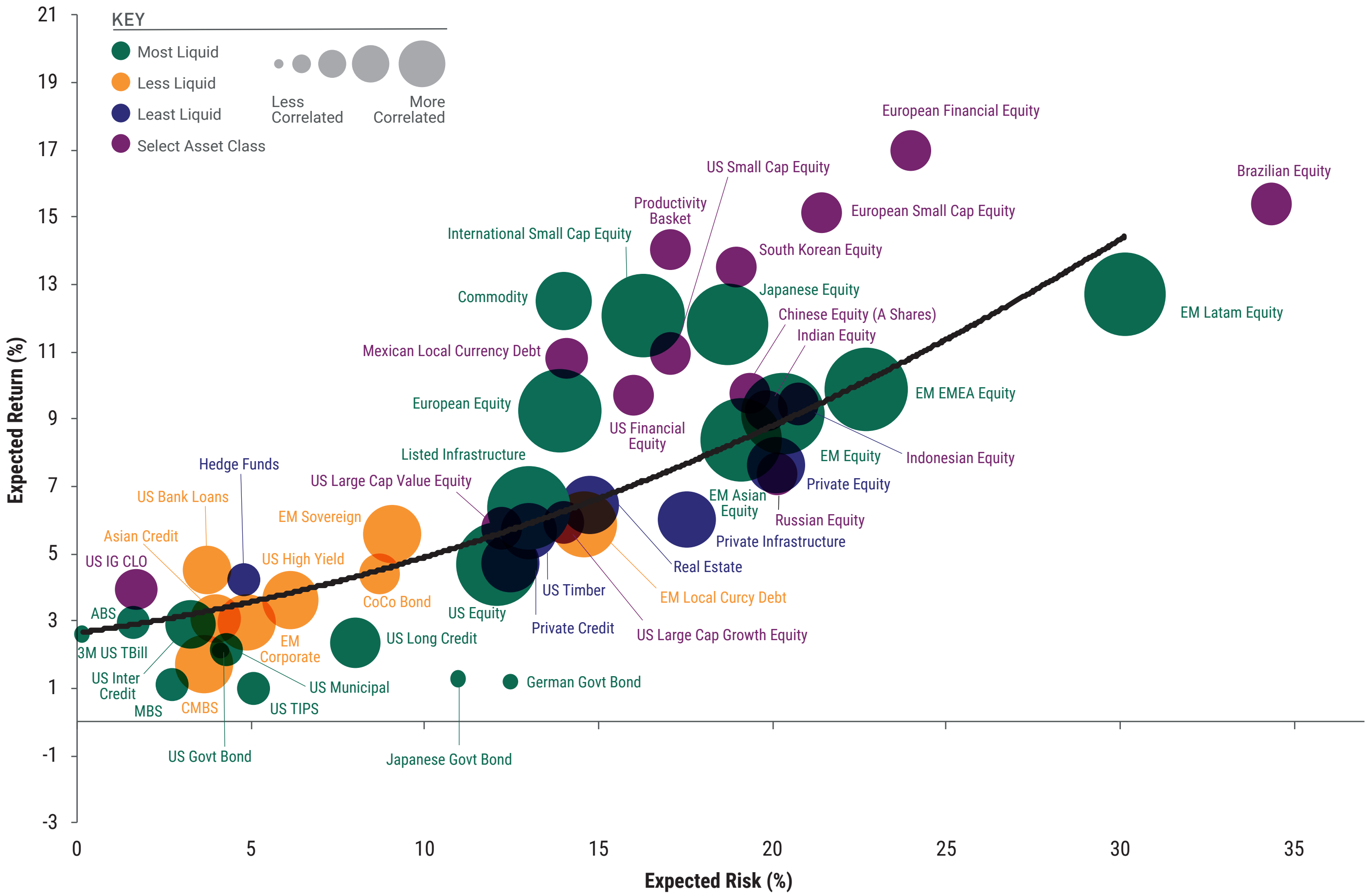
Capital Market Line as of 31 March 2019 (USD View, Local Currency)



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 March 2019 (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 CML is relatively steep. Despite a first-quarter rally, which merely undid the fourth-quarter's false alarm, reflation of cash flows results in a relatively steep CML. The fundamental forecasts that underpin our CML incorporate the fading of post-crisis drags from developed market (DM) private sector deleveraging and the global regulatory spike, as well as the handoff of monetary policy to fiscal policy. We also recognize the crucial role played by productivity and the changing nature of China's growth contributors (and their effect on commodities) in defusing cost pressures. Equally important is the recognition that neutral interest rates are substantially lower than in prior cycles, and – crucially – this is recognized by pragmatic central banks that have learned important lessons about post-crisis inflation dynamics.

The US risk-free rate anchors the CML. Growth is expected to be more broad-based than during the "stall speed" economy, with stronger contributions coming from corporate investment and the fiscal channel, anchoring yields at higher levels than in the last decade. Notwithstanding the Fed's recent pause, we expect a few more hikes in the federal funds rate in the next several years to get more within the band of neutral, instead of pushing into restrictive territory. Other DM sovereign bonds such as German Bunds and Japanese Government Bonds remain unattractive, in our view, as their normalization processes remain largely ahead of them.

Growth assets continue to be most attractive to us in the new regime. Low neutral rates provide a cap to yields. This limits downside risk for safety assets, yet the starting level of yields also implies unattractive return potential. In contrast, current valuation levels for growth assets are relatively undemanding and supported by capped yields and the more robust growth backdrop. The nascent investment wave we see developing is enabling firms to offset cost pressures while also benefiting from higher top-line growth. The result is resilient margins, as confirmed in fourth-quarter earnings, and a higher baseline level of earnings growth across many equity markets.

We find exposures linked to the global investment cycle attractive. Although recent data show a pullback in overall business investment, we believe this to be temporary, driven by trade tensions and uncertainty that will be resolved as firms accustom themselves to the evolving trade landscape. Yet investment into technology continues unabated. As well as driving disinflationary growth at the macro level, we believe providers of productivity-enhancing technology are attractive as intermediate-term investments. Moreover, digitization goes beyond process optimization to the fundamental transformation of business models, the altering of value chains, and a blurring of industries. Beyond improving existing business operations, the innovations create new digital products and features, introduce new ways to deliver them, and enable new business models. We continue to see this as the single most underestimated and unrecognized driver shaping the cycle ahead and making the coming decade fundamentally different from the previous one.

Credit markets remain uninspiring. We have been very cautious about credit markets due to deteriorating credit fundamentals and tight credit spreads. Recent improvement in credit fundamentals is not expected to persist. The discipline currently displayed by the corporate sector is likely to fade and leverage may resume building as trade uncertainty abates and the next leg of investment begins. The next downturn is likely to materialize in credit markets first, given the buildup of leverage in corporate balance sheets and weak underwriting standards that are becoming the norm. As a result, we continue to see US investment grade credit as relatively unattractive.

Private asset forward-looking returns continue to deteriorate. Although the pace of fundraising has abated somewhat recently, demand continues to outpace supply. Overall we find this cycle to be playing out very similarly to previous cycles, albeit over a longer period. Private assets are not immune to the spreading of disruptive technologies in a wide range of sectors, warranting a cautious approach before locking oneself into investments long into the future. 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

Monetary policy is supportive and fiscal easing is moderate. Central banks have demonstrated a remarkable level of flexibility, with inflation dynamics continuing to provide them with room to remain so. The US will be the first to arrive at its terminal rate, with other DM central banks in tow. Yet at the same time, fiscal policy globally has continued to shift from being a significant drag on global growth to a modestly positive contributor. This is partly in response to the rise of populism and partly a result of healthier levels of growth and income relative to the years immediately after the financial crisis. This combination of staggered, yet steadily tighter, monetary policy and looser fiscal policy is a mirror image of the stall-speed regime of 2010-2016, and has important implications for growth, interest rate differentials, and currencies.

A US yield plateau is on the horizon. Investments in productivity-enhancing technology continue, and are likely to accelerate, helping to contain unit labor costs. We have not been surprised by the lack of overheating. We are increasingly in a supply-dominated world, and expect US inflation to remain well-behaved, providing central banks with room to be patient. The "neutral" interest rate remains low, albeit rising very gradually, and implies peak US yields on the horizon. Beyond the US, slower yet above-trend growth reinvigorated by China will allow the European Central Bank and the Bank of Japan to continue to normalize rates slowly but surely, which will likely keep their sovereign bonds unattractive.

China is likely to transition to more stable and sustainable growth. We expect the Chinese authorities to maintain their dual objective of smoothing the transition of the economy toward greater value-added production and services and providing support when needed. Private sector confidence was damaged in recent years, and the extent to which this trust and confidence returns will be important not only for China, but for global growth prospects. 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 may be disruptive to the existing model, potentially increasing policy errors as untested policy tools are deployed, yet should lead to more sustainable growth than those focused on "stimulus down/stimulus up." China's major challenge is likely to be its access to technology, as trading partners turn to protecting their IP, forcing China to innovate at higher cost.

A better global trading system appears to be emerging. The World Trade Organization has been presiding over an outdated trading model in which tariffs are virtually the only metric for judging "free and fair trade," while non-tariff barriers and unfair advantages accruing to certain trading nations are either de-emphasized or ignored. It remains to be seen the extent to which this system will be challenged, but further bouts of conflict are likely as technology becomes central in global trade considerations. We continue to expect China to face more challenges in sourcing Western technology relative to the past. A US-China trade deal will likely ease near-term disruptions and may signal that the US is seeking to adjust trade relations rather than pursue a complete structural overhaul.

The capability cycle is fueling a productivity wave. We see clear confirmation from top-down and bottom-up data that a burgeoning global investment cycle is underway. Latest uptrends in investment in intellectual property are a case in point. They confirm that corporate investment is predominantly taking the form of technology-focused capital expenditures that enhance the ability 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 rise in growth as technologies that were conceived of 30 years ago are finally commercialized and adopted on a global scale.

The EM-DM growth differential will widen modestly and shrink negative output gaps. Over the intermediate term, we recognize that emerging markets (EMs) are earlier in their recovery cycles than DMs after sustaining multiple shocks from the commodity price collapse and China's self-inflicted slowdowns. We expect EM growth to accelerate from its lows as a result of healthier commodity markets, strong DM growth, and macroeconomic stability of their external accounts. Countries with wide yet shrinking output gaps, such as Brazil, are best positioned to sustain above-trend growth rates over the next few years, in our view.

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.

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 31 December 2018, the firm managed US$89.6 billion across global asset classes for sophisticated investors around the world.

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