Capital Market Line

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

PineBridge® INVESTMENTS

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The Coming Reboot of US Exceptionalism

In the years following the pandemic, the US has stood out among global economies, with its rapid recovery fueling the narrative of "US exceptionalism." This outperformance was driven by an unprecedented wave of fiscal stimulus, including major legislative packages such as the CARES Acts, the Infrastructure Investment and Jobs Act, the CHIPS Act, and the Inflation Reduction Act, along with robust productivity gains. Together, these measures injected trillions of dollars into the economy, bolstering consumption, investment, and job creation at a time when many other advanced economies maintained a more cautious fiscal stance. The US also benefited from a flexible labor market, dynamic private sector innovation, and a strong consumer base, all of which helped it recover faster and stronger.

However, the era of clear US dominance is showing signs of transition. By late 2024, investor enthusiasm for US assets began to wane, driven by concerns over erratic trade policy shifts, rising tariffs, geopolitical tensions, and the erosion of traditional US governance structures. Additionally, after years of strong inflows, some investors began reassessing their overexposure to US equities and bonds, leading to a more cautious stance. A key factor behind this recalibration is the narrowing gap in fiscal activism. While the US deficit remains high – currently around 6.5% of GDP and likely to stay in this zone once tariff revenues are factored in – other countries are beginning to adopt more assertive fiscal approaches. This suggests that the relative advantage from aggressive US stimulus has peaked.

In Europe, Germany's debt brake has been a drag on growth ever since the financial crisis, when the private sector was naturally retrenching and could have benefited from governments taking the opposite tack. Germany is now loosening the fiscal purse strings to rearm. The electorate slowly began to contemplate removing the debt brake to revive Germany's military and infrastructure assets. This marks a seismic shift for a country traditionally wary of debt, signaling a new willingness to use fiscal policy as a tool for both economic renewal and national security. Germany's fiscal reboot has medium-term growth implications, and while it is primarily a German story, there is some spillover into the rest of Europe, especially now that NATO members in Europe are considering raising their annual defense expenditures to 5% (from close to 2% at present).

Meanwhile, China's internet sector is regaining investment appeal, thanks largely to the rapid rise of DeepSeek and its potential to reshape the country's tech landscape. DeepSeek has made advanced large language models (LLMs) widely accessible – even to companies without top-tier AI hardware – spurring a new wave of innovation and enabling more sophisticated digital services. As DeepSeek's technology evolves, Chinese firms are better positioned to compete globally and drive broader adoption of domestic AI solutions.

The company's swift emergence has become a key investment theme, signaling renewed confidence in China's tech sector. DeepSeek has also fostered renewed cooperation between the government and private industry, marking a shift from regulatory crackdowns to a more supportive environment for technology companies and innovation. This has opened opportunities for a wider range of companies, not just tech giants, to benefit from cutting-edge AI. Looking ahead, DeepSeek's success is ushering in new possibilities in voice, vision, and reasoning technologies. While it has helped China close the AI gap, continued progress will require ongoing innovation across multiple fronts.

These developments question the narrative of unchallenged US market dominance. Yet, does this mean investors should step away from US markets? The answer is more nuanced.

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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Despite recent headwinds, productivity and innovation remain core strengths of the US economy. America's deep capital markets, flexible regulatory environment, and strong intellectual property protections continue to support entrepreneurship and rapid technological diffusion. The pandemic-era investments – from supply chain modernization to semiconductor reshoring and digital infrastructure – have further reinforced these advantages, creating a durable productivity premium relative to other economies. Moreover, the US continues to lead in sectors such as advanced semiconductors, life sciences, renewable energy, and AI, driven by a unique ecosystem that integrates academia, venture capital, and established corporates.

We don't expect US fundamentals to outperform in the near term, largely because of the one-time stagflationary impact of new tariffs. Yet that risk is strictly in the goods sector. Recent data show that services, which comprise the bulk of the US economy, are largely insulated from tariff shocks and are where US productivity is shining brightest, continuing their disinflationary trend, particularly in shelter costs. Both the Consumer Price Index (CPI) and Producer Price Index (PPI) have surprised to the downside in recent months, indicating that inflation pressures remain contained before tariff pass-through begins – a one-time event we expect in the second half. In response, the Fed has maintained its guidance for two rate cuts by year-end. Yet as we draw closer to the tariff pass-through into prices, Fed minutes show that while most FOMC voters are still in this temporary camp, some have become less confident in this scenario. Our view is that short-term headwinds will appear but will not be significant enough to break the expansion.

Meanwhile, another round of deregulation under the Trump administration is just beginning, and like most Trump 2.0 initiatives, it is likely to run at a feverish pace. This could provide additional support to a continued widening of US productivity versus other developed market peers as early as 2026. Even without that, the US is poised to widen its productivity lead, largely due to its early and aggressive embrace of AI, which is rapidly becoming the next transformative force in economic history. We view AI as comparable to the steam engine, electricity, and the internet with respect to its potential to drive non-inflationary growth for a sustained period of time.

In contrast to pandemic crisis-driven investment, the US AI investment wave is being driven purely by the private sector. US companies, particularly those rich in data and digital infrastructure, are moving quickly to develop and deploy AI applications, even as trade uncertainty lingers. Despite tariff-driven uncertainty that many felt would pause investment, the hyperscalers are forging ahead, ensuring that the US maintains its leadership as the AI landscape shifts from a focus on raw computing power to real-world applications. This strategic focus is already translating into measurable gains: AI is expected to boost productivity across most sectors, freeing up workers for higher-value tasks and supporting faster GDP growth.

A focus on deregulation will also likely translate into less attempts by the US government to block the job loss, cost advantages, and disruption that comes with AI, particularly vis-à-vis regions like Europe. All this joins private equity-driven industry consolidation, "winner take most" dynamics in many technologies where the US leads, and a much stronger alignment of ownership and management, with greater incentives tied to financial performance. Numerous industries in the US have a distinct edge with respect to delivering higher margins and more stable cash flows, setting them apart from international peers.

Most estimates of the US fiscal deficit begin with the Congressional Budget Office (CBO) figures and then make adjustments. They often keep the CBO's assumed 10-year growth rate of 1.8% for real GDP. This pace is notably lower than the pre-financial crisis average but aligns with the slower post-crisis era, and it stands in contrast to earlier periods of strong, productivity-driven expansion in US history. Recent data suggest that AI alone has added up to 1% of US real GDP growth in the first quarter,[1] with hyperscalers reporting accelerating momentum in their latest earnings.

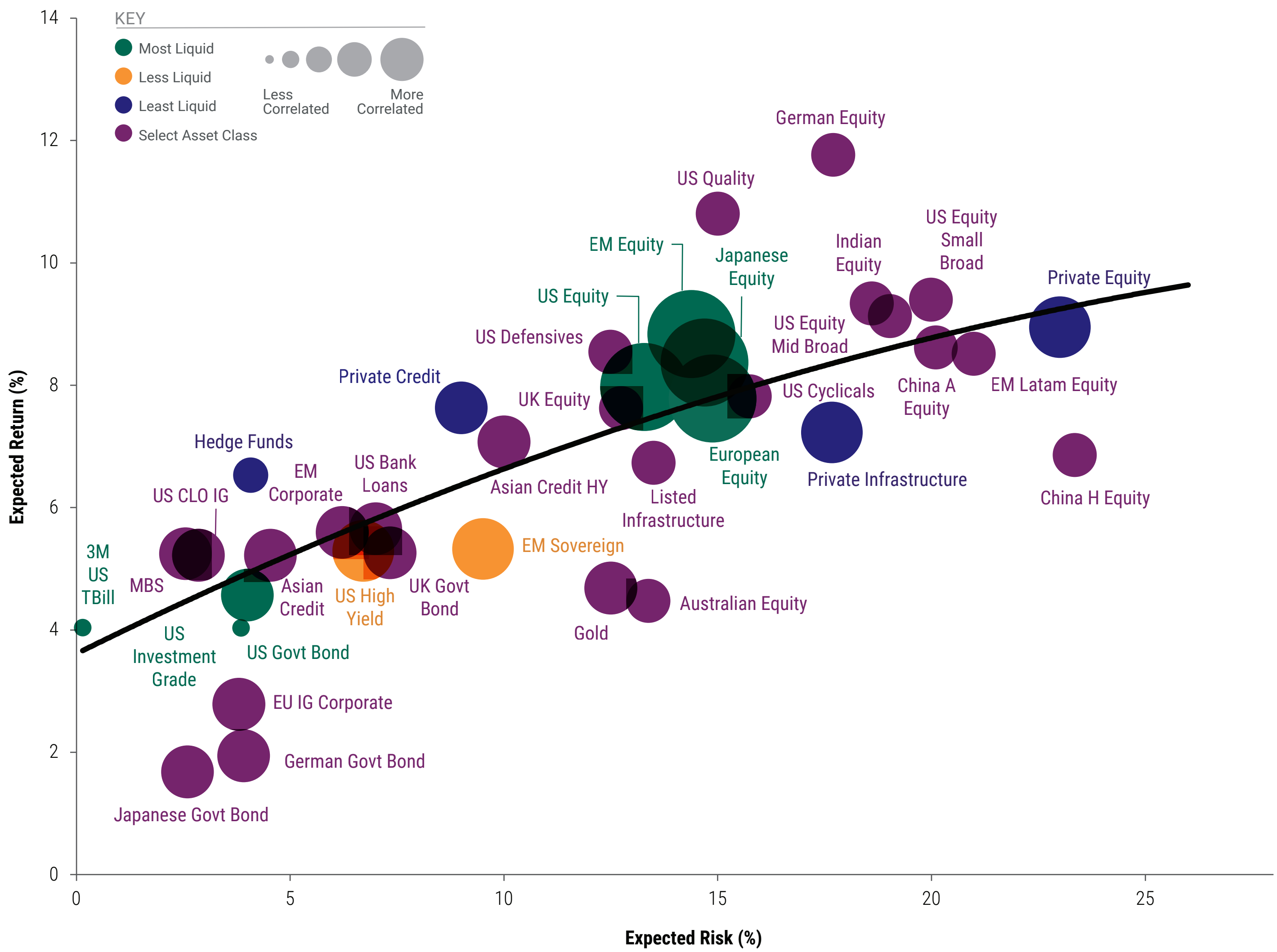
This tailwind is expected to strengthen as AI adoption broadens. Notably, following President Trump's recent Middle East visit, the number of global hyperscalers expanded from seven to 10, as three Middle Eastern countries gained access to Nvidia chips and the capacity to build out their own datacenters. If AI-driven productivity continues to accelerate, US real GDP growth is likely to exceed the CBO's 1.8% baseline, which would help gradually reduce the fiscal deficit as a percent of GDP from its current 6.5% level, which may well lower risk premiums, the term premium in Treasuries, and FX hedging costs.

Yield curves have been steepening at the long end across global markets. Historically, steeper yield curves align with periods of robust, investment-led economic growth. Looking ahead, drivers such as reshoring, climate-related infrastructure spending, and AI innovation are set to fuel this trend. Now add NATO countries in Europe committing to 5% defense spending (up from 2% for the most part), with many countries becoming more fiscally active. In such an environment, growth-sensitive assets like equities tend to outperform more defensive fixed income instruments, which must contend with rising yields and inflation expectations.

Beyond a likely stagflationary "head fake" in the second half of 2025, in 2026 and beyond we expect US productivity gains to widen versus international peers, with industrial policy being replaced with a more private-sector-driven form of US exceptionalism. In short, we expect US exceptionalism to return, with a reboot in 2026.

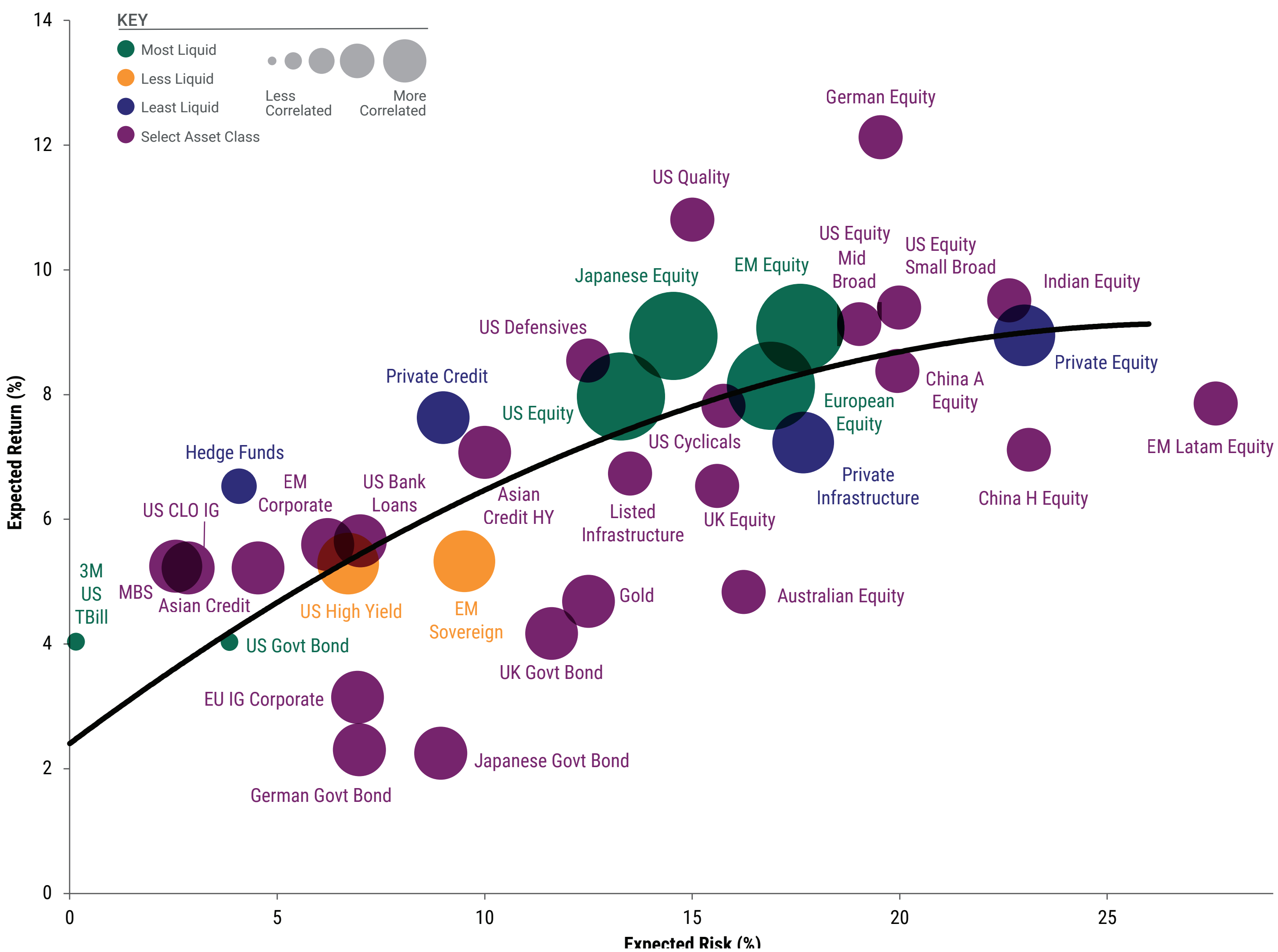
[1] Source: Apollo Academy as of June 2025.

Capital Market Line as of 30 June 2025 (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 2025 (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 a set of assumptions to certain 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

Our Capital Market Line (CML) is steepening after a long flat period, with continued high dispersion. Powerful shifts in geopolitics, policy, and technology are driving the steepening – factors more influential now than in most past cycles. The coming years will see efforts to address unsustainable trends that have built up over decades, leading to significant changes in cash flows and potentially widening global growth disparities, though with considerable uncertainty. These dynamics are generating both risks and opportunities, fueling the current high dispersion. Rather than relying on long-term mean reversion, our approach is to capitalize on medium-term growth opportunities created by lasting technological and geopolitical changes. We expect this era of transformation to spur investment and put upward pressure on real interest rates.

Focus on equities with strong resilience amid tariff threats. Tariffs are a potential challenge for profit margins, making quality companies with more resilient moats and margins more likely to outperform. The rollout of AI in both the US and China presents attractive opportunities over the medium term, driving productivity growth beyond the tech sector. US reshoring is already underway and is likely to accelerate as tariffs change the capex calculus in favor of US industrials. We are also constructive on Indian stocks, which we view as well positioned against today's backdrop, both due to India's status as an importer (with deflationary pressures poised to spread outside the US) and its likelihood to benefit from US-China tensions.

More UK gilts and long-end Japanese government bonds in the mix. We have been leaning away from US Treasuries, which face the prospect of tariff-driven reflation, in favor of areas where disinflation would continue. Despite Germany's recent stimulus, it still has plenty of room. We still see more value in fully FX-hedged bunds over Treasuries as the eurozone advances with disinflation and rate cuts, while the US remains on hold, anticipating potential stagflation from tariffs. More recently, we have entered the very long end of Japanese government bonds. Our move to extend duration is less about confidence in fiscal sustainability and more about recognizing that fiscal concerns are already reflected in prices. This creates an opportunity to position for a likely slowdown in US growth and strengthening disinflationary trends abroad.

Credit spreads are tight, but opportunities exist. In the current "Balanced Growth" regime, the correlation between stocks and risk-free bonds is around zero, unlike the -0.4 correlation during the "Stall Speed" regime. This change diminishes the appeal of risk-free fixed income relative to growth assets at any point on the rates curve. Credit spreads remain tight across most markets, supported by the strong growth environment. Still, select opportunities stand out – particularly in Asia's high yield bonds (outside China's property sector) and, to a lesser degree, in US mortgage-backed securities, where spreads remain more attractive than in most other credit markets. Upcoming regulatory easing for large US banks, specifically changes to the Supplemental Leverage Ratio, should boost demand for both mortgage-backed securities (MBS) and Treasuries. At the same time, we are closely monitoring US high yield markets for potential spread widening if recession fears spark market overreactions as economic data softens in the coming months.

Gold is viewed as a reliable geopolitical risk diversifier. Gold continues to perform well as a hedge for geopolitical risk. While a prolonged ceasefire in the Russia-Ukraine conflict might temporarily lower gold prices, a comprehensive peace agreement, which would likely require significant sanctions relief for Russia, seems less probable than an extended ceasefire without a formal deal. Meanwhile, the trend of de-dollarization among Global South central banks is expected to persist, supporting gold prices. Since the global financial crisis, gold has been in a long bull market, driven by Western central banks' quantitative easing policies, which caused global M2 money supply growth to outpace global GDP growth. Currently, even as the Fed and the European Central Bank reduce their balance sheets, the People's Bank of China (PBOC) is surging its own, offsetting the Western contractions. If the PBOC continues to increase its balance sheet to address its creeping balance sheet recession, China's M2 growth alone could reignite the expansion of global M2 relative to global nominal GDP, likely boosting gold's rise.

The Fundamentals Driving Our CML

Tariff and geopolitical risks lead to shifts in supply chains. Higher tariffs are speeding up the trend toward deglobalization and encouraging companies to reshore production. As firms work to secure more reliable supply lines, costs are rising, which is likely to keep medium-term inflation pressures elevated and spur new waves of capital investment. These changes, rooted in strategic and geopolitical priorities, are also prompting businesses to invest more heavily in productivity-enhancing technologies and processes.

Transitioning to more balanced public and private sector growth. Following the global financial crisis, Western economies faced mild balance sheet recessions marked by sluggish consumption and investment as the private sector deleveraged. The clash between reduced private investment and a strong inclination to save, which typically drives rates down, was intensified by monetary policies like quantitative easing and negative interest rates. Fiscal policy was relatively passive, placing the burden on monetary authorities. This "old abnormal" era persisted until around 2015, when our CML cash flow growth projections reflected less growth and more lenient capitalization rates than anticipated. Since then, growth has accelerated, supported by healthier household and corporate balance sheets and secular changes. Since the pandemic, fiscal policy has become much more aggressive, but we see this surge in government spending as a temporary and fragile version of "US exceptionalism." The Trump 2.0 administration is now looking to scale back the government's role in driving growth and instead pushing the private sector to take on a greater share of economic activity. While this shift may create short-term headwinds as public support is dialed back, we view this as a necessary adjustment to build a healthier, more sustainable foundation for long-term growth.

AI as a catalyst for productivity. Technological advancements and enhanced human capital investments are reshaping labor, business models, and national security. Tools like generative AI are set to automate a significant portion of tasks across various jobs, improving labor efficiency, creating new job opportunities, and boosting overall productivity. This transformation not only increases US labor productivity but also drives innovation and efficiency across multiple sectors, positioning AI as a key driver of future economic growth and supply-led expansion. China is also ramping up its AI development efforts. With DeepSeek driving down costs, the transition toward application deployment and monetization is likely to accelerate, supporting faster integration and broader use of AI technologies. This secular trend will reshape economies and drive long-term productivity growth.

A test for US assets. A major concern for financial markets is the recent loss of confidence in US assets, driven by the Trump administration's unpredictable policies. We expect a gradual rebalancing away from US assets, reversing the heavy concentration seen in recent years. Slower US growth – due to tariffs and fiscal tightening – combined with stronger fiscal efforts in Europe and China, could accelerate this trend. While some outflows may pause if Trump de-escalates, the sheer scale of US asset holdings is likely to keep medium-term pressure on the dollar. Although the risk of the dollar losing its reserve status remains low, ongoing global rebalancing could erode its current overvaluation.

Germany's fiscal stance shifts from restraint to renewal. Germany's long-standing debt brake has restrained growth by limiting public investment during a period when the private sector was retrenching. Now, Germany is loosening fiscal constraints to fund a €500 billion plan over the next 12 years focused on infrastructure, defense, and climate initiatives – a significant shift for a traditionally debt-averse nation. This move, driven by growing public support to modernize the military and upgrade infrastructure, allows higher defense spending and greater borrowing flexibility for federal states. While primarily a German development, this fiscal reboot is expected to boost growth domestically and spill over positively into the broader European economy.

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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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 March 2025, the firm managed US$188.9 billion across global asset classes for sophisticated investors around the world.

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