Investment Strategy Insights

Monthly Views From Our Diverse Global Investment Teams

PineBridge® INVESTMENTS

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A Midyear Check-in on Risks to the Base Case

Hani Redha, CAIA, Global Multi-Asset Portfolio Manager

At the midyear point, our outlook for risk assets leans constructive as we enter a global easing cycle. The European Central Bank (ECB) has cut rates for the first time since 2019. While the Fed has delayed rate cuts due to inconvenient first-quarter inflation, it proceeded with easing through its other policy tool – tapering of quantitative tightening. At this pivotal moment, it is crucial to extend our analysis beyond the base case to probe what could go wrong – or right – and the implications for various asset classes.

In our base case we see a soft landing unfolding, with economic growth converging across regions. The US is transitioning from an overheated to a Goldilocks state, while other economies accelerate toward better growth. Such conditions typically bode well for equities and are moderately favorable for credit, though their impact on rates is more muted. In this scenario, only a few rate cuts are necessary, as opposed to a few hundred basis points of cuts. Conversely, unsuccessful soft landings would involve extensive rate cuts, which would be detrimental to equities and credits but beneficial for rates; however, we do not foresee the latter outcome.

The shifts that a global easing cycle ushers in opens up opportunities across various asset classes. Given that the policy rate cutting cycle is expected to be gradual and modest, those assets most sensitive to interest rates are likely to benefit. In fixed income, we favor a balanced barbell strategy, incorporating US Treasury bonds and high yielding credit. This approach hedges against adverse scenarios whilst locking in attractive all-in yields. In Asia, we are constructive on high yield bonds, driven by the attractive combination of low default rates and high spreads amid a more sustainable upturn outside of China. In equities, we see opportunities in companies that may seem less promising in the short-term but have already started to gain from structural tailwinds, including green energy spending, electric vehicle uptake, and momentum for certain medical treatments.

But what could go wrong? If central banks delay rate cuts for too long, it could effectively morph into overtightening, potentially hurting both corporate and consumer behavior and raising unemployment. This is particularly concerning given the current state of consumer markets; activity in the US has slowed, Chinese consumers show no signs of resurgence, and both Europe and Japan are experiencing subdued consumer spending. These conditions could potentially prolong a manufacturing sector recession, especially as the ongoing destocking and restocking cycles obscure true demand. At the opposite end of the spectrum lies the risk of persistently high inflation should central banks cut too soon. Both scenarios are plausible, with recession risk being more probable than persistent inflation, yet the base case enjoys a large share of the probability distribution.

A key risk event to keep top of mind is the November US presidential election, which could significantly alter the policy trajectory over the short and medium term. A victory for Biden would likely stabilize US policy, benefiting both US and global markets, particularly Asian and European equities. In contrast, Trump 2.0 could introduce aggressive economic policies such as permanent tax cuts and increased tariffs. This outcome could be reflationary in the US, while simultaneously causing deflationary pressures abroad due to increased tariffs and restrictive immigration policies. Performance across asset classes will likely be driven by economic conditions at the time of the election and inauguration.

Upside risk scenarios are more difficult to envisage currently, as they would require an even better-than-expected rapid drop in inflation without a recession, which is difficult to achieve. The route to this scenario would be enabled by a "productivity miracle," perhaps facilitated by artificial intelligence (AI), and a continuation of favorable immigration trends that lead to supply-led disinflationary growth – plausible over the medium term, yet unlikely to materialize in the remainder of 2024.

When assessing economic outlooks, it's vital to recognize the rarity of a successful soft landing, with only two such instances in the past 60 years. The risk of veering toward a hard landing or no landing at all highlights the importance of maintaining a high-conviction yet dynamic investment approach. The heightened risks arising from the rarity of current economic conditions and key political events ahead point to the value of nimble active management in such unusual times.

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 Macro

Ilke Pienaar
Head of Sovereign Research, Global Emerging Markets Fixed Income

CS 2.75 (unchanged)

Contrary to expectations, the US economy lost momentum in the first quarter as government expenditures and export growth slowed significantly. The two-speed economy is converging, with retail sales growth trending lower and manufacturing remaining lackluster. A combination of slower momentum in credit growth, the savings rate sitting below its long-term average, and no expectation of a reacceleration in government spending underlie the view that the economy will continue its gradual slowing. While that pace is still far from recessionary and immigration has provided a lift, the decline in productivity growth suggests below-potential performance.

Look for upward surprises in the Consumer Price Index (CPI) to fade as increases in insurance premiums normalize and shelter inflation catches up with the rental surveys. The rate of deflation in durable goods prices accelerated in the second quarter at the fastest pace in 20 years, showing underlying pricing power is weak outside of services. Against this backdrop, CPI should reach close to 2% in the first quarter of 2025.

While the Fed remains cautious, seeing only one cut in 2024, the market is pricing closer to two cuts this year, with the first likely between September and November. With sufficient evidence of lower inflation to be received only after the July meeting, the likely start date for the cutting cycle is now later than previously thought.

With the European Central Bank (ECB) commencing its cutting cycle and the remaining big central banks (excluding the BOJ) set to ease this year, global growth has generally come in stronger, helped by sideways to more stimulatory fiscal policy. As proof, global PMIs are in expansionary territory for the first time since mid-2022. European growth, with the exception of Germany, has bottomed and is commencing an upward trajectory, albeit mild.

Rates

Gunter Seeger
Portfolio Manager, Developed Markets Investment Grade

CS 3.25 (-0.25)

The Federal Reserve is attempting to balance a rapidly slowing economy with stubbornly persistent inflation, and the job is proving more difficult than imagined. The European Central Bank cut once this month and raised its inflation forecasts going forward, leaving market participants wondering if everything is under control. Norges, the Norwegian central bank, left rates unchanged at 4.5% and sees no reason to cut this year, believing the economy is doing fine. We believe the Fed's view is closer to Norway's than it is to the ECB's, and there are many reasons to be hawkish for higher rates. For now, we favor a long duration stance for three main reasons: this is an election year; we believe the Fed will follow through with earlier predictions to not seem political; and two prominent banking CEOs are warning of higher rates and either one cut or none.

Credit

Steven Oh, CFA
Global Head of Credit and Fixed Income

CS 3.50 (unchanged)

Another month of economic data showing signs of weakening provided support for a Treasury rally that, in keeping with a common trend over the past year, led to spreads moving in an inverse direction to Treasuries, causing spread widening across most fixed rate credit assets. The Fed's dot plots have pulled back their easing forecast from three cuts to a single cut, while the market is pricing in two cuts. We continue to see a weakening yet still favorable corporate credit environment combined with less near-term monetary policy support and fairly tight valuations. Overall, we have maintained our CS at a somewhat defensive level despite expectations that coupon yields will drive returns for the rest of the year.

As we look across the relative value spectrum of credit, nothing stands out as being particularly cheap or expensive. Therefore, we have become more neutral with respect to asset and geographic allocations. There have been some surprise election outcomes resulting in greater political risks in Europe that have the potential to introduce volatility across rates and credit markets this summer.

Currency (USD Perspective)

Anders Faergemann
Senior Sovereign Portfolio Manager, Emerging Markets Fixed Income

CS 3.00 (unchanged)

Factors supporting the US dollar earlier in the year continue to dissipate, while the euro faces its own issues given a weaker growth outlook (albeit stabilizing from a low base) in Germany and France. The ECB's June cut was well telegraphed, and its path to further monetary easing remains clearer than the Fed's. We are neutral on the US dollar against the euro and a wide range of currencies.

The last 18 months have seen the euro and US dollar trading in the same range (1.05-1.10), forcing FX volatility lower. Beyond November's US elections, it's increasingly difficult to find a catalyst that would push the cross outside this range on a sustainable basis. Waning support for the US dollar is justified by budding evidence that areas of the US economy are slowing, reining in the policy divergence that kept the US dollar in demand in the first quarter. Terms of trade support for the US dollar has also reversed with the recent drop in oil prices. Moderating US inflation and higher breakeven levels in jobs growth should provide the Fed with a greenlight to start adjusting interest rates lower in the second half. Fed Chairman Powell continues to hint that the next Fed move will be a cut, but Fed speakers continue to sound hawkish, and we believe a data-sensitive Fed will remain patient.

The Bank of Japan faces the dilemma of trying to raise interest rates at a measured pace without losing the market's trust. The recent intervention by Japan's Ministry of Finance to prop up the Japanese yen was only a temporary fix. With outflows continuing unabated, the Japanese yen is at risk of new losses despite being significantly undervalued on a historical basis.

Emerging Markets Fixed Income

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

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

Local Markets (Sovereign)
CS 2.50 (unchanged)

Positive, but not bullish: That was the consensus outlook of 70 companies we met with at a recent bank conference, corroborating our market expectations for no material deterioration in fundamentals, continued fair valuations, and technicals that are supportive due to net negative issuance for the year. Major emerging market (EM) elections, now mostly in the rearview mirror, produced a few surprises, but market reaction was generally muted. The risk for EM now comes from the US election, with expectations that market volatility will tick up in anticipation.

Now more able than in the past to borrow locally for a longer term, EM corporations have become less reliant on debt issuance in US dollars. In addition, companies are looking to fund capex from their balance sheets rather than add leverage. In commodities, we see a bottoming-out in the petrochemical sector, a positive outlook for gold, and a neutral outlook for copper, with major projects now online and a relatively light pipeline of new projects. We expect oil to stay within an $80-$85 per barrel price range for 2024.

In Turkey, a surprise rate hike along with a restrictive loan policy has meant that banks' net interest margin has been declining. For 2025, we expect a recovery, the start of rate cuts, and easing of restrictive monetary policy. The key for Turkey is that conventional policy continues. Mexico's election supermajority was a surprise, but expect policy continuation to be neutral for US/Mexico ties, with some tail risk of AMLO policy changes in September. There is some risk for more tariffs and increased protectionism regardless of who wins in US, but look for Mexico to continue to be an attractive US trading partner. As the Pacific transitions from El Nino to La Nina, look for much higher agricultural yields and exports next year, with Brazil a beneficiary.

We maintain our global macro scenario weights at 70% for stabilization and 15% each for recession and extension.

Multi-Asset

Peter Hu
Portfolio Manager, Global Multi-Asset

CS 2.50 (unchanged)

While Chair Powell has postponed interest rate cuts, he has moved forward with quantitative tightening, tapering more aggressively than anticipated. Together with the Treasury-launched bond buyback, we will likely see a soft version of yield curve control in the US. With the ECB rate cut in June and expected rate cuts in July by the Bank of England and the People's Bank of China, a global easing cycle is under way.

After an unexpected rise in the first quarter, we see indications that inflation is starting to decrease again. Rental prices and used car prices are beginning to decline, and the outlook for inflation in goods remains subdued, partly due to China's efforts to boost exports. A more relaxed job market is highlighting the benefits of increased immigration, with employment and wages moving from overheated to a more balanced state often referred to as "Goldilocks" territory.

Markets are always about cash flows and capitalization rates, the latter driven by central bank policies and prevailing risks. This dynamic, along with the tapering of QT, indicates potentially more favorable capitalization rates over the next nine to 18 months, supporting long-duration risk assets. Now it's up to earnings to continue moving north after slightly exceeding expectations in the US in the first quarter, and a bit more so in some areas outside of the US. With earnings and capitalization rates moving in a favorable direction, we keep our score at a modestly constructive 2.5.

Global Equity

Ken Ruskin
Director of Research and Head of Sustainable Investing, Global Equities

CS 3.00 (unchanged)

Equity markets have hit all-time highs as inflation expectations moderate slightly. The rise continues to be top-heavy as market breadth remains weak.

Rolling de-stocking continues across the industrial economy, though companies are becoming more confident that the worst is behind them. Second-half sales should see a boost from the end of de-stocking. It's a similar story in portions of healthcare, where de-stocking appears to have bottomed out and funding activity is rebounding. Consumer excess savings appear to have normalized, but we have yet to see any significant weakening of spending from current levels. The AI sector remains a standout, exhibiting the strongest trends, with the outlook further upgraded by increased capex guides from major hyperscale companies. IT spending has not rebounded, but this should be a temporary phase associated with the Covid-related pull-forward of demand as well as the evaluation and development stages of AI implementation.

Global Emerging Markets Equity

Taras Shumelda
Portfolio Manager, Global Equities

CS 2.50 (unchanged)

In China, export-related consumer segments show strong growth. Electric vehicle (EV) penetration of the auto market surpassed 50% in May. However, industrial automation orders are slowing, mainly due to declining capex in solar and NEVs (new EVs), and in healthcare there is continued pressure on drug prices. In India, consumer staples and discretionary companies with exposure to rural areas have improved guidance. The IT sector, however, remains less upbeat and counts on the second half for improvement. Taiwan and Korea continue to benefit from AI momentum, with some investors questioning if it has run too far too soon.

In Latin America and EMEA, political risk – something we prefer to avoid – took center stage. The landslide victory for Claudia Sheinbaum and the Morena Party in Mexico brought new constitutional reforms back on the table, which caused a large sell-off in equities. In EMEA, South African equities responded positively to the formation of the coalition government. In emerging Europe, markets have been volatile due to the French elections.

The market's breadth has improved moderately. Although investors have low conviction in bottom-up fundamentals, this is nonetheless a small improvement over the heavily top-down and sentiment-driven behavior seen in previous months. In our investment decisions, we try to look as much as possible past such factors and focus on companies with strong and improving business models, quality management, sound financial structure, and proper adherence to ESG values.

Quantitative Research

Haibo Chen, PhD
Portfolio Manager and Head of Fixed Income Quantitative Strategies

Our US Conviction Score is virtually unchanged as credit spread tightening of five basis points and curve flattening of three basis points almost offset each other. Our global credit forecasts are negative, and our relative model favors EM over developed markets (DM). In DM, the model favors banking, finance companies, and industrials; it dislikes utilities and communications. Among EM industries, it likes infrastructure, pulp and paper, and metals and mining. It dislikes real estate, transportation, and diversified companies. Our global rates model forecasts lower yields and a steeper curve globally. The rates view expressed in our G10 model portfolio is overweight global duration; overweight North America; and, in Europe, overweight Belgium, Spain, and Austria while underweight France and Germany. It is also overweight Japan and underweight Oceania. Along the curve, it is overweight in the two-year and 20-year and underweight in five-, 10-, and 30-year durations.

All market data, spreads, and index returns are sourced from Bloomberg as of 27 May 2024.

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pinebridge.com

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