Investment Strategy Insights
Monthly Views From Our Diverse Global Investment Teams

PineBridge® INVESTMENTS

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A Desynchronized, Divergent, Muted Industrial Cycle

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The industrials sector serves as a critical barometer of economic activity. After undergoing a prolonged destocking phase, the sector appears to be approaching a turning point in the coming months, as new orders have started to outpace inventories since late last year. If true, this could offset weakness in other areas of the global economy and help to prolong the cycle, staving off recession for even longer.

Yet this cycle has been unique in many respects. The industrials sector, usually highly synchronized, is displaying unusual divergence within its verticals. This shift was triggered by supply chain bottlenecks and a surge in demand for consumer goods during the pandemic lockdowns. When economies reopened, consumers shifted their demand to services, leaving consumer goods companies with excess inventories and a deep destocking process to absorb. This sharp shift in both supply and demand conditions for consumer goods caused different industry groups to move through stages of their cycles at different times, a divergence from the broad-based slowdown that usually follows the tightening of financial conditions.

In contrast to the consumer goods sector, sectors with longer cycles, like aerospace and defense, along with markets benefiting from secular tailwinds, have remained robust during the shorter destocking cycle; this includes areas such as renewable energy, reshoring, and data centers. A further tailwind for these segments' earnings has been unprecedented pricing power in the upstream capital goods sector due to large backlogs, leading to record-high margins. However, with improving supply, pricing power is now waning and threatening those elevated margins. On a positive note, capital expenditure expectations for 2024 and 2025 remain substantially above pre-Covid levels, buoyed by initiatives such as the CHIPS Act, the Inflation Reduction Act (IRA), and the Infrastructure Investment and Jobs Act (IIJA) in the US, ensuring sustained demand for capital goods products; the structural backdrop remains very bright amid the more immediate cyclical headwinds.

A similar trend is emerging in Europe, marked by signs of a manufacturing recovery, as indicated by positive momentum in manufacturing purchasing managers' indices (PMIs) and industrial production growth. However, this positive development is in contrast to the continued decline in German industrial production since 2018. Germany is the latest "sick man of Europe," suffering from, among other factors, weak Chinese demand and high energy costs. These factors suggest that although a cyclical recovery appears imminent, structural challenges may constrain the scale of the rebound.

The overall picture that emerges in the developed world suggests that, although manufacturing is set to rebound from its current lows, overall growth and the restocking process may be limited in magnitude.

Emerging markets (EM), on the other hand, have demonstrated stronger resilience in industrial production than developed nations since the global pandemic, driven by structural factors such as nearshoring, automation, and increased defense spending. In Asia, excluding China, the picture is even more positive, with PMI readings consistently above 50 across the region. China, on the other hand, is facing a continued decline in manufacturing activity due to overcapacity, with no immediate solution in sight. Domestic overcapacity threatens demand for imports from other Asian countries, intensifying price competition. Conversely, the shift of investment from Chinese firms to those in regions such as ASEAN remains a powerful catalyst for increased manufacturing activity, particularly in countries like Vietnam and India.

Overall, we are seeing tentative signs of an industrial recovery, mitigating downside risk for the global economic cycle. Yet any hopes for a vigorous rebound also appear misplaced. The sector is unusually desynchronized and witnessing divergence across regions as well as segments such as consumer and capital goods. The typical feedback loops enjoyed by synchronized recoveries, which tend to amplify pro-cyclical demand, are unlikely to materialize in the near term. The result may be a muted recovery amid financial conditions that are likely to remain restrictive for several more quarters.

A hallmark of the new economic regime is this desynchronization at the regional and sector levels, and this partly explains why a broad-based slowdown has not materialized at the macro level amid monetary tightening. On a positive note, the divergence across sectors adds to dispersion at the company level, providing fertile ground for active security selection.

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

CS 3.00 (unchanged)

Government spending appears to be the main support of US growth. Consumer credit growth continues to slow, albeit from high levels, which has fed into slowing retail sales. A decline in weekly work hours has dragged real average weekly earnings into negative territory again after a rebound that began in second-quarter 2023. Commercial credit continues to contract, leading to the view that investment will struggle to recover this year in the absence of ambitious rate cuts. While survey results paint a mixed picture of the labor market, initial jobless claims remain relatively contained.

Despite the upward surprise in January's Consumer Price Index (CPI), the downward trend is still intact, as core goods prices showed year-on-year deflation for the first time since 2020. With the January number propped up by a few sticky services components, inflation is still expected to trend toward 2% by the end of this year. Still, higher-than-expected inflation has led the market to pare back its projected Fed rate cuts this year to four from six. Usually, there has been a 10-month lag between the last hike and the first cut, which puts May in the sweet spot for easing.

Global trade is contracting on an annual basis, with Japan and the UK dipping into recession in the fourth quarter as Europe stagnated. But with all three of the world's main economic blocs expected to ease monetary and fiscal policy this year, it is doubtful that this downturn will meaningfully spill into 2024.

Rates

Gunter Seeger
Portfolio Manager, Developed Markets Investment Grade

CS 3.00 (unchanged)

After the "Powell pivot" in December, the market priced in six rate cuts for 2024, as well as the end of quantitative tightening (QT), using the WIRP (World Interest Rate Probabilities function on Bloomberg). Following the Fed's 31 January meeting, six rate cuts still were being priced in, but that soon changed. On 2 February, an exceedingly strong nonfarm payrolls report dropped the number of expected cuts this year to 4.981, while the stronger CPI numbers on 13 February reduced expected cuts to 3.497. On that day, too, the 10-year Treasury reached a 2024 peak after a roller-coaster ride that saw the 10-year rise from 3.88% at the start of the year to 4.17%, dip to 3.88%, then surge to 4.32% by mid-February. While we maintain a hyper-neutral trading stance, with the 10-year above 4.30%, we can begin to see the case for "micro longs" on duration. Position management will be key.

Credit

Steven Oh, CFA
Global Head of Credit and Fixed Income

CS 4.00 (unchanged)

Credit spreads continue to grind tighter despite the pullback in Treasuries as the market adjusts to more realistic expectations about the timing and magnitude of Fed easing. The strong technical demand for yield is easily absorbing supply. Valuations are tight by most historical measures, particularly in the fixed-rate segments of credit markets. Investment grade (IG) spreads are below +90 and high yield (HY) spreads are hovering in the low-300s, with single-B spreads — a better gauge — below +300 levels. Parts of the credit curve are more fairly priced and offer idiosyncratic opportunities, but broad beta is trading through fair value despite expectations for a stable economic environment.

Our fundamental outlook calls for an extension of the current cycle, with signs that more cyclical industrial elements may have bottomed. As fourth-quarter earnings continue to be reported, concerns about a decline in near-term results have not yet emerged. Currently, the relative value opportunity has shifted toward areas of the market that have not rallied strongly, including geographies outside the US. Floating credit spreads are cheap relative to fixed-rate spreads, and we would further tilt toward floaters, though hedging duration is prudent with the backup in Treasury yields.

Currency (USD Perspective)

Anders Faergemann
Senior Sovereign Portfolio Manager, Emerging Markets Fixed Income

CS 2.75 (unchanged)

January's strong nonfarm payroll figures and generally robust household spending have given the US dollar a new lease on life. While the January data have increased reacceleration risk (with greater likelihood of sticky inflation paired with slightly stronger economic growth) and the Fed has walked back on the market's unrealistic expectations of six policy cuts in 2024, our "stabilization" scenario over the next 12 months outlines a more gradual monetary policy normalization amid real yields that are too high. As a result, we are projecting a mildly stronger US dollar due to growth and interest rate differentials that favor the currency. We have kept our 12-month euro/US dollar forecast unchanged at 1.05, arguing for measured, synchronized rate cuts by the Fed and the European Central Bank.

The US economy's built-in fiscal stimulus likely will remain a tailwind for US job creation and economic growth in the first half of the year, while fiscal easing should turn into a mild drag in the second half. The fiscal deficit could become a hot potato in the US presidential campaign and may be a significant market mover after the November election. Political uncertainty combined with a historically overvalued US dollar should act as a dampener on material US dollar strength into the second half of the year. That said, we would consider a move toward parity with the euro to be an overshoot without increases in energy prices or geopolitical risk. The move to 1.10 in December appears to have played itself out with the correction in the perceived difference in central bank behavior between the Fed and the ECB. While the Fed put remains intact, we believe the ECB has data support for an earlier rate cut than the Fed.

Improving structural forces in emerging markets (EM), as seen through rising trade and current account surpluses, provide support for EM foreign exchange even in a mildly stronger US dollar environment. High real yields linked with the rapid disinflation process have created a decent yield buffer in the EM space, which further enhances the ability of EM currencies to withstand US dollar appreciation.

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)

Seeing neither a turnaround nor a collapse for China's economy this year, we are forecasting growth of 4.5%, which is below the unachievable official growth target of 5%, which market participants tend to ignore. Our bias has turned negative as we reduce the bull case and shift the weight into the bear case. The Xi administration has earned a reputation for being unpredictable and behind the curve in providing support for the economy. We believe fiscal support is required, but stimulus is likely to remain measured, and monetary policy remains ineffective.

Today's higher commodity prices should level off in 2024, with the main exceptions being uranium, which is trending higher based on structural factors, and platinum, which is expected to bounce off a low base. Gold has broken its correlation with real US Treasury yields, trading at a significant premium, yet we expect prices to remain elevated and increase further amid geopolitical uncertainty and central bank demand. We maintain our oil price range at $80-$85 per barrel, keeping a watchful eye on OPEC and Saudi Arabia. Food prices retreated significantly in 2023 and remain in a benign environment. Higher shipping costs are being balanced out by declining fertilizer costs and softer growth. Excess supply is driving the price action in lithium and nickel, which is seeing the impact of China's construction weakness. Supply cuts should enable both commodities to find a floor this year after substantial price declines last year. Divided opinions on the copper supercycle and a less-than-expected upswing in demand from China have kept copper prices listless, but we expect a solid price floor to prevail. Iron ore is expected to ease slightly within a tight range of $100-$120 per ton. We kept our global macro scenarios unchanged, favoring the "stabilization" scenario (60%) with a slight skew toward "recession" as a risk (25%).

Multi-Asset

Deanne Nezas
Portfolio Manager,
Global Multi-Asset

CS 3.20 (unchanged)

Although the economy feels resilient, it is no longer translating into private-sector job creation. We continue to foresee a slowdown, although one that does not tip into recession. The fiscal thrust that supported strong growth in 2023 and pent up savings that propped up consumer spending are drawing to an end. While the Fed waits to play its rate-cutting card, it has begun to signal an earlier-than-expected tapering of QT. Less liquidity drainage leaves in place more of the excess. This suggests capitalization rates will "land" more softly than we previously thought, along with the economy.

While the onset of rate-cutting cycles typically sets off rallies, this one has been so widely anticipated that its benefits have been front-loaded into prices. Given today's narrow credit spreads and equity risk premiums, even an economic soft landing may not provide much upside in 2024. Meanwhile, Europe is likely to experience only a mild contraction, making it closer to a market trough than the US and presenting a strong market recovery opportunity. In China, much more generalized and forceful monetary policy is necessary to turn around equity and property prices, and to avoid a balance sheet recession. We remain slightly cautious, with a bias toward becoming more constructive should weakness unfold.

Global Equity

Rob Hinchliffe
Portfolio Manager,
Global Equities

CS 3.00 (unchanged)

Expectations of a US economic soft landing and Fed rate cuts, along with continued excitement about AI and strong fourth-quarter earnings thus far, have driven market strength year to date. Growth has sharply outperformed value, while small-caps have been weak. Market breadth has been slim, with just the information technology, communication services, and healthcare sectors outperforming. Similarly, only the US and Japan are positive. Market expectations for rate cuts are moving closer to Fed guidance. Growing attention is being paid to the upcoming US elections.

Global Emerging Markets Equity

Taras Shumelda
Portfolio Manager,
Global Equities

CS 2.50 (unchanged)

Emerging market breadth has narrowed considerably, driven by investors' changing views about the timing of US rate cuts and the pricing-in of trade tension risks in the event of a second Trump presidency. In China, fourth-quarter results have been mixed, with guidance generally weak. The main Chinese banks guided for a slight decline in net interest margins and moderation in loan growth in 2024. Construction machinery export growth will slow, given that Russia was the main market last year and set a high base. In India, results from most of the consumption-based companies were tepid, with segments including staples, fast food chains, and apparel retail showing a marked slowdown. On the other hand, pockets including automobiles, airlines, and cement enjoyed strong performance.

In Latin America, earnings have been good; consumer staples and discretionary goods, as well as the financial companies we favor, generally beat expectations. The macro outlook is also supportive. In EMEA, despite strong reported results, geopolitics and the potential escalation of Russian aggression are once again becoming dominant themes.

Investors' lack of conviction in bottom-up fundamentals and highly unpredictable geopolitical and top-down factors continue to have a disproportionate impact on markets. As the expectation of March rate cuts has disappeared, a tendency to take profits has returned. We try to look past such factors as much as possible and continue to focus on companies with strong and improving business models, quality management, sound financial structures, and proper adherence to ESG values.

Quantitative Research

Qian Yang
Quantitative Strategist,
Fixed Income
Quantitative Strategies

Credit spread tightening by 3 bps and steepening of the curve slope by 7 bps contributed to a slight improvement in our US conviction. With global credit forecasts negative, our relative model favors EM over developed markets (DM). The industries our model favors in DM are brokerage, technology, and financials, while it dislikes electric, energy, and consumer goods. Among EM industries, our model likes consumer goods and dislikes real estate, pulp and paper, and transportation. 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 but divided within regions. In North America it is overweight Canada but underweight the US. In Europe, it is overweight Belgium, the Netherlands, and France and is underweight the UK and Germany; In Asia and Oceania, it is overweight Japan and underweight Australia. Along the curve, it is overweight the five- and 20-year and underweight the two-, 10-, and 30-year.

All market data, spreads and index returns are sourced from Bloomberg as of 19 February 2024.

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pinebridge.com

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