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

Capital Market Line: No Return to the Old Abnormal

September
2024

With capital spending tracking most recovery periods since World War II – quite a change from the lethargic investment following the global financial crisis – capital deepening is finally taking hold. As a result, we're not surprised to see productivity trending higher and with room to keep growing. Put this against a backdrop where new technologies are accelerating AI's impact, and it looks ever more likely that we've entered an era of supply-led growth. These forces should go a long way toward combatting the stickiness of inflation caused by tight labor forces and geopolitically driven decoupling.

During eras of supply-led growth, inflation has trended lower while growth and profitability trended higher. With recent disappointing Consumer Price Index (CPI) data, many have dialed back their rate-cut expectations, which they previously believed were returning to the "old abnormal" rate structure of 2% and below. Our policy cutting expectations never went so deep. Today is a more vibrant environment, with strong investment demand pulled along by rising return on invested capital (ROIC), which we expect to keep real and nominal rates from returning to levels in the post-financial-crisis period, which we viewed as an abnormal balance-sheet-driven era and is now over. Despite two recent months of sticky CPI readings, we still expect that when core personal consumption expenditures (PCE) inflation prints, just like in September, it will once again be well-behaved, with rolling six-month core PCE staying below 2.5%, allowing the Fed to proceed toward a 3% federal funds rate, even if at a bit slower pace. Periods of supply-led growth need to be nurtured, not stomped out.

Revisions to economic data have been huge recently. Profit and savings revisions were strongly to the upside. It's now clear that the three months of abrupt payroll slowing through August (which encouraged Chair Powell to push for 50 basis points of rate cuts) represented a temporary departure from an even more resilient backdrop than could have been known at that time. The disconnect between weakening payrolls and strengthening income has now been resolved, with payrolls being tugged back toward the stronger savings and income backdrop. We have soft-landed, and with this behind us, the investment focus needs to shift toward the next several years.

The US looks ever stronger from a global perspective, which will keep the dollar firmer than we previously expected. Europe, on the other hand, appears to be stuck in something akin to long Covid. The aftermath of Germany's bet on cheap Russian oil is still playing out, with industries that need cheap energy, like chemicals, still in the process of exiting Germany. Chinese electric vehicles (EVs) are arriving. German exports of luxury consumer goods to China now need their own retooling. In China's world of common prosperity, luxury brands and conspicuous consumption are out. While a modest cyclical recovery might finally be taking hold in the eurozone, as evidenced by bank loans finally nudging higher, Germany and Europe need to reshape their business models – as laid out by Mario Draghi's September report, "The future of European competitiveness" – and will likely remain laggards for the rest of this cycle.

After its economy was pulled into a nasty downturn in the second and third quarters, China has now joined the global easing cycle. It is laying down plans for strong central

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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bank balance sheet expansion to absorb higher fiscal ratcheting while allowing rates to keep drifting down. The fiscal boost aims to finance a stabilization (not recovery) in China's real estate and banking systems, local government finances, and low-income households. While acknowledging the need to create a better environment for private business, and that improvement in the overall economy beyond stabilization will require incentivizing the private sector once again, providing such incentives will require tough political choices. We must wait and see.

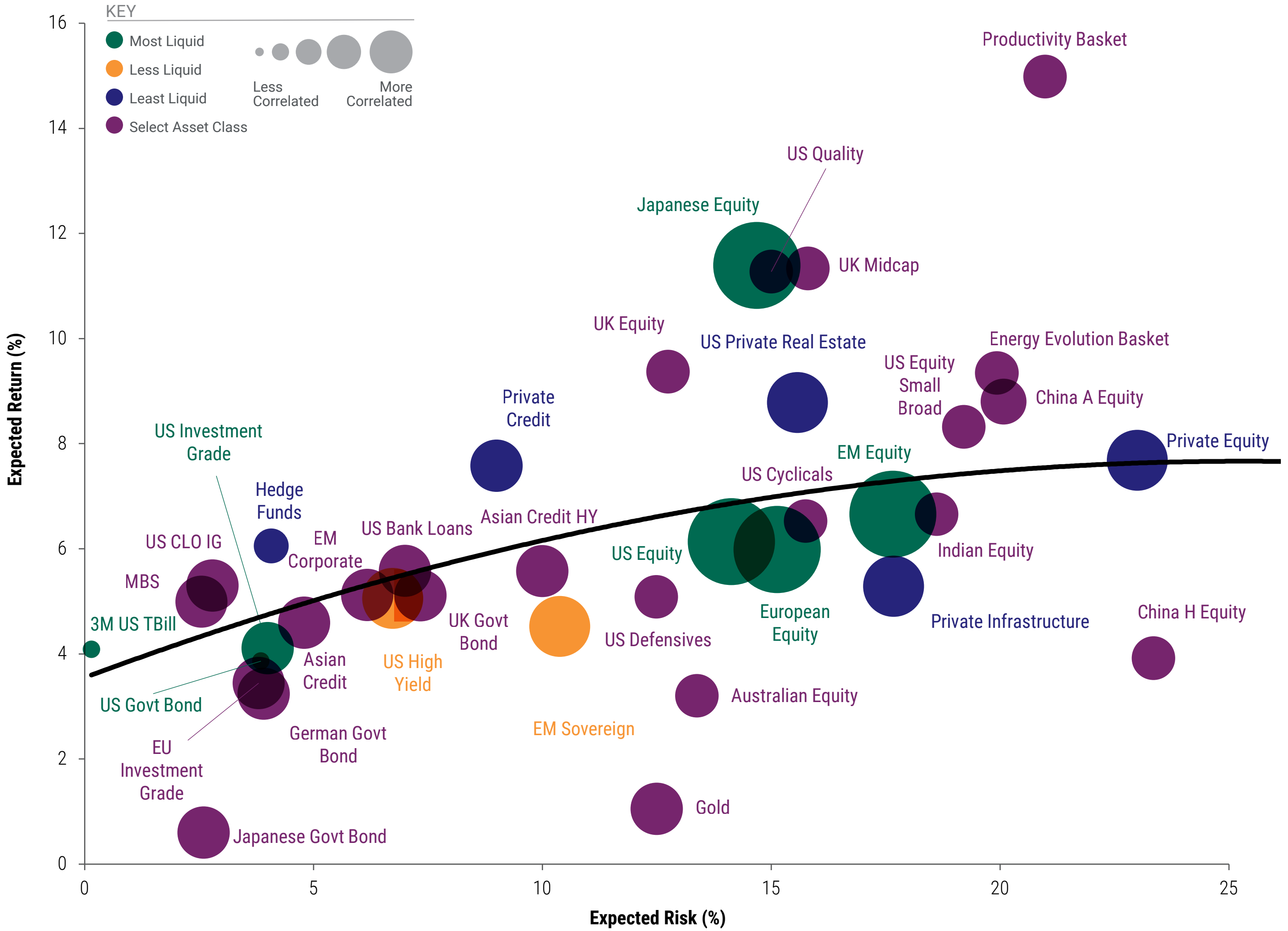
Meanwhile, China's monetary support is stronger than its other two stimulus legs (fiscal and deregulatory moves). When other countries have fallen into balance sheet recessions with liquidity traps, monetary stimulus ultimately helped markets even if it did not revive economies. Only when powerful monetary and fiscal policies were put in place for as long as it took, were other economies able to escape their balance sheet recessions. The Standing Committee of the National People's Congress session at the end of October is the next opportunity to quantify China's fiscal expansion.

China does appear focused on providing more favorable conditions for its stock market, with clear policies now in place to do so. This is certainly a new twist, backed not only by the government's commitment but also by its need to revive confidence through any source of countervailing wealth effect, since property prices will remain depressing even if today's stabilization policies succeed. US-led decoupling centered on critical technologies also requires China to build up its initial public offering (IPO) market to finance a new wave of technology companies. A rising stock market is now a policy goal, just as a rising bond market was during the Clinton administration and a rising stock market was during the Trump administration.

To tackle its mounting issues, Beijing needs to restructure bad debt and increase the money supply to alleviate its debt service burden without triggering excessive inflation. Such reflationary measures are designed to encourage risk-taking by making cash less attractive than other assets. While not quite a "whatever it takes" moment, it does reflect Beijing's current pragmatism, aimed at stopping the economy's downward spiral.

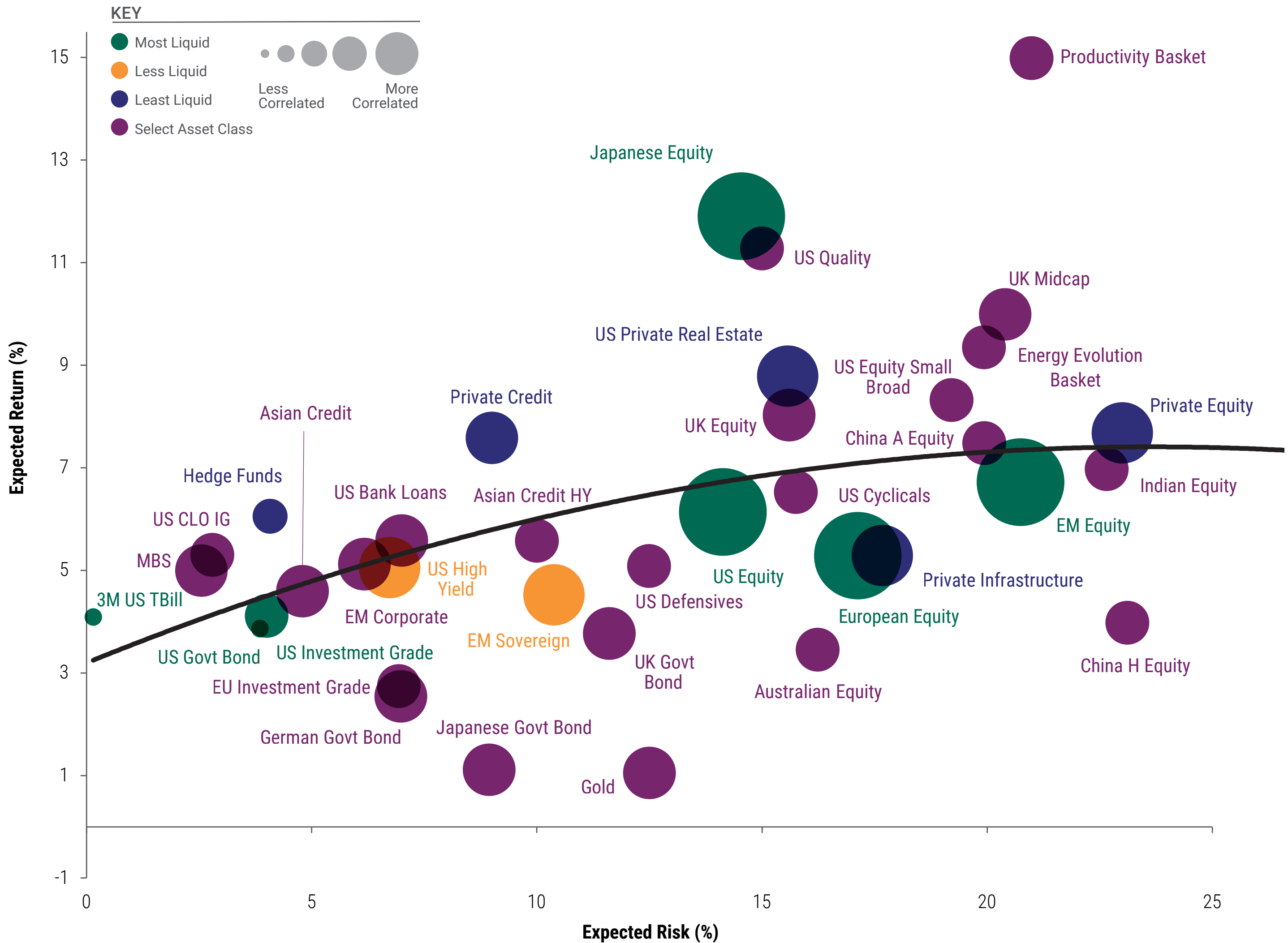
Elsewhere, geopolitical tensions are escalating and are a partial offset to the global easing cycle. Structurally, we expect more investments in AI, the energy transition, and reshoring despite rising geopolitical risks; we see few alternatives, and lower rates will nurture these trends along. With the soft landing now behind us and later phases of the business cycle ahead, we maintain a modest overweight in equities, underweights in fixed income and the US dollar, and a continued strategic position in gold.

Capital Market Line as of 30 September 2024 (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 September 2024 (USD View, Unhedged)



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Capital Market Line Endnotes

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Insights From Today's CML

A flatter Capital Market Line (CML) with greater dispersion. The current flatness of our CML compared to historical norms is driven in large part by ongoing policy distortions, yet simultaneously there are forces creating dispersion opportunities. We focus on strengthening growth arising from technological and geopolitical changes. Despite a well-established global easing cycle now in place, we don't see today's positive real interest rates shrinking all the way back to post-crisis norms. However, equities stand to benefit from the more vibrant climate that should hold real rates above the old abnormal.

Equities tend to outperform in a global easing cycle. The Fed has finally joined the rate-cutting party, cementing the global easing cycle. With China also easing monetary and fiscal policies, recession risks now look minimal. The policy rate-cutting should boost wealth effects for upper-end consumers and provide rate relief to low-end consumers and small businesses that are now suffering from high floating-rate loans. There is room for more companies and industries to participate on the upside. Soft cyclical and moderately economically sensitive US mid-caps may start showing better financial results and market performance. As growth picks up in the latter half of 2025, promising sectors include US large banks, along with equities in the UK and Taiwan, which are joining our core investments in structural growth areas such as productivity enhancements, new energy initiatives, US quality stocks, and the Indian market.

Credit spreads will likely remain tight, but opportunities exist. In the current "Balanced Growth" regime, the typical correlation between stocks and bonds has diminished relative to the "Stall Speed" regimes, when it was strongly negative. This lessens the appeal of risk-free fixed income. Despite tighter credit spreads compared to post-crisis norms across most sectors, we believe this is justified given the expected vibrancy over the next five years. Exceptions can still be found in Asia's high yield bond market (excluding China's property sector) and mortgage-backed securities (MBS), which maintain typical spreads in an otherwise tight market. Additionally, the likelihood of banks holding deposits could improve following rate cuts, which would take the technical pressure off MBS.

With the soft landing now in the rearview mirror, shorten duration into the belly of the curve. We now expect the last mile of sticky inflation to gradually give way to a more vibrant supply-led environment. With the start of the US rate-cutting cycle, real rates are expected to decline on the short end through the belly of the curve yet steepen at the longer end. In response, we have shortened our position in long US Treasuries, expecting most of the remaining decline in the yield curve to occur within one to five years.

Gold is viewed as a safe-haven asset amid rising geopolitical risks. China's efforts to reduce its dependency on the US dollar by shifting its reserves from US Treasuries to gold, along with People's Bank of China (PBOC) tactics to stabilize the yuan, are reinforcing gold's role in international markets. As China aims to export more subsidized goods like EVs and solar panels to Global South countries, market-based economies that initially opened their markets to China – expecting mutual market access and fewer subsidies from both sides – will continue to revisit their policies. Additionally, rising geopolitical tensions, fueled by Putin's ambitions for post-Soviet territorial expansion, direct conflicts between Iran and Israel, and strengthening ties among North Korea, Venezuela, Iran, Russia, and China, are exacerbating global uncertainties. As economic ties weaken and geopolitical risks mount, gold is increasingly recognized as a strategic hedge.

The Fundamentals Driving Our CML

A more balanced policy regime. The period after the global financial crisis (GFC) was marked by the aftermath of a balance sheet recession, with slow consumption as the private sector deleveraged. This created a tepid investment climate, exacerbated by fiscal austerity. The tension between weak investment and a determined urge to save by deleveraging would have naturally led to low rates, and monetary policies exacerbated this tendency, with quantitative easing (QE) and negative interest rate policies piling on in some countries. This was a temporary "new abnormal" era, in place while the deleveraging lasted. Most of the forces leading to lower rates were not secular. In contrast, our new regime features healthier household and corporate balance sheets, leading to more robust consumption and investment. Political polarization and cultural shifts have pushed fiscal policy toward increased government spending. This looser fiscal stance, combined with more vibrant investment relative to savings, requires a monetary policy which, even while lowering real rates, must also mop up some of the prior massive excesses accrued as central bank balance sheets grew much faster than nominal GDP. So although real yields are declining with rate cuts, they are expected to stay well above the levels observed in the 15 years following the GFC.

From demand shortfall to supply-driven growth. Following the financial crisis, a period of consumer-led deleveraging reduced consumption, subsequently dampening investment and productivity. Over time, consumer balance sheets improved, and savings increased. The onset of the pandemic unleashed a wave of demand for goods and services, spurred by unprecedented fiscal and monetary stimulus that echoed Modern Monetary Theory (MMT) principles. Concurrently, massive Covid-related disruptions in supply chains briefly spiked inflation. Since these global bottlenecks have largely cleared and the US labor market has been revitalized by an influx of immigrants and productivity gains, the economy has seen robust growth paired with disinflationary effects since 2023. We believe we're entering a "Balanced Growth" regime with a tilt toward supply-led growth, though geopolitical tensions continue to pose a significant risk to global economic stability.

AI enhances productivity. Advances in technology, combined with improved human skills and investments, are reshaping labor trends. Innovations such as ChatGPT are revolutionizing the tech industry by improving labor efficiency, generating new employment opportunities, and elevating productivity. Generative AI in particular is set to influence up to two-thirds of existing jobs by automating roughly a quarter of tasks. This shift is poised to significantly boost US labor productivity, reshape job definitions, and spur innovation and efficiency across various sectors. Furthermore, AI's ability to streamline operations, cut costs, and enhance decision-making positions it as a vital catalyst for future supply-led growth and sustained economic expansion.

China's decoupling from developed markets (DM) may restrict supply growth. Geopolitical tensions are leading Western firms to relocate their supply chains from China to regions closer to their consumer base or with similar political values, such as the US, Mexico, India, and Vietnam. Although emerging markets (EMs) still offer lower labor costs, the all-in expenses from moving supply chains may surpass those in China. In a deglobalizing world, securing supply chains incurs higher costs, resulting in substantial investments and reduced efficiency. These forces are adding to medium-term inflation stickiness while spurring investment in the interim. Of course, these are just some of the many countervailing forces, which on net we still expect to result in an era of elevated productivity and supply-led growth.

The energy transition drives growth while reducing savings. The energy crisis ignited by the Russia/Ukraine conflict has hastened the transition to green energy. In response, initiatives such as the US Inflation Reduction Act (IRA) and the EU's Green Deal Industrial Plan have been launched to promote investments in low-carbon energy. This surge in decarbonization and defense spending is expected to drive economic growth and sustain structural tightness in specific product markets. However, it is also expected to diminish the global savings glut. Alongside tight monetary policies from central banks, these developments will limit both the supply and demand for funds, leading to a medium-term trend of less favorable capitalization rates.

Rising geopolitical risks. Geopolitical tensions are escalating, with intensifying conflicts in the Middle East and Ukraine, fueled by the conflict between Israel and Iran and Putin's ambitions for reclaiming Soviet territorial borders. As Ukraine now pushes further into Russia, the US has ramped up its military aid, and Russia in turn has updated its nuclear policy, now asserting the right to use nuclear weapons if attacked by non-nuclear states backed by nuclear powers. Additionally, strengthening alliances among North Korea, Venezuela, Iran, Russia, and China further heighten global uncertainties.

ESG 2.0. We see an emerging shift in ESG practices that has been increasingly adopted outside the eurozone. This "ESG 2.0" approach emphasizes engaging with companies to promote better ESG practices, rather than simply withholding capital from those with poor existing ESG scores. By encouraging sectors traditionally lagging in ESG to improve, this strategy proffers the advantage of reduced capital costs. Industries with high emissions that have used their substantial cash flow to transition toward greener operations have often credited ESG 2.0-oriented engagement by existing owners. This is crucial to bridge the $2.9 trillion funding gap required to reach net-zero emissions. The ESG 2.0 strategy, a blend of incentives and penalties, marks a significant evolution from the ESG 1.0 model, which strictly focused on withholding capital from low-ESG-rated companies and industries, thereby surrendering the influence that comes with active ownership.

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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MULTI-ASSET | FIXED INCOME | EQUITIES | ALTERNATIVES

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