Capital Market Line

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

March
2024

Why Supply-Side Growth Will Power This New Regime

Each market and economic regime has its own opportunities and challenges. The post financial crisis regime was characterized by a balance sheet recession. Challenges from that period included consumer deleveraging, resulting slow consumption and investment, below-target inflation, and fiscal lethargy. These led to extreme monetary policy in the midst of a liquidity trap, which bloated financial markets. In contrast, today's post-Covid regime is witnessing robust consumption (at least in the US), corporate investment, and a lack of rate sensitivity. Today's challenges appear to be managing growth without overheating to bring inflation back to target. Another is fracturing geopolitics which is threatening global trade and could potentially lead to war. Prices of asset classes begin the period on the expensive side, given flush liquidity. This poses return obstacles to asset classes that cannot grow into, and through, today's valuations. Fortunately, supply-driven growth can address many of these challenges, and is showing through, particularly in the US, driven by immigration and productivity.

Early in 2023 a favorable global supply shock unfolded with the clearing of Covid disruptions to goods related supply chains. This enabled faster growth with less inflation. In the second half of 2023 a second favorable (and more US centric) supply shock began to take hold. Temporary post-Covid restrictions to legal immigration were lifted in July 2023, joining 2022's surge of undocumented immigrants, which continues into 2024. The US Congressional Budget Office (CBO) now estimates a 3.3 million increase in the foreign-born population in 2023 alone, which alone is a 1% increment to population growth, 80% of which are of working age. While this influx contributes immediately to population growth, its contribution to labor force growth is harder to pinpoint given lags involved between entering the US and finding one's way into the labor force. However it's notable that service inflation began dis-inflating in the last five months of 2023. While difficult to estimate, without immigration, the US labor force growth rate in 2023 would likely have grown an estimated 0.7%. Instead, it grew by 1.5% according to the CBO. This has not only helped labor markets rebalance, it did so while also helping the economy to accelerate while domestically generated inflation in services began to decelerate. These supply shocks have been very favorable for markets as well as the economy. While the timing and magnitude are still in question, their help in alleviating domestically generated inflation will at some point open the door to Federal Reserve policy easing. The question now is how sustainable they are, and whether they are enough on their own to bring inflation back to the Fed's 2% target. Supply-side benefits at present appear to be country specific, evident in the US and Japan, missing in Europe, and going backwards in China.

November's US election will likely carry immense consequence with respect to labor force growth, given the polar opposite immigration policies of Biden versus Trump. Yet a third potential supply driver is emerging. Productivity in the US looks poised to accelerate irrespective of politics. After long stretches with elevated capital spending, capital deepening sets in, particularly when new technologies are involved, leading to stepped up productivity (and vice versa). After the financial crisis, consumer deleveraging slowed consumption growth which in turn discouraged business investment. Productivity eventually slowed to a 1% crawl. With consumer balance sheets now fortified, jobs plentiful and real incomes rising, post-Covid consumption and business investment are much more vibrant, with the benefits of capital deepening and AI still laying ahead. Following a slow decade, corporate leaders are now heavily investing in technology to power significant efficiency improvements.

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.

Contributors:

Michael J. Kelly, CFA
Global Head of Multi-Asset

Hani Redha, CAIA
Portfolio Manager

Steven Lin, CFA
Portfolio Manager

Peter Hu, CFA, FRM
Portfolio Manager

Sunny Ng, CFA
Portfolio Manager

Mikhail Johaadien
Research Analyst

Teresa Wang
Research Analyst

All told, productivity appears to be inflecting higher and could settle into a sustainable 2% pace. In 2023's fourth quarter, it already hit 2.7%, albeit helped temporarily by unexpectedly strong growth. Yet if productivity can now sustain a 2% trend, today's 4% wage growth would become aligned with the Fed's 2% inflation target. A stronger investment backdrop in the current regime is also being driven by de-globalization, the energy transition, and the strategic imperative for companies to go on offense in a world where technological change is not only presenting opportunity, but also threatening disruption to current business models.

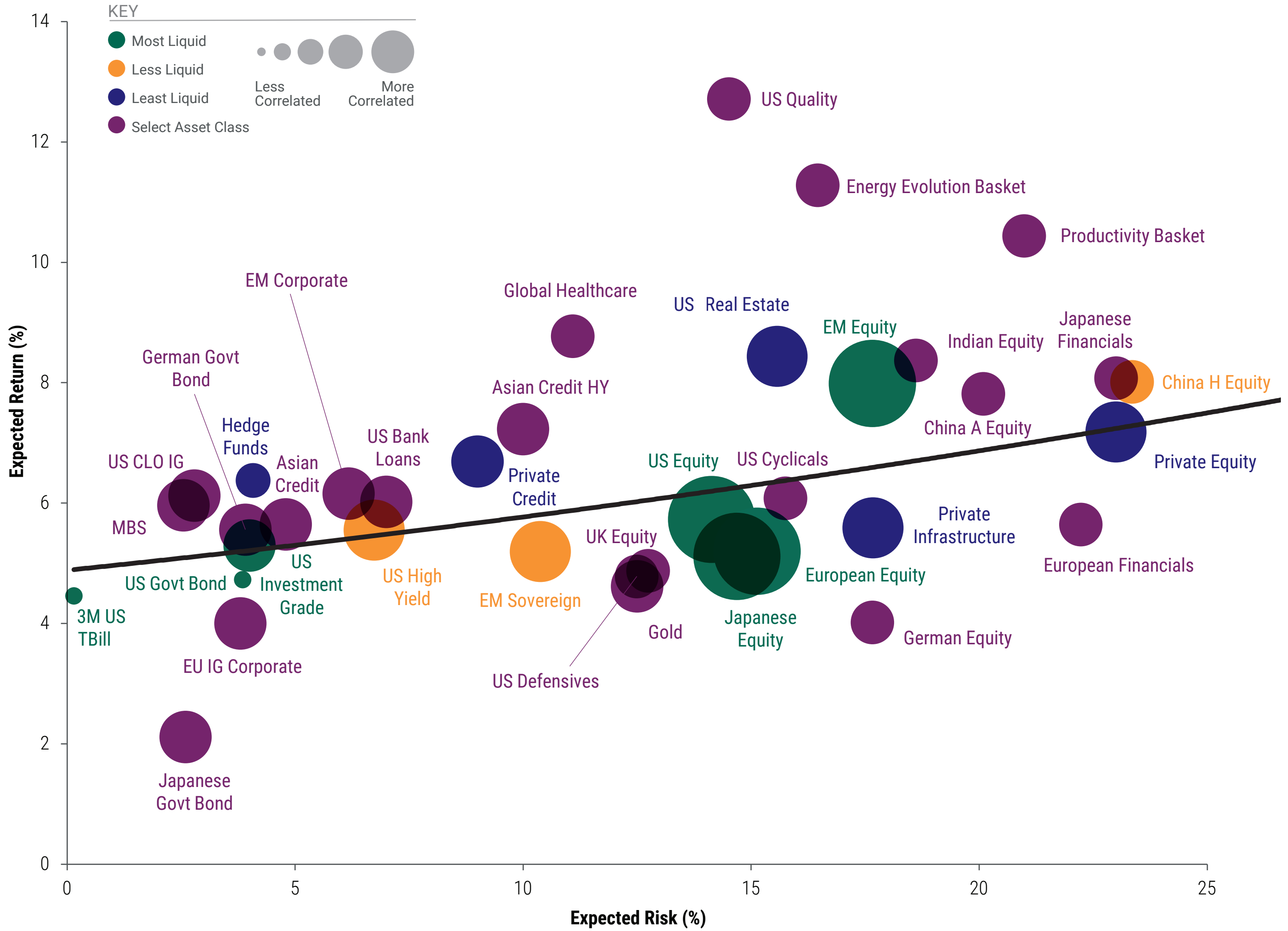
In the 1990's post the fall of the Berlin Wall, the World Trade Organization created a new global consensus of opening markets by members reducing subsidies and trade barriers. China's more recent redirection back towards centralized state investment with increasing subsidies in selected industries is triggering rethinks elsewhere. Offsetting industrial policy ramps are now evident in the US and Japan, and the geopolitical rules of trade may be under transition. Key sectors like semiconductors and batteries are becoming the focal points, with growing trade tensions and economic re-regionalisation. An example of this is near shoring with shifting supply chains from China to Mexico and India. Or re-shoring, evident in leading edge semiconductor processing technology diversifying itself into the US and Japan as a geopolitical precaution. These forces are adding to medium term inflation stickiness, while spurring investment in the interim. The green energy transition also poses challenges while opening up investment opportunities. Initiatives like the EU's "Fit for '55" and various US programs like Inflation Reduction Act (IRA) are boosting related investments.

Back in the US, the combination of an increasing labor supply, faster productivity growth, and a reduced propensity of consumers to save (despite higher rates) within the context of a more robust investment environment is shifting the neutral level of interest rates higher. So too is the troublesome fiscal trajectory. The dual crises of the global financial crisis followed by Covid witnessed central banks creating emergency excess liquidity, which has never meaningfully unwound. So while we expect 'less loose' financial conditions than at present over the next five years, this backdrop should remain far looser than most of financial history, sustaining generous capitalization rates. With this development, historical mean reversion-based valuation should beware.

Japan finally concluded its extraordinary loose monetary policy on the short end by lifting Negative Interest Rate Policy (NIRP), as well as by removing yield curve control (YCC) on the long end. Despite these tightening actions, the BOJ will continue with quantitative easing. The new policy mix appears to be interest rate tightening on the front end of the JGB curve while continuing to ease on the back end through QE. This appears designed to end (instead of reverse) their extraordinary monetary leniency, preserving today's weak level of the yen, thereby preserving the export and inflationary gains achieved from a very weak yen in the context of an overvalued CNY. The PBOC also now appears poised to ease monetary policy a bit more forcefully once the Fed and ECB begin their easing. Yet their marching orders in all likelihood will continue to prioritize a sturdy CNY (in relation to the Global South currencies). As a result, we do not envision a Draghi-like "whatever it takes" moment to unfold from the upcoming PBOC easing. Many investors argue the latter is required with China's economy, despite a first half of 2024 cyclical bounce, having begun a slow slide into a balance sheet recession.

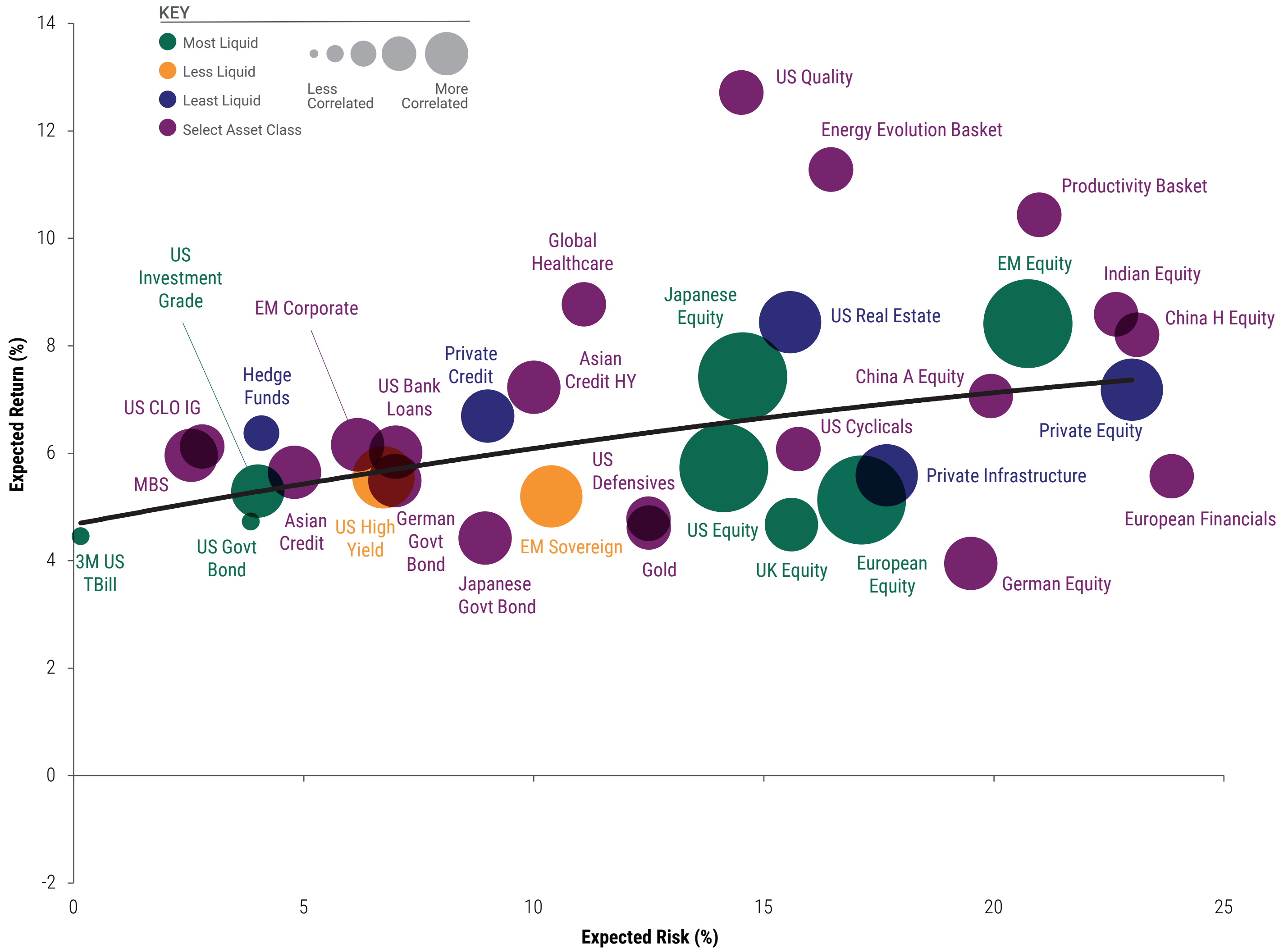
Despite the flatness of our current Capital Market Line (CML), significant dispersion still presents focused opportunities. High real policy rates that gradually edge lower have historically bolstered longer duration financial instruments relative to cash. This reallocation has begun yet is far from over. Successful soft landings have also served as siren songs for markets, signalling later-cycle dynamics, which have favoured stocks over bonds, secular growth over cyclicals, developed markets over emerging, and large over small caps. What might be different this time? The only two successful soft landings took place during powerful secular disinflationary periods. This one appears to be unfolding into a more balanced growth setting. As a result, markets may be a bit more of a blend between secular strength and balanced growth beneficiaries.

Capital Market Line as of 31 March 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 31 March 2024 (USD View, Unhedged)



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 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

A flatter Capital Market Line (CML) with a higher level of dispersion. The flatness of our Capital Market Line (CML) relative to historical norms can be attributed to higher yields lifting the expected return of fixed income assets, as well as the strong price appreciation of equities in recent quarters outpacing fundamentals. With quantitative tightening (QT) expected to begin tapering sooner than previously expected, the market will continue to be saturated with excess liquidity, providing some relief relative to our previous forecasts for risk premia. However, the significant variation around the CML suggests that the current environment still offers opportunities for targeted investment strategies, focusing on new secular growth in a period of rapid technological and geopolitical change.

Reducing exposure to Treasury. In the current Balanced Growth regime, the correlation between stocks and bonds becomes very muted, unlike Stall Speed regimes which exhibit strongly negative correlations, particularly during stressed conditions. This lessens the allure of fixed income. At the same time, yields that hover higher than the previous 15 years provide more attractive expected returns through carry, even if yields don't decline much going forward; as a result.

Pockets of opportunity in developed markets. Western equities are challenged by valuations. However, cashflows look poised to be structurally higher in the new regime, with higher nominal growth and potentially higher margins due to productivity gains. Certain sectors appear particularly resilient, with AI's rapid advancement beyond the internet's initial growth

boosting its share in technology budgets and addressing tight labor issues. With steady consumer spending, business investments in technology, including IT budgets, are set to expand. Our productivity basket is aimed at such business-focused technology, which we see as good value. Investments related to climate change present further opportunities given an annual funding gap of c.$2.9 trillion required to reach net zero targets by 2050, by our estimates. The healthcare sector also stands out as attractive, with a resilient profile in down markets while also benefiting from structural tailwinds due to technological breakthroughs along with an aging population. Emerging market equities also present opportunities, with India and Mexico offering secular growth stories.

Gold perceived as a safe-haven asset amid rising geopolitical risks. In times of uncertainty and global turmoil, gold emerges as a potential safe haven. China's push for de-dollarization in the Global South by shifting reserves from US Treasuries to gold, combined with the People's Bank of China's strategy to stabilize the yuan, bolsters gold's position. Furthermore, the potential for global disruptions is on the rise due to China's pivot to allow state led investment to play the more decisive role, Russia's ambitions to reclaim its borders under the Soviet Union, and Iran's enhanced ability to project power via drones. All these lead to increased tensions, currently capped through proxy conflicts. Nonetheless the support for globalization is fracturing, nationalism rising, and against this backdrop, gold is seen as a strategic hedge against geopolitical risks, aided and abetted by de-dollarization.

'Green commodities' are structurally attractive, despite short-term headwinds. Rising investments in military capabilities and the push for decarbonization, along with the imperative to upgrade energy systems, are driving strong demand for "green commodities." Yet, an anticipated shortage of key minerals such as nickel and dysprosium, vital for renewable technologies, threatens to emerge by 2030. This could interrupt supply chains and inflate prices. In the short term, though, prices are dipping due to China's economic deceleration and a general slowdown in goods consumption within developed economies.

The Fundamentals Driving Our CML

A regime with a more balanced policy mix. The previous regime was characterized by the aftermaths of a balance sheet recession, exacerbated by fiscal austerity combined with excessively loose financial conditions as monetary policy was the only game in town. In the new regime, household and corporate balance sheets are healthy leading to more normal and vibrant consumption and investment. Fiscal policy has shifted to a looser stance as political polarization and cultural shifts demand more government spending. Looser fiscal, and more vibrant investment relative to savings, necessitate a more restrictive monetary policy stance. While real yields are very high, and are likely to experience some relief, they will settle down to lower levels that nonetheless hover well above the prior 15 year post global financial crisis regime.

From a lack of demand, to supply-driven growth. Following the financial crisis, a consumer-led deleveraging process resulted in decreased consumption of goods, and in response, lower investment and productivity. Over time consumer balance sheets delevered while savings rose. The pandemic served as a tipping point, igniting a surge in demand and services, fuelled by an unprecedented doses of monetary and fiscal thrusts, together bringing to life a form of MMT (Modern Monetary Theory). Teamed with massive Covid supply chain disruption, inflation spiked tipping the regime temporarily into a reflationary one. Since then, global bottlenecks in goods have largely been resolved and more recently, the US labor force experienced an immigration driven supply shock, alongside productivity improvements. This contributed significantly to the robust economic growth in 2023 with concurrent disinflation. In our view, we are heading back to a more medium-term regime personified as balanced growth. Although the risk to this is primarily geopolitical, which has a rising potential to abruptly upset global economics.

AI enhances productivity. Technological advancements, alongside improvements in human skills and investments, have the power to alter demographic and labor trends. Notably, breakthroughs in AI technologies, such as ChatGPT, are driving significant changes in the technology sector. These changes are expected to enhance labor efficiency, create new job opportunities, and boost workforce productivity. AI automation, particularly generative AI, is projected to affect up to two-thirds of existing jobs, taking on about a quarter of current tasks. Such a transformation could notably increase annual labor productivity in the US, redefine work, and stimulate innovation and efficiency across industries.

China's decoupling from developed markets (DM) could limit supply growth. Geopolitical strains are prompting Western firms to shift their supply chains from China towards regions closer to their consumer base or those with similar political values, such as the US, Mexico, India, and Vietnam. Although emerging markets (EMs) offer lower labor costs, the overall expenses may exceed those in China. In a world moving towards de-globalization, securing supply chains comes at a higher cost, resulting in major investments and reduced efficiency. This strategic distancing of China from DM economies in crucial industries is expected to curtail supply growth, further driving inflation amid changing demographic trends and societal transformations from past cycles.

The energy transition contributes to growth while reducing savings. The Russia/Ukraine conflict-induced energy crisis has fast-tracked the shift towards green energy, prompting initiatives like the US Inflation Reduction Act (IRA) and the EU's Green Deal Industrial Plan to enhance low-carbon energy investments. This surge in decarbonization and defense spending is expected to drive economic growth and maintain structural tightness in certain product markets. However, it will also contribute to reducing the global savings glut. In combination with tight monetary policy by central banks, this will tighten the supply and demand for funds and create a medium-term trend of less generous capitalization rates.

ESG 2.0. There's a growing trend towards ESG practices, more prevalent outside the eurozone, focusing on a company or industry's progress towards ESG objectives as a major factor for investment, determined by investors assessments of progress and engagements, instead of denying capital to those with currently poor ESG standings, as determined by governments and related standard setters. Dubbed "ESG 2.0," this newer methodology focuses on incentivizing sectors traditionally seen as ESG-laggards to improve their ESG metrics to draw investment with the carrot of a lower cost of capital. High-emission industries, now generating significant cash flow, are moving towards greener operations. Such progress is vital for bridging and financing the estimated $2.9 trillion funding gap needed to achieve net-zero emissions. The "carrot and stick" tactic of ESG 2.0 with its progress of measured metrics marks a notable shift in sustainable investing versus the "just say no" ESG 1.0 stick approach, focused only on a company or industry's "state of" measured metrics.

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.

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.

This information is for educational purposes only and is not intended to serve as investment advice. This is not an offer to sell or solicitation of an offer to purchase any investment product or security. Any opinions provided should not be relied upon for investment decisions. Any opinions, projections, forecasts and forward-looking statements are speculative in nature; valid only as of the date hereof and are subject to change. PineBridge Investments is not soliciting or recommending any action based on this information.

Disclosure Statement

PineBridge Investments is a group of international companies that provides investment advice and markets asset management products and services to clients around the world. PineBridge Investments is a registered trademark proprietary to PineBridge Investments IP Holding Company Limited.

Readership: This document is intended solely for the addressee(s) and may not be redistributed without the prior permission of PineBridge Investments. Its content may be confidential, proprietary, and/or trade secret information. PineBridge Investments and its subsidiaries are not responsible for any unlawful distribution of this document to any third parties, in whole or in part.

Opinions: Any opinions expressed in this document represent the views of the manager, are valid only as of the date indicated, and are subject to change without notice. There can be no guarantee that any of the opinions expressed in this document or any underlying position will be maintained at the time of this presentation or thereafter. We are not soliciting or recommending any action based on this material.

Risk Warning: All investments involve risk, including possible loss of principal. If applicable, the offering document should be read for further details including the risk factors. Our investment management services relate to a variety of investments, each of which can fluctuate in value. The investment risks vary between different types of instruments. In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved.

Performance Notes: Past performance is not indicative of future results. There can be no assurance that any investment objective will be met. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. PineBridge Investments often uses benchmarks for the purpose of comparison of results. Benchmarks are used for illustrative purposes only, and any such references should not be understood to mean there would necessarily be a correlation between investment returns of any investment and any benchmark. Any referenced benchmark does not reflect fees and expenses associated with the active management of an investment. PineBridge Investments may, from time to time, show the efficacy of its strategies or communicate general industry views via modeling. Such methods are intended to show only an expected range of possible investment outcomes, and should not be viewed as a guide to future performance. There is no assurance that any returns can be achieved, that the strategy will be successful or profitable for any investor, or that any industry views will come to pass. Actual investors may experience different results.

Information is unaudited unless otherwise indicated, and any information from third-party sources is believed to be reliable, but PineBridge Investments cannot guarantee its accuracy or completeness. All information is sourced from PineBridge Investments unless otherwise noted.

This document and the information contained herein does not constitute and is not intended to constitute an offer of securities or provision of financial advice and accordingly should not be construed as such.

The securities and any other products or services referenced in this document may not be licensed in all jurisdictions, and unless otherwise indicated, no regulator or government authority has reviewed this document or the merits of the products and services referenced herein. This document and the information contained herein has been made available in accordance with the restrictions and/or limitations implemented by any applicable laws and regulations. This document is directed at and intended for institutional and qualified investors (as such term is defined in each jurisdiction in which the security is marketed). Before acting on any information in this document, prospective investors should inform themselves of and observe all applicable laws, rules and regulations of any relevant jurisdictions and obtain independent advice if required.

Where applicable, the Manager may determine to terminate any arrangements made for marketing the Shares in one or more jurisdictions in accordance with the AIFM Directive and UCITS Directive respectively, as may be amended from time to time. Investors and potential investors can obtain a summary of investor rights and information on access to collective redress mechanisms at www.pinebridge.com/investorrights.

Certain Geographic Disclosures:

Australia: PineBridge Investments LLC is exempt from the requirement to hold an Australian financial services license under the Corporations Act 2001 (Cth) in respect of the financial services it provides to wholesale clients, and is not licensed to provide financial services to individual investors or retail clients. Nothing herein constitutes an offer or solicitation to anyone in or outside Australia where such offer or solicitation is not authorised or to whom it is unlawful. This information is not directed to any person to whom its publication or availability is restricted.

About PineBridge Investments

pinebridge.com

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 2023, the firm managed US$157.1 billion across global asset classes for sophisticated investors around the world.

MULTI-ASSET | FIXED INCOME | EQUITIES | ALTERNATIVES

Disclosure Statement (Cont'd)

Bermuda: PineBridge Investments Asia Limited is registered as a Class A Registered Person with the Bermuda Monetary Authority pursuant to the Investment Business Act 2003 (as amended).

Hong Kong: The issuer of this document is PineBridge Investments Asia Limited, a company incorporated in Bermuda with limited liability, licensed and regulated by the Securities and Futures Commission (SFC). This document has not been reviewed by the SFC.

Malaysia: PineBridge Investments Malaysia Sdn Bhd is licensed and regulated by Securities Commission of Malaysia (SC). This material is not reviewed or endorsed by the SC.

Singapore: PineBridge Investments Singapore Limited is licensed and regulated by the Monetary Authority of Singapore (MAS). In Singapore, this material may not be suitable to a retail investor. This advertisement or publication has not been reviewed by the MAS.

Taiwan: PineBridge Investments Management Taiwan Ltd. Is licensed and regulated by Securities and Futures Bureau of Taiwan (SFB). In Taiwan, this material may not be suitable to investors and is not reviewed or endorsed by the SFB.

Last updated 7 February 2024. For additional legal and regulatory disclosures including other cross border information, please refer to https://www.pinebridge.com/en/regulatory-disclosure.