

# Capital Market Line

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



## Something Familiar, Something New

While the spiking number of Covid-19 cases in the US West and South are cause for concern, built-up consumer demand and nascent recoveries in autos, housing and manufacturing are signs that recovery is still on its way. Nevertheless, sustained and incremental monetary and fiscal policy support are the “training wheels” the economy needs (and is likely to be forthcoming) to keep the recovery on track long enough for human ingenuity in the form of new therapeutics and vaccines to turn the tide for good.

The massive public and private resources that have been marshaled to battle the virus through science are just one component of the already unprecedented policy responses to Covid-19, which will leave a lasting legacy of substantially higher public debt globally. Its sheer size will necessitate monetary and fiscal regime rethinks. Historically, high public sector debt led independent central banks to conclude that yields on public debt had to be constrained beneath inflation for decades in order to facilitate the growth of nominal GDP so that the debt-to-output ratio returned to some measure of normalcy. While most central bankers have not yet chosen that route, we believe they will this time as well.

Fiscal rethinks are driven by politics, and therefore are less predictable. After the Financial Crisis, austerity exacerbated private sector deleveraging and deteriorating demographics, leading to economic frustration and the advance of populism. Given that backdrop, the current crisis is likely to turn last cycle’s austerity into fiscal activism. While that might offer improving demand growth, supply growth and efficiency are likely to suffer as the US and China now appear headed down the road to greater competition and decoupling. In contrast to the world in the wake of the breakup of the Soviet Union, when increasing globalization led to greater efficiency, lower inflation, and faster growth with higher profitability and lower capital intensity, we’re likely now in a long, slow transition to a less interconnected world, during which time slowing cash flow growth will be offset by rising excess liquidity driven by central banks.

Those conditions still provide a favorable investing backdrop, even if less favorable than in the past. At the micro level, the new economy has been ushering in a wave of disruption and creative destruction that has only just begun. Covid-19 has accelerated the already rapid digitization of the global economy, yet regulatory and political risks will only grow for leaders in this winners-take-most environment.

Overall, our Capital Market Line retains a moderately positive slope that favors risk taking. We are still only in the early stages of a multi-year economic recovery. While its growth path looks lackluster and risks linger, negatives are largely offset by liquidity and policy support, thus favoring growth and risk assets over safety. In real terms, large pockets of defensive assets are poised to lose value, so caveat emptor.

June  
2020

### 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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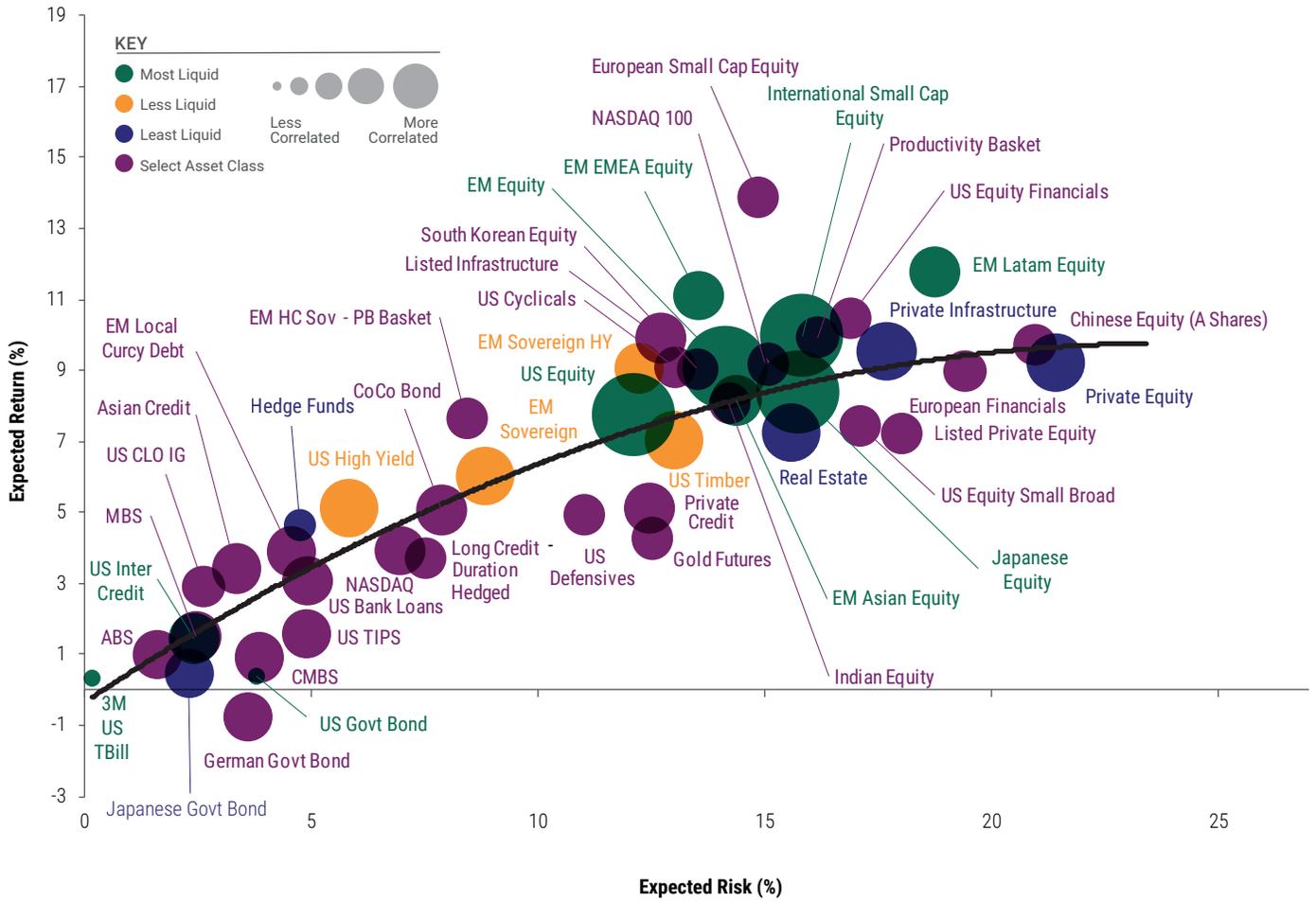
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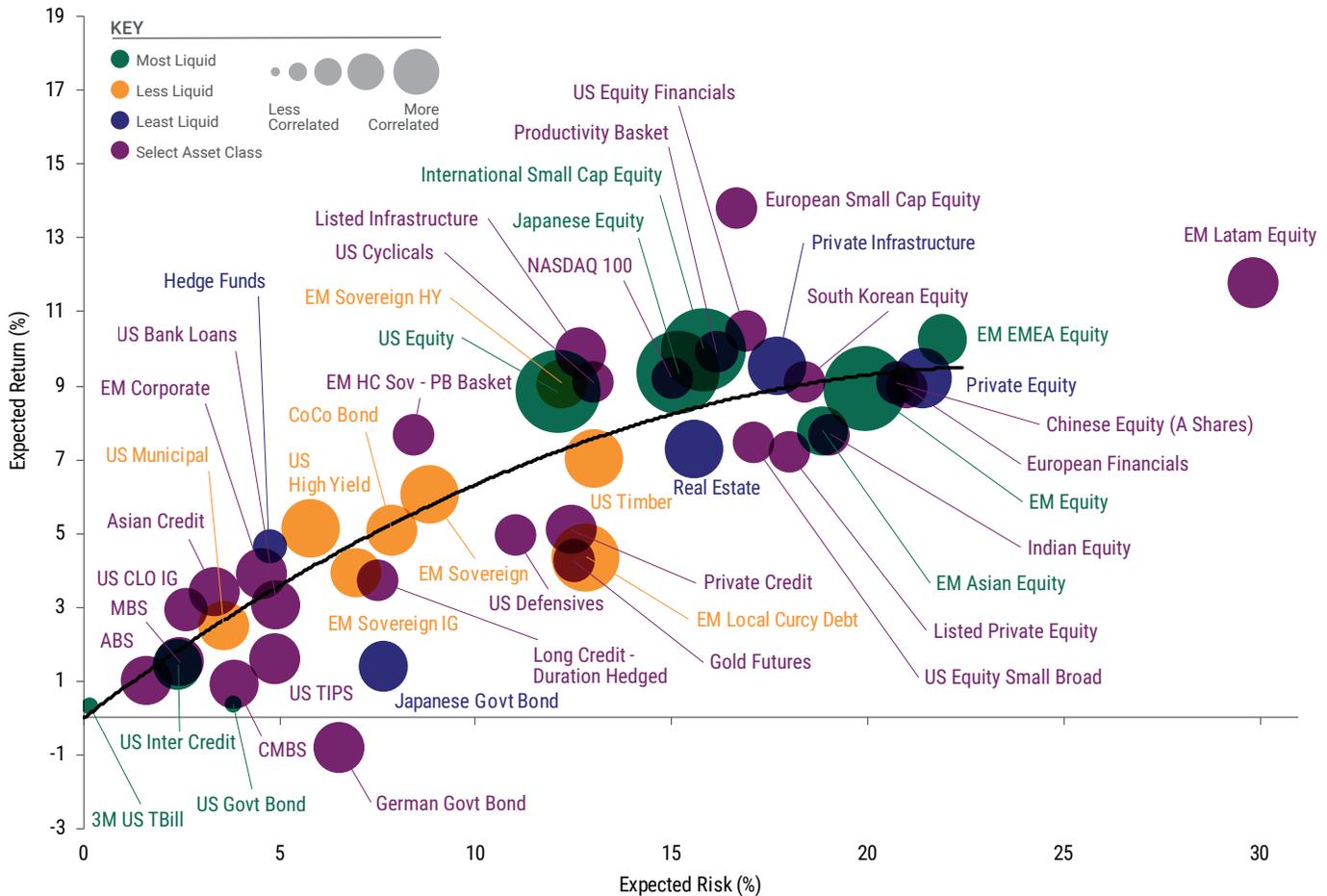
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## Capital Market Line as of 30 June 2020 (Local Currency)



Please see Capital Market Line Endnotes. Note that the CML's shape and positioning were determined based on the larger categories and do not reflect the subset categories of select asset classes, which are shown relative to other asset classes only.

## Capital Market Line as of 30 June 2020 (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.

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## Insights From Today's CML

**The slope of our Capital Market Line (CML) remains modestly steep.** The remarkable recovery in financial markets over the last quarter has dampened forward-looking returns and somewhat flattened the curve as equities outperformed all asset classes. Somewhat slower cash flows colliding with exceptionally high liquidity have resulted in a high risk premium for growth assets despite valuations that are above long-term historical averages. These valuations are justified as long as the 'twin gluts' – in global savings and central bank balance sheets – do not dissipate over our investment horizon; we continue to believe they won't. Meanwhile, the low-risk end of the CML indicates that safety assets (unsurprisingly) are priced at a premium. This leaves the middle of the curve looking more attractive, with credit particularly attractive.

**Developed market (DM) government yields will remain range-bound, supporting risk assets.** The clearest legacy of the Covid-19 crisis for financial markets will be the substantial debt load left in its wake. The ongoing policy support that we anticipate will necessarily require yields to remain under control, to avoid disrupting the recovery. The mechanisms to achieve this may vary across major economies, but the outcome will be the same: low yields for the foreseeable future. The caveat is, of course, inflation. In the lively inflation/deflation debate, we come down in favor of 'deflation first, inflation later'. The sheer scale of the negative output gap will take years to close, limiting any sustained inflation until then. In the US, additional support for keeping yields low comes from the potential adoption of an 'inflation makeup' strategy that will allow inflation to rise a bit above target levels.

### **The search for yield leads to Emerging Market (EM) debt and investment-grade (IG) credit.**

The lack of yield from risk-free bonds will intensify the search for yield elsewhere. Credit assets now appear as attractive on the CML in terms of their risk/return profile as risk-free assets, yet they offer further tailwinds in the form of yield-based return and a likely improving trajectory for corporate credit fundamentals. After the initial spike in leverage levels, we expect to see leverage multiples decline over the intermediate term, as earnings recover and corporates turn to balance sheet repair. In EM, sovereign hard-currency debt is attractively priced, especially in high-yield names. Central bank credibility and the absence of inflation in major EMs has enabled the current shock to be addressed more effectively than previous crises, when the nations were preoccupied with defending over-valued currencies. Low core yields and a weaker US dollar will provide much-needed policy space to maintain growth-friendly policies. The fact that this crisis is largely 'blameless' will ensure that supranational support also is forthcoming, as witnessed by swift assistance from the International Monetary Fund over the last few weeks. Yet selectivity remains key, as the pandemic has resulted in vastly different fiscal profiles across the asset class. Although we expect EMs to face lower structural growth rates (see below), this should not be problematic for EM fixed income.

**Emerging markets face lower structural growth than in the previous cycle.** In the cycle ahead, several factors lead us to handicap EMs usual growth premium relative to the past. China's lower structural growth rate and domestic focus will be an important impediment, as will lackluster demographic profiles in large economies such as China and Brazil. A commitment to structural reform remains the critical ingredient for EM countries to sustain a growth premium relative to DM, yet we see limited prospects for serious reform ahead. Over the coming cycle, many EMs will benefit less from intellectual property (IP) transfers and foreign direct investment as automation costs fall and EM cost advantages erode. With climate change bending down the demand curve for energy, EM countries largely dependent on exporting natural resources face a tougher future. On a structural basis, EM is morphing into more of an attractive duration play than a growth play, hence requiring a highly selective approach to EM equity allocations.

**Private assets largely remain unattractive.** The unfolding of this crisis has been exceptionally rapid thus far. Financial markets experienced the fastest drawdown in history, followed by a record rally in the following weeks. In theory, bear markets can provide opportunity for private equity managers to take advantage of dislocations and benefit from the recovery ahead. In practice, the speed of the decline can render the opportunity merely theoretical. Our colleagues suggest that alternative asset managers found themselves in a defense mode through this unprecedented period, as opposed to playing offense. Given the operational challenges faced by businesses, private equity owners and managers were largely preoccupied with assisting their portfolio companies in managing credit lines and near-term cashflows, rather than looking for buying opportunities. And when opportunities were identified, sellers remained reticent to transact. As a result, the policy response worked against the asset class in the sense that it limited their potential to benefit from attractive entry levels. We continue to see challenges to investor returns, even after the reset of the cycle. In the opaque world of private credit, we have been concerned about the quality of underwriting. The current exogenous shock is precisely the type that puts illiquid exposure to weak underwriting standards at risk of impairment.

# The Fundamentals Driving Our CML

## **Deep output gaps combined with persistent policy support.**

The scale of the economic shock from voluntary lockdowns is large, but so too has been the policy support to offset its severity. A deeply negative output gap will be unavoidable, requiring ongoing monetary and fiscal support to close. Political minds appear to appreciate this reality, and electoral pressures will encourage the support to be forthcoming regardless of which party is in control. The ability to maintain the support will depend on the combined global savings glut as well as central bank balance sheets. We remain confident that the willingness and ability will be aligned to keep financial conditions conducive to closing the output gap over the intermediate term.

## **Rising government involvement in commerce and markets.**

Governments have stepped up massively to address the challenge at hand, yet any “bailouts” of the private sector likely will come with strings attached for corporations. The alternatives involve either more fiscal discipline or higher tax burdens, particularly on corporations and wealthier individuals. Both paths likely will be pursued to varying degrees, in a mix that will ebb and flow in the political cycles ahead. Yet corporates are unlikely to change their prioritization of shareholder returns unless explicitly handcuffed by policy.

## **Scarring of potential growth, yet perhaps less than feared.**

Through lower discretionary consumption and dampened investment appetite, severe economic shocks have the potential to change consumer and corporate behavior in ways that typically impede growth. In the past, pandemics have exacerbated these shifts by provoking higher precautionary savings. Swift and sizable policy offsets could avoid this fate, by reducing the hit to household and corporate balance sheets and buttressing confidence. Beyond an initial bounce in growth as lockdowns are lifted, we see lower potential growth rates for several years, weighed down by debt burdens, inequality, and global demographic trends. Yet we are cautiously optimistic that policy can lessen this slide.

**The US-China cold war will expand beyond trade.** Beyond the cliché, China’s relationship with the US truly is moving rapidly from vertical integration to horizontal competition. Bipartisan support to confront China is palpable and likely to persist regardless of who is in power; only the tone and extent of cooperation with erstwhile allies will vary. China’s assertiveness under Xi Jinping may become cemented at the next Party Congress when he is eligible to become ‘leader for life’, leading to a difficult environment for other major players, such as Europe and Japan, to balance their interests between China and the US.

**Restructuring of global supply chains.** ‘Just in time’ is no longer the focus of corporates as they assess their supply chains and production processes. Increasingly, the focus will shift to ‘just in case’; a need to develop resilience to shocks such as pandemics or geopolitically-driven disruption. Over the coming years, we see governments re-evaluating strategic capabilities, such as sensitive areas of healthcare and food production, and requiring local re-shoring of production that is deemed vital, regardless of economic costs. Concurrently, we see corporates accelerating diversification of supply chains and localization of production to serve regional markets directly and reduce risks embedded in concentrated supply chains. The result will be lower efficiency and lower returns on capital relative to the prior cycle.

**Acceleration of digitization.** The pace of digitization in the global economy is going into hyper-drive. In the post-GFC years, several technological developments enabled the digitization of the global economy and the scaling of “new economy” businesses, creating clear winners relative to “old economy” businesses that were systematically disrupted. At the same time, the ratcheting up of regulation conspired with network effects to put small businesses at a disadvantage relative to their global competitors. The after-effects of the Covid-19 crisis will effectively accelerate these trends, resulting in rising market share and return on equity for industry leaders.

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## 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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