

October 2017 Market Update

Key Points

- The September FOMC meeting was an important milestone for the Fed as the decision to begin unwinding the massive balance sheet was made.
- The likelihood of a December rate hike moved higher as hawkish rhetoric from the Fed has pushed expectations above 70%.
- Less weight is being placed on recent economic data as Hurricanes Harvey and Irma appear to have distorted economic data.
- The composition of the Fed is likely to change when President Trump makes his nomination for Fed chair, which is expected in the coming weeks.

Outlook

GROWTH: The third reading on real GDP surprised to the upside by a tenth of a percent with a reading of 3.10%. Driving the small upward revision was a larger build in inventories, which falls into the fixed investment component of GDP. Fixed investment has picked up meaningfully as it has gone from a negative contributor to GDP in 2016 to a positive contributor for most of 2017. Looking ahead, we still expect growth to continue at an above-trend pace, but it's likely we will encounter distortions in the coming months as a result of the recent hurricanes. The third quarter could be affected by the slowdown in activity, while the fourth quarter may see a boost from the rebuilding process. Despite the potential noise from the recent hurricanes, the overall outlook for growth remains positive for the remainder of the year.

2017 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	2.00% - 2.50%

INTEREST RATES: Interest rates are about 30 basis points higher than they were on the first trading day in September, as geopolitical tensions have waned and the debt ceiling issue has been temporarily resolved. Furthermore, there has been a renewed focus on tax reform that has put upward pressure on rates. From a simplistic perspective, tax cuts that are not budget-neutral would lead to a higher deficit, requiring more Treasury issuance during a period when the largest buyer, the Federal Reserve, is scaling back their reinvestments in Treasury bonds. At the September Fed meeting the committee reiterated their view for policy rates as their median forecast was left unchanged for 2017 and 2018. With the expectation of further rate increases and balance sheet reduction, we expect interest rates will continue to drift higher toward the top end of our target range.

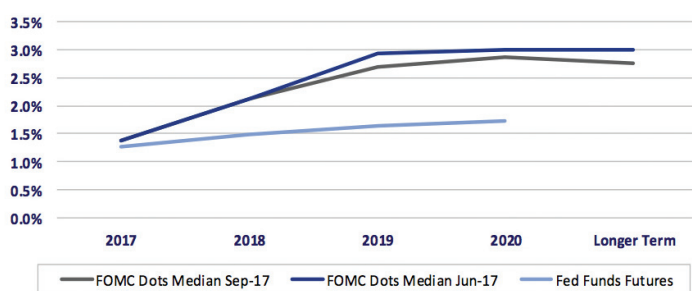
FORECAST PERIOD	10-YEAR TREASURY YIELD
12 months	2.25% - 2.75%

September 2017 Recap & Macro Themes

Investors sought out U.S. Treasuries as a safe haven from the temporarily resolved but ongoing debt ceiling debate and the host of idiosyncratic risks that were on the radar in September. Further provocations from North Korea combined with two powerful hurricanes were enough to send the 10-year U.S. Treasury to a new low of 2.03% this year. These low levels were short-lived as positive economic data, hawkish rhetoric from the Fed, and a renewed push for tax reform lifted 10-year rates to 2.35%. Thematically, we think it's important for investors to pay attention to the central banks' removal of policy accommodation. The Fed is well along on this path and it's likely other central banks will follow soon. We are somewhat cautious that investors have become too complacent in a low rate environment, especially as the Fed begins unwinding their balance sheet.

The September FOMC meeting marks an important milestone for the Fed as the decision to begin unwinding the massive balance has finally been made. With many market participants already expecting this to occur, much of the focus was on the Summary of Economic Projections and the so-called "dot plot." There was much speculation around a third rate hike in 2017 and with the median dot for 2017 not shifting, there appears to be a higher likelihood of a December hike. Beyond 2017, markets were looking for a downward shift in the median dots for 2018 and the longer-run dots, as markets imply only another one-and-a-half hikes in the cycle. With the median dots unchanged, the Fed is sending a message to the markets that normalization will likely continue.

FOMC Dots vs Market Expectations



Source: Bloomberg, Allianz Investment Management LLC

There still appears to be some reluctance from the market to price in further rate hikes for next year, and we expect the gap between the FOMC projections and the market's expectations to continue to converge over the next year.

Regarding the Fed, the one question market participants want answered is President Trump's next appointment for Fed chair. While there are many candidates considered in the running,

there are a few in particular who are being closely watched, including former Fed member Kevin Warsh and current Fed member Jerome Powell. Warsh is seen as a more hawkish pick as he believes the Fed's balance sheet shouldn't be so large, and Powell is viewed as the status quo pick when compared to Janet Yellen. In addition to the nomination for Fed chair, President Trump will have to nominate someone for the vice chair, as Stanley Fischer has decided to resign. The main takeaway is that the composition of the Fed is going to change, and this could have the potential to impact the speed and direction of monetary policy in the coming years.

While economic data, particularly in the latest business surveys, was quite solid during September, we are somewhat cautious of the results as Hurricanes Harvey and Irma have introduced potential noise to the economic data. For example, retail sales for the month of August dropped two-tenths of a percent versus an estimate of a one-tenth of a percent increase. Given that much of the weakness in the latest retail sales data can be explained by the weather and possibly a payback from strong Amazon.com sales in July, we are not too concerned. In fact, there is a strong likelihood that consumption picks up in the coming months as areas affected by the hurricanes start to rebuild. Furthermore, both the ISM manufacturing and nonmanufacturing surveys pointed to accelerating output for the U.S. after reporting 13- and 12-year highs respectively. While this is a positive sign for growth in the economy, we are again mindful of the noise brought by the hurricanes. Lastly and probably the most affected data point from the hurricanes was the payroll number in the recent employment report, with a reading of negative 33k. The figure was 113k below consensus estimates and highlights how distorted the data can become. More interesting to investors was the average hourly earnings figure, which came in at 0.5% for September. The strong wage number combined with calendar effects lifted year-over-year wage growth to 2.9%. As wages continue to pick up and lift expectations for inflation, it will be difficult for the Fed to not raise the policy rate in December.

While the rates picture is often contentiously debated, the potential for a steeper yield curve remains possible as several factors could put upward pressure on longer-term rates. First, global central banks appear to have reached the limits on policy accommodation and as a result, bond purchasing programs should be decelerating. Second, the U.S. is working on fiscal reform, which includes a tax plan with the potential to add over \$1 trillion to the deficit. Lastly, after being dormant for the last six months, inflation may pick up again as signals like survey-based measures and higher wages have the potential to lead to higher prices. Regardless of which direction rates may go, the fundamental backdrop should pave the path for further economic gains.

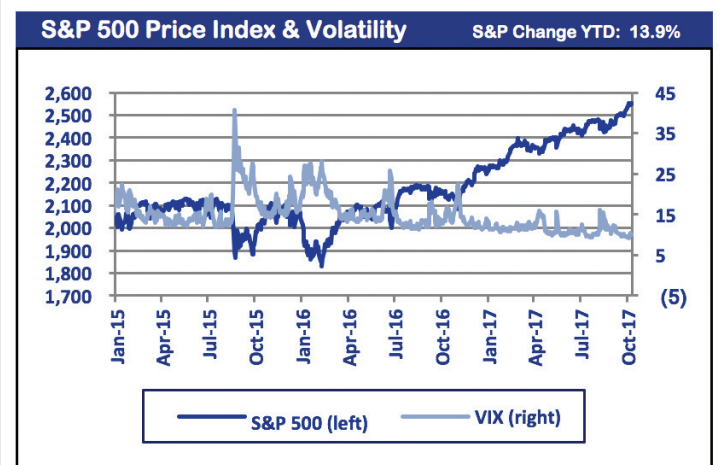
Market Indicators (figure a)

- The temporary resolution of the debt ceiling debate in combination with a renewed push for tax reform has pushed equities to new highs. There has been much debate about the lofty valuations in equities, with the P/E metric for the S&P 500® at 21.8. Sure, this looks expensive by historical standards, but on a forward basis with a market expectation of 20% earnings growth it's tough to argue these levels. Overall, the solid economic environment, in conjunction with low rates, is a recipe for solid earnings growth and should support equity markets in the coming year.
- Equity volatility was mostly subdued in September following the multiple spikes witnessed in August. A jump was recorded in early September as the debt ceiling discussions played out, but continued its upward trend soon after resolution.
- Treasury yields moved sharply higher after the resolution of the debt ceiling and the announcement from the Fed to begin balance sheet reduction and continue normalizing policy rates. Inflation appears to have bottomed out as the latest CPI data moved higher. We expect continued upward pressure on rates if tax legislation becomes more probable.
- Energy prices moved higher during the month of September after falling below \$47 per barrel early in the month on refinery closures caused by Hurricane Harvey. Overall, the price for West Texas Intermediate crude oil rose by 8% during the month as refineries came back online and weekly supply figures showed higher-than-expected drawdowns in crude oil late in the month.

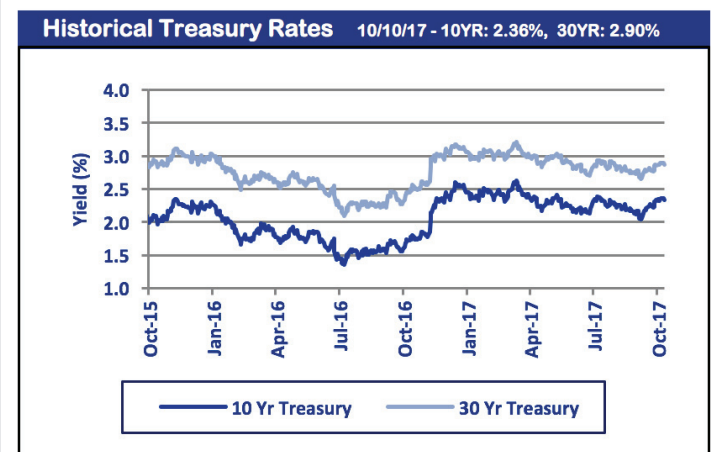
Economic Indicators (figure b)

- The level of confidence from the consumer slipped a bit in September, as both the Conference Board's Index of consumer confidence and the University of Michigan's Sentiment Index dropped slightly. On a broader level confidence continues to remain elevated, which isn't surprising given the economic backdrop. Optimism from the consumer should lead to stronger consumption in the coming quarters and elevate growth.

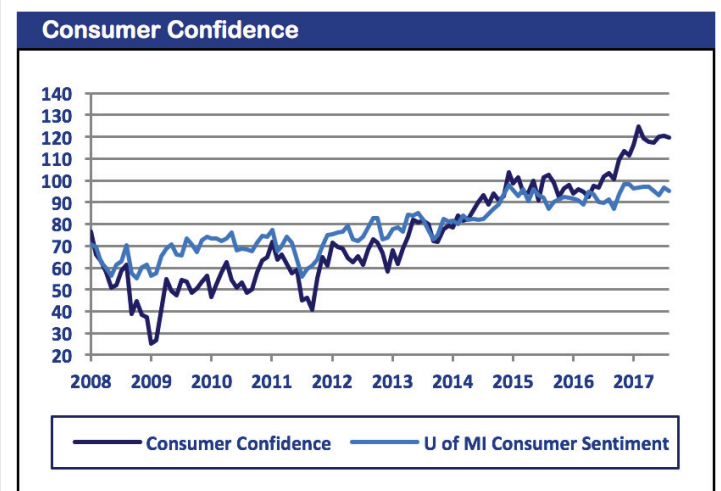
figure a



Sources: S&P, CBOE



Source: Bloomberg

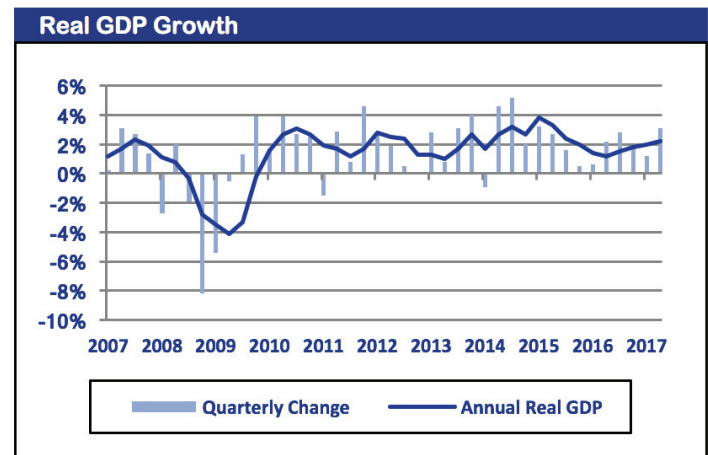


Source: Bloomberg

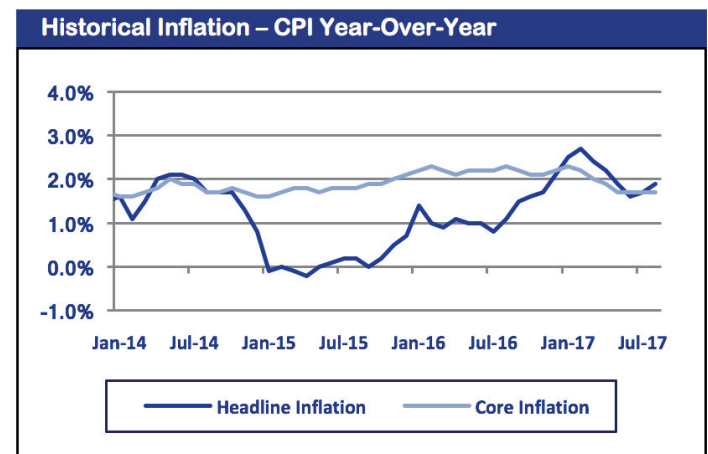
Economic Indicators *(continued)*

- The second estimate on second-quarter GDP saw a surprising jump to 3.0%. This was the first time quarterly GDP data has been at or above 3.0% since the first quarter of 2015. Driving the upward revision was stronger consumption data and a pickup in business investment. The data is encouraging, as stronger consumer spending is likely going to drive above-trend growth during the second half of the year.
- Finally, after five consecutive months of weak inflation prints, we saw a solid increase in consumer prices. Headline CPI rose by 0.4% and pushed the annual figure up to 1.9% from a previous reading of 1.7%. Core inflation rose by 0.2% lifting the year-over-year figure to 1.7%. This is welcome news for a Fed that has been insistent that weak inflation data is transitory.
- Not surprisingly, jobless claims spiked to a two-and-a-half year high in September as workers impacted by Hurricanes Harvey and Irma sought out unemployment aid. Implications from the hurricanes may linger and create noise in the short term; however, their economic impacts should be temporary.
- After falling to the lowest level since December of 2014, the U.S. dollar index rebounded somewhat on the hawkish tone from the latest FOMC meeting. The dollar has been weakening since the beginning of the year and given the prospects of the global economy and the expectation for global central banks to remove accommodation, it is conceivable for this trend to continue.
- The ISM Manufacturing survey pointed to accelerating output for the U.S. economy as the index surprised to the upside and surpassed consensus estimates. More specifically, the ISM Manufacturing Index rose two points to 60.8 from August's reading of 58.8. The increase above 60 is the highest reading in 13 years and reinforces the recent strength in the sector. Overall, this is a positive sign for growth, but as mentioned before, we are wary of potential distortions the recent hurricanes may have caused.

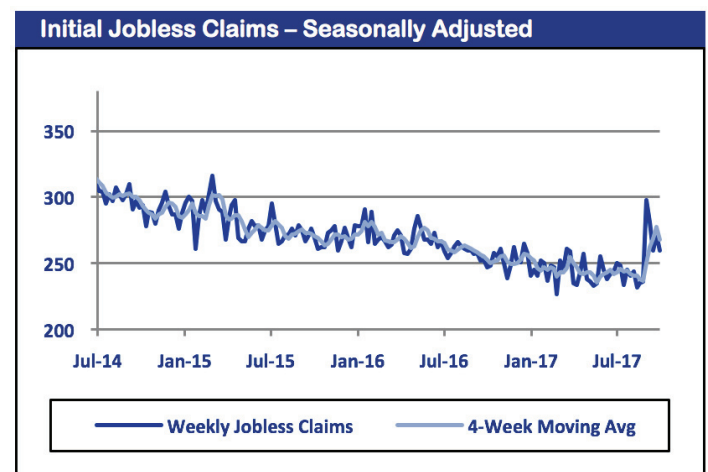
figure b



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	58.8	58.1	60.8	November 1 (Wednesday)
GDP Annualized	3.0%	3.0%	3.1%	October 27 (Friday)
Unemployment rate	4.4%	4.4%	4.2%	November 3 (Friday)
Retail sales	0.6%	0.1%	-0.2%	October 13 (Friday)
Consumer Price Index (YoY)	1.7%	1.8%	1.9%	October 13 (Friday)
U. Mich. Consumer Sentiment	95.3	95.0	95.1	October 13 (Friday)
Home Price Index (MoM)	0.11%	0.20%	0.35%	October 31 (Tuesday)

Definitions

Table Columns

Previous – Observation as of the end of the prior month

Survey – Economist survey prediction for current month's observation

Actual – Actual observation as of the end of the current month

Next – Date of next period's observation

ISM Manufacturing Index

Based on a survey from the Institute for Supply Management, this index indicates a positive growth in the manufacturing sector when the figure is above 50 and a contraction of the sector when it is below 50. An increase in the figure indicates either slowing contraction or accelerating growth. The index represents underlying figures in employment, inventories, new orders, production levels, and deliveries. (Source: Bloomberg)

Unemployment Rate

Based on a monthly survey of households, the unemployment rate is one of many figures in the Current Population Survey that move markets by indicating what portion of the population is at work or looking for work, what they are getting paid, and how many hours they work. The unemployment rate is the percentage of workers unable to find work who are actively seeking a job. The survey is conducted by the Bureau of Labor Statistics.

Retail Sales

Retail sales measure the total amount of purchases by consumers in stores that sell merchandise, food, and other services to end consumers. This measure is a large indication of trends in consumer spending, which moves markets because consumer spending accounts for over ⅓ of U.S. economic output. Data is compiled by the U.S. Bureau of the Census.

Consumer Price Index (CPI)

The Consumer Price Index measures the prices of a fixed basket of goods that reflect an average consumer's cost of living. CPI is a popular indicator of inflation, driving prices on U.S. inflation-linked bonds and used to adjust tax brackets and Social Security payments. CPI is compiled by the Bureau of Labor Statistics monthly.

Home Price Index

The S&P Case-Shiller Home Price Index we track is the seasonally-adjusted average price of residential homes in 20 major cities in the U.S. Data is published with a 2-month lag (numbers available in March reflect price changes from January). Housing prices affect consumer wealth and consumers' ability to borrow and spend, which affects U.S. economic growth.

Gross Domestic Product (GDP)

Gross domestic product is the sum of all goods and services produced in the economy. It is one of the most comprehensive benchmarks for economic performance. Real GDP measures economic productivity adjusted for inflation, which measures growth that is not due to goods getting more expensive. GDP is published by the Bureau of Economic Analysis.

University of Michigan Consumer Sentiment Index

The index is derived from surveys of 500 households by the University of Michigan on consumer finances and attitudes regarding the economy. The index is set to 100 as of 1966, reached a high of 107.3 in June of 1999 and a low of 56.4 in June of 2008. High consumer confidence levels lead to robust consumer spending, whereas low consumer confidence levels lead consumers to pull back on spending.

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