Market Update

(11/2018)

Allianz Investment Management LLC

November 2018 Market Update

Key Points

- Uncertainty around future growth crept into the market, causing the worst equity rout in seven years.
- Volatility is elevated and we expect this to persist as the Fed makes further progress on removing accommodative monetary policies.
- The labor market continues to be blistering hot, with 250K jobs added in October.
- Trade tensions between the U.S. and China remain elevated, which is causing some concern around growth.
- To the extent uncertainty and the potential for slowing growth persist, we believe markets may remain volatile.

Outlook

GROWTH: The U.S. economy continues to ride the coattails of fiscal stimulus as the advance reading on third-quarter real GDP surprised to the upside, coming in at 3.5% versus expectations of a 3.3% gain annually. While the result was better than expected, we understand the lift from fiscal stimulus cannot last indefinitely. Looking further into the details, consumption continues to remain solid, which is likely a result of a very strong labor market. Reversing the trend from last quarter, net trade subtracted from GDP in this quarter, while inventory build added to GDP. All in all, we continue to expect growth to be strong going into next year, but appreciate the fact that the stimulus in the economy will eventually fade. Our forecasted target for real GDP growth remains in the range of 2.65% to 3.15% for this year.

2018 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	2.65% - 3.15%

INTEREST RATES: Positive economic data combined with increasing Treasury issuance has persistently kept upward pressure on interest rates during the second half of this year. The yield on the 10-year U.S. Treasury reached the highest we have seen since 2011, and the current economic environment continues to be conducive for rising interest rates. Despite the volatility in equity markets, the Fed appears committed to continue lifting short-term rates to a level that is considered neutral. The economy is likely not as fragile as today's volatile equity markets suggest and therefore expect continued modest upward pressure on rates, barring any significant idiosyncratic events. Thus, we expect the 10-year Treasury to remain within our target for the rest of the year, but we wouldn't be surprised to see further upward pressure.

FORECAST PERIOD	10-YEAR TREASURY YIELD
12 months	2.75% -3.25%

M-5334

October 2018 Recap & Macro Themes

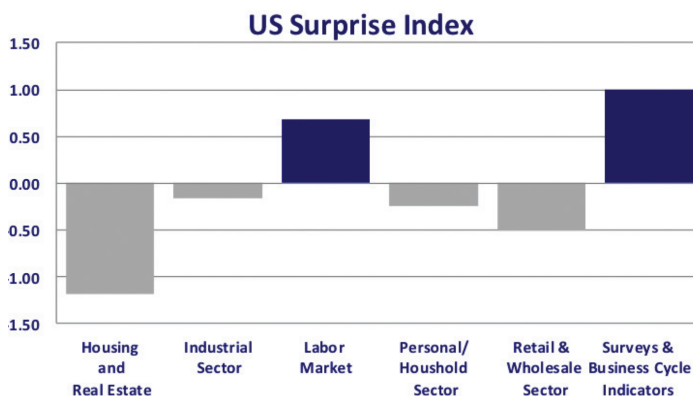
Volatility strikes back! October was setting up to be another solid month of equity gains given the very strong economic backdrop, but that quickly turned south as uncertainty crept into the market causing the worst equity rout in seven years. The S&P 500® Index recorded a loss of 6.94%, while the Nasdaq -100® Index was even worse with an 8.66% monthly drop. The sell-off in stocks highlights investors' concerns around several factors including rising interest rates, U.S. and China trade relations, and peaking corporate profits. Ultimately, all of these factors are leading to greater uncertainty around future growth.

It's easy to point fingers at the Fed in response to the equity market sell-off, but we should note there are some parallels to the previous equity rout back in February and it's likely there will be additional turbulence in the future. Leading up to both events, economic data was very strong and to some extent equity valuations became rich. We know the current economic environment is conducive to rising rates. Higher interest rates typically bring on tighter financial conditions which dampen the growth outlook going forward, and equity markets are reacting to that. Hence, the Fed is attempting to carefully shift monetary policy away from an accommodative stance without leaving a trail behind them. This is obviously a difficult task and what we are observing are the repercussions in the markets as the Fed attempts to take the punch bowl away from the party.

Another sticking point for market participants has been the progress on U.S. and China trade relations (or the lack thereof). While progress was made with our trading partners to the north and south with the new U.S.-Mexico-Canada trade agreement, trade tensions remain elevated between the U.S. and China. Currently 10% tariffs on $200 billion in Chinese imports are set to rise to 25% on January 1, 2019 and additional threats have been made to add tariffs on the remaining imported goods from China. With the tensions between the U.S. and China being a large driver of uncertainty in the markets, the news of progress on the trade front will be welcomed by investors and businesses alike.

The third factor making investors uneasy has been centered on corporate profits and the potential for them reaching a peak. There has been some belief among market participants that the third-quarter earnings will be as good as it gets, and growth in earnings will begin to slow. Specifically, the technology sector has been a large area of concern with large-cap companies such as Apple and Amazon dropping significantly over growth concerns. We recognize the difficulty of forecasting peaks in equity markets and business cycles, but going forward we expect market volatility to remain elevated as investors wrestle between the tailwinds of a solid macroeconomic backdrop and the desire for protection from the downside.

Regarding macroeconomic data, we continue to see positive signals from the labor market and survey-based business cycle indicators, while there has been some weakness in housing and real estate markets. The U.S. Economic Surprise Index portrays that. For investors who were concerned about the potential for a slowing economy, it certainly didn't show up in the latest employment data. The U.S. economy added 250K jobs during October, which was well above the 200K consensus estimate. Most notably, the average hourly earnings rose by 0.2% and lifted the annual figure to 3.14%, the highest annualized wage figure since 2009. On the other hand, rising interest rates have started to become a headwind for the housing sector and a slowdown in activity has shown up in the data.



Source: Bloomberg, Allianz Investment Management LLC

Equities appear to be off to a better start in November after giving up most of the gains for the year in October. But to the extent uncertainty and the potential for slowing growth persist, we believe markets may remain volatile.

Market Indicators *(figure a)*

- After months of gains and reaching higher highs, it appears the equity markets hit a brick wall in October as the S&P and Nasdaq indexes slid 6.9% and 8.6% respectively. We expect equity market volatility to continue so long as we remain in a rising rate environment and trade tensions remain unresolved between the United States and China.

- Unsurprisingly given market events in October, the CBOE VIX Index, a measure of volatility, was elevated for most of the month. More specifically, 18 consecutive business days in October were at or above 15, a trend we had not seen since the volatility spike in early February and March.

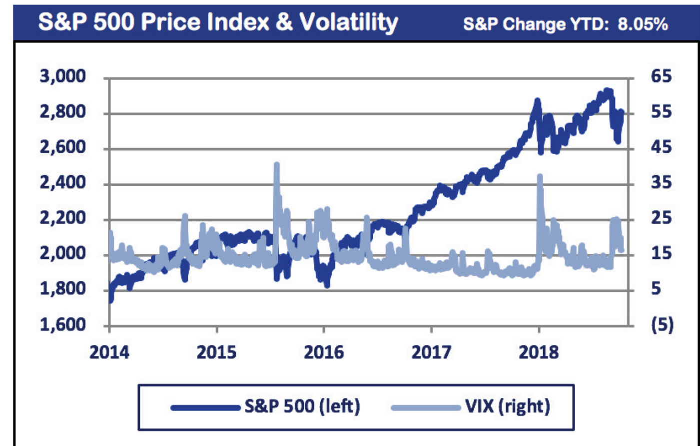
- The yield on Treasuries declined across the curve in the latter half of October as investors purchased safe haven assets in the midst of the equity market volatility. More specifically, the yield on the 10-year Treasury declined from its high of 3.23% to 3.06%, before ending the month near 3.13%.

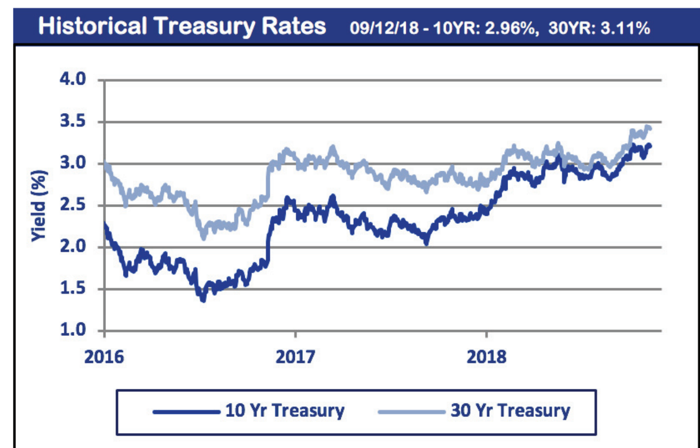
- After ending September over $73 per barrel, crude oil ended the month just over $65 per barrel after declining more than 13% over the month. The decline marked the worst monthly decline in more than two years. We expect oil to remain volatile, especially in the midst of ongoing equity market volatility, increasing oil inventories, and unresolved trade tensions between the United States and China.

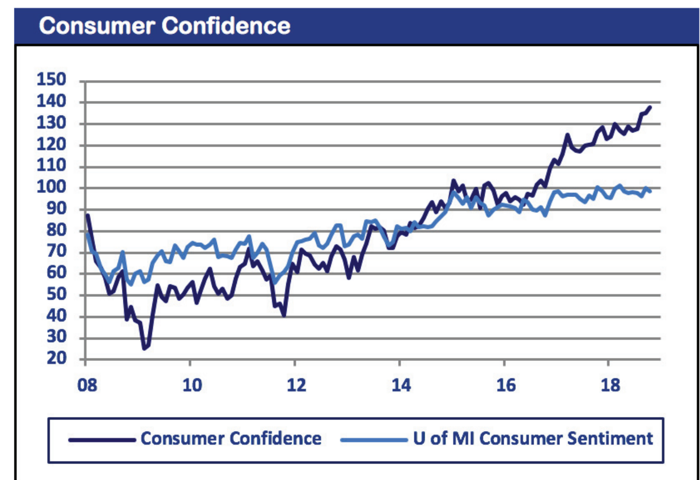
Economic Indicators *(figure b)*

- The preliminary reading of consumer sentiment for October fell to 99.0 from 100.1 but still remains historically elevated. The report from the University of Michigan stated the decline was due to "less favorable assessments by consumers of their personal finances." As a result both the current economic conditions and consumer expectation components declined. It is important to note that although the survey was conducted in the beginning of October, the University of Michigan does not expect the recent sell-off in equities to have had any impact on the survey results.

figure a







Economic Indicators *(continued)*

- The advance reading of third-quarter GDP surprised to the upside, coming in at 3.5% on an annualized basis. Driving the uptick were increased levels of government and consumer spending. It's important, however, to keep in mind that although the third-quarter reading for GDP was strong, the positive implications from this year's fiscal stimulus are still being felt and are likely to subside in the coming months and into next year.

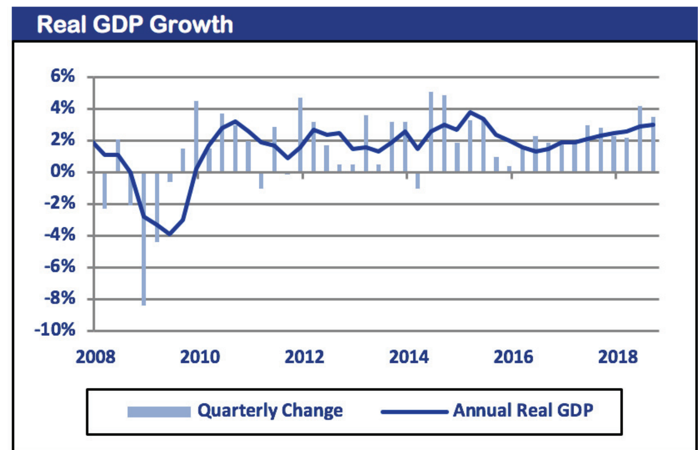
- It feels like market participants were wiping sweat off their brows after the latest report on consumer price inflation fell short of estimates. Against the current backdrop, a larger-than-expected CPI print would have likely caused bonds to sell off further and the equity rout to continue. However, both headline and core CPI came in at 0.10% on a monthly basis, which was below estimates of 0.20%. What was driving prices lower was mostly the drop in used vehicle prices.

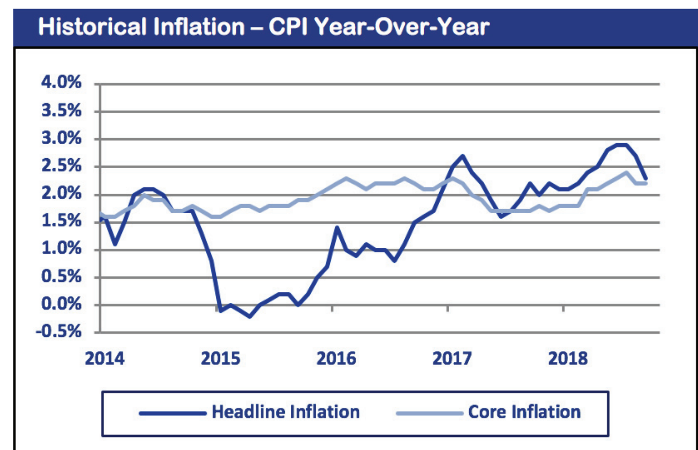
- For investors who were concerned about the potential of a slowing economy, it certainly didn't show up in the latest employment data. The U.S. economy added 250K jobs during October which was well above the 200K consensus estimate. The unemployment rate held steady at 3.7% and the labor force participation rate rose to 62.9%. Most notably, average hourly earnings rose by 0.2% and lifted the annual figure to 3.14%, the highest annualized wage figure since 2009.

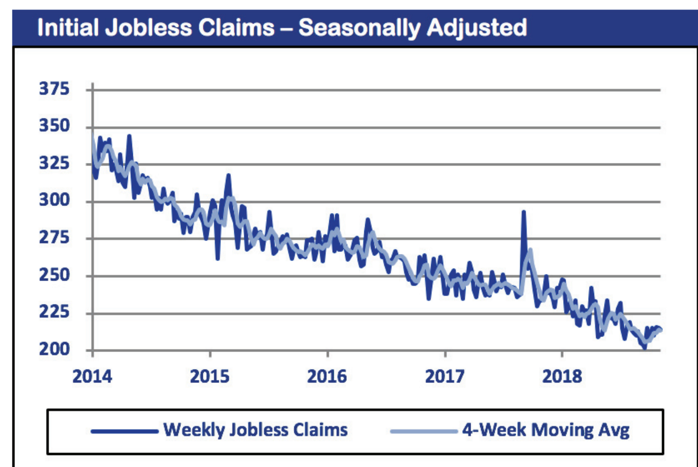
- The U.S. dollar index rallied back in October and ended the month at a nearly one-and-a-half-year high. Although the strength of the U.S. dollar stems from the positive economic backdrop within the United States, it has given rise to some concerns from investors because as the dollar rises, so too does the cost to U.S. corporations of doing business in foreign countries.

- After peaking in August at 61.3 the ISM manufacturing index declined for the second month to 57.7. While the manufacturing sector remains healthy, it's apparent that tariff-related price pressures have started to trickle down, causing some weakness in the survey data. Additionally, a stronger dollar is crimping foreign demand for exports which doesn't bode well for the sector. That being said, the sector remains robust and today's employment report showing 32K manufacturing jobs added to the economy in October can attest to that.

figure b







EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	59.8	59	57.7	December 3 (Monday)
GDP annualized	4.20%	3.30%	3.50%	November 28 (Wednesday)
Unemployment rate	3.70%	3.70%	3.70%	December 7 (Friday)
Retail sales	0.10%	0.60%	0.10%	November 15 (Thursday)
Consumer Price Index (YoY)	2.70%	2.40%	2.30%	November 14 (Wednesday)
U. Mich. Consumer Sentiment	99	99	98.6	December 7 (Friday)
Home Price Index (MoM)	0.09%	0.10%	0.07%	November 27 (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, 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 significant indicator of trends in consumer spending, which moves markets because consumer spending accounts for over ⅔ 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 CoreLogic Home Price Index is the seasonally adjusted average price of residential homes in 20 major cities in the U.S. Data is published with a two-month lag (numbers available in March reflect price changes from January). Housing prices affect consumer wealth and consumers' ability to borrow and spend, which in turn affects U.S. economic growth.

Gross Domestic Product (GDP)

Gross domestic product is the sum of the value 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 1999 and a low of 56.4 in June 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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