Market Update

(12/2018)

Allianz Investment Management LLC

December 2018 Market Update

Key Points

- The narrative around slowing growth domestically and abroad weighed heavily on risk assets in November.
- A dovish sentiment around Fed rate hikes has emerged as financial conditions tightened.
- For the first time since the financial crisis, both the 2-year U.S. Treasury and the 3-year U.S. Treasury are yielding more than the 5-year Treasury.
- Trade tensions between the U.S. and China continued in November and uncertainty around the effects on growth remained.
- Against the backdrop of geopolitical risks we would expect risky assets to continue to be challenged, but recognize the potential for opportunities.

Outlook

GROWTH: The Bureau of Economic Analysis reported the second estimate for third-quarter growth to be unchanged at 3.5%. More importantly, business fixed investment appears to have slowed less than previously expected. While the latest measure of growth in the U.S. economy continues to look robust, the narrative around slowing growth domestically and abroad for 2019 has begun to pick up steam. We can appreciate the fact that tailwinds from fiscal stimulus will eventually fade, but the declining growth story is somewhat exaggerated. There is something to be said about the solid business survey data, upbeat consumer confidence figures, and healthy labor statistics that cannot be ignored. In discussing the growth outlook for 2019, we expect growth to slow at a gradual pace, but believe the annualized rate of growth will continue to remain above trend for the year. We will be updating our forecast for 2019 growth on next month's Market Update, but we continue to expect GDP for full-year 2018 to be within our range.

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

INTEREST RATES: After reaching the highest level since 2011 at just under 3.25%, the 10-year Treasury has swiftly retreated almost 40 basis points as fears of slowing growth created a risk-off environment. In addition, market expectations for future rate hikes have declined significantly to less than one hike priced in for next year. Also, for the first time since the recession both the 2-year U.S. Treasury and the 3-year U.S. Treasury are yielding more than the 5-year Treasury. While this is not an indicator of an immediate recession, it does signal that the US economy is in the later stage of the business cycle. As we look forward into 2019, we expect the slowdown in growth to be less pronounced, allowing the Fed to orchestrate a softer landing for the economy than in previous cycles. We expect the Fed to increase rates in 2019, but likely not as aggressively as the previous year. With a few weeks left in 2018, we don't expect the 10-year Treasury to end outside our forecasted range, but stay tuned for our next Market Update where we will provide specific details on our 2019 forecast for rates.

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

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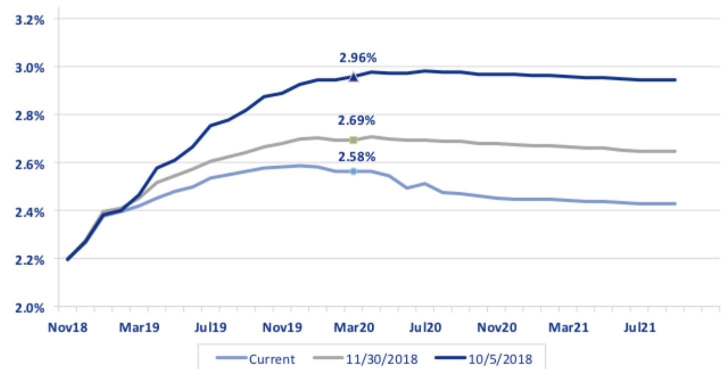
November 2018 Recap & Macro Themes

The narrative around an abrupt slowdown of U.S. growth in conjunction with the effects of fiscal stimulus wearing off continues to weigh heavily on risk assets. Volatility remained elevated and equity markets have given up most of their gains for 2018. Adding fuel to the fire, for the first time since the financial crisis, both the 2-year U.S. Treasury and the 3-year U.S. Treasury are yielding more than the 5-year Treasury. While an inversion of yields at this point on the curve is not an indicator of an immediate recession, it does signal that the U.S. economy is in the later stage of the business cycle. With regard to an inverted Treasury yield curve signaling a recession, the Fed believes a more appropriate indicator would be the spread between 3-month Treasury bills and 10-year Treasury notes. The last seven recessions have been preceded by an inversion of the Treasury yield where 3-month Treasury bills have yielded more than 10-year Treasury notes. Thus, in a postwar era this has typically been a decent predictive indicator of a recession. However, it should be mentioned the Treasury curve could be inverted for many months before a recession actually takes place.

For most of the month investors continued to struggle with uncertainties around U.S. and China trade, Fed rate hikes, and slowing corporate profitability. However, recent Fed-speak has toned down the hawkish language around Fed hikes as global growth has shown signs of slowing and financial conditions have begun to tighten. Specifically, newly appointed Fed Vice Chairman Richard Clarida indicated the Fed "needs to be especially data dependent" as they adjust monetary policy. In addition, Fed Chairman Powell has certainly shifted the tone as his message in early October indicated, "The Fed Fund's rate is a long way from neutral," where this month's message to the markets was "Fed Funds remain just below the broad range of estimates of the level that would be neutral for the economy." The market has clearly acknowledged the shift in sentiment, but there still is considerable uncertainty around how many more rate hikes there will be next year. As a result, the market participants have meaningfully reduced rate hike expectations for 2019 from three to less than one.



Source: Bloomberg, Allianz Investment Management LLC

From the chart above we can see that expected rate hikes based on Fed funds futures dropped. The expected Fed funds rate in March of 2020 has fallen from almost 3.0% to 2.58%, suggesting less than one rate hike year, given the Fed hikes at their December meeting. Investors will be paying close attention to the forward guidance from the Fed through the so-called "dot plot" at the December meeting. We suspect the Fed will be able to continue hiking rates, albeit less aggressively than previously thought.

Lastly, one area of the market that hasn't received as much attention lately is the energy sector - in particular oil prices, which have quietly moved toward bear market territory with a nearly 20% drop from the latest peak. The decline should help offset some of the tariff-related price pressures that have been showing up in the recent data. Nonetheless, the precipitous decline in the price of oil is partly a reflection of slowing growth in the economy. On the other hand, lower gas prices at the pump could be a nice tailwind for consumers during a busy holiday season.

Overall, the month of November was a wild ride with risk assets repricing and volatility remaining elevated, but as we project forward into 2019 we expect late-cycle themes to continue to emerge. Growth is likely to slow and the Fed will be focused on a softer landing for the U.S. economy. Against the uncertain backdrop of geopolitical risks we expect risky assets to continue to be challenged, but recognize the potential for opportunities.

Market Indicators *(figure a)*

- It would have been hard to imagine after the strong start this year that equities would end up in negative territory as we near year-end. The S&P 500® Index has erased all of its gains and is currently hovering near the lows for the year. The challenging environment has been relentless through November and is expected to continue as uncertainties persist.

- Volatility in equity markets remained elevated during most of November as the CBOE VIX Index was above 20 for most of the month. The above-average levels of volatility continue to be driven by investor uncertainty around slowing growth. Until we see further clarity on trade issues with China and the rate path from the Fed, we expect volatile conditions in risk assets to continue.

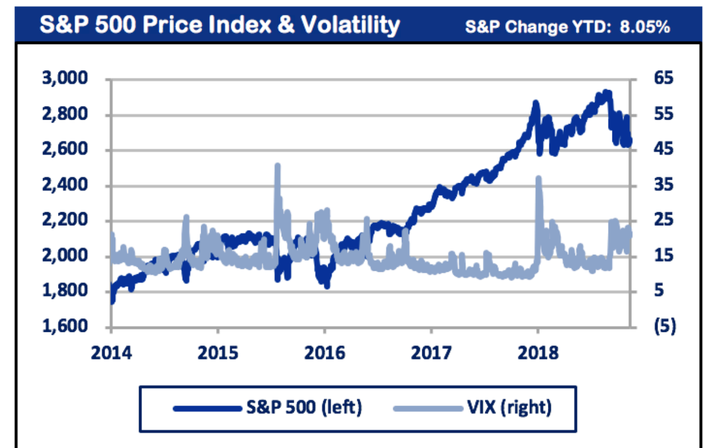
- It has been a very interesting month for U.S. Treasuries. Most notably we saw the Treasury curve flatten and invert at the 2-year and 5-year point as well as the 3-year and 5-year point. Long-term rates have also declined as tightening financial conditions, mostly driven by the equity sell-off, weighed on Treasuries.

- Crude oil extended losses in November with the price of West Texas Intermediate crude declining below $50 per barrel for the first time since September 2017. The peak-to-trough decline is over 30% in the latest rout. Contributing to the decline was the unremitting buildup of supply coming from U.S. producers. Against a backdrop of declining global growth expectations and the effectiveness of production cuts from OPEC it's not surprising to see prices lower, but the move lower was very swift. Looking ahead, we expect some stability in oil prices as economic growth is expected to remain healthy.

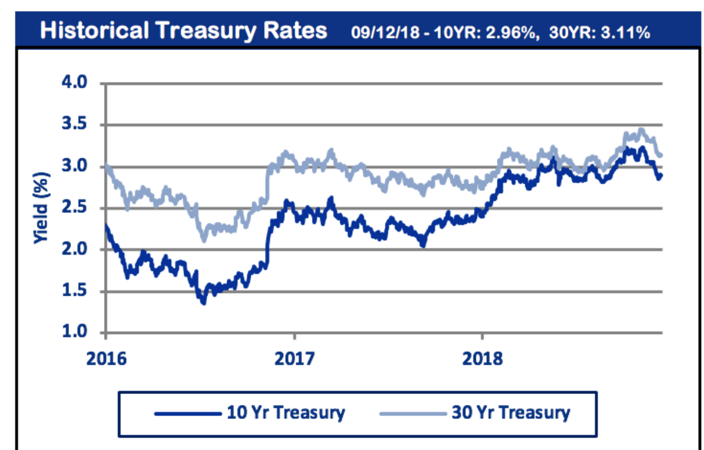
Economic Indicators *(figure b)*

- Despite volatile markets, consumer sentiment measured by the University of Michigan continues to be elevated. The preliminary reading for December was unchanged at 97.5 and is a positive sign for consumption. Market participants continue to look for strong holiday spending this season and solid consumer sentiment certainly provides a tailwind for growth in the economy.

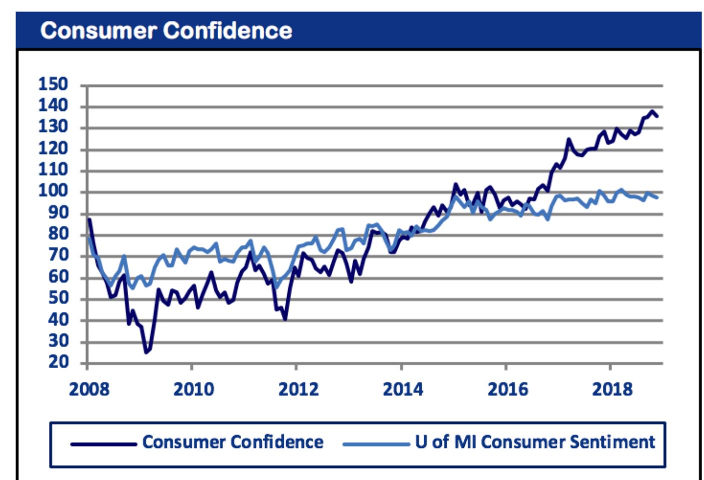
figure a



Sources: S&P, CBOE



Source: Bloomberg



Source: Bloomberg

Economic Indicators *(continued)*

- The second reading of third-quarter GDP was unchanged, coming in at 3.5% on an annualized basis. While the topline figure was constant, the details showed that business fixed investment has slowed less than previously estimated and personal consumption was revised slightly lower. Overall, growth for the U.S. in previous quarters continues to look robust, but looking ahead there is some consensus building in a narrative that has growth slowing in the coming year.

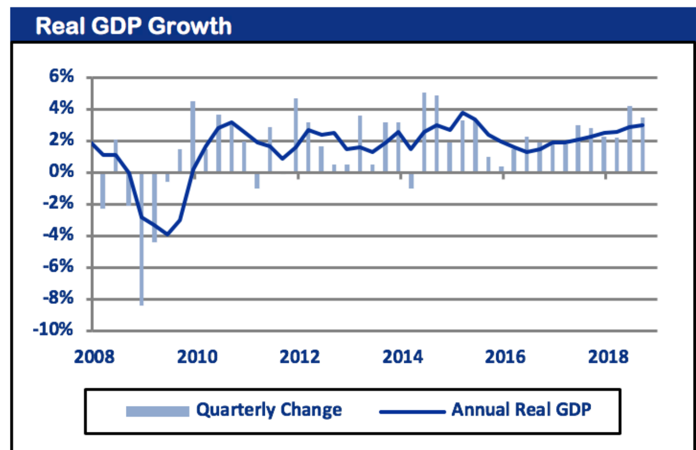
- Headline CPI increased 0.3% in October while core CPI, which removes the volatile food and energy sectors, shifted higher by 0.2%. The uptick in headline inflation was driven by increases in almost every component, with the most notable being energy. The change in core CPI was driven primarily by an increase in used car prices. Despite the strong economic backdrop, inflation continues to remain contained.

- Nonfarm payrolls added to the U.S. economy in November were 155K which were well below expectations of 198K. The labor force participation rate remained unchanged at 62.9% and the unemployment rate held steady at 3.7%. Wage growth continues to climb, but the monthly gain for November was below expectations at 0.2%. Overall, with sentiment shifting toward a more dovish Fed, the recent employment report should give the Fed more food for thought as they debate the path forward for policy rates in 2019.

- The U.S. dollar index continued to march higher throughout the month of November. Volatile markets along with a risk-off environment led to a strong bid in safe-haven assets like the U.S. dollar and U.S. Treasuries. While dollar strength has been a persistent theme throughout 2018 as the Fed lifted short-term rates, there is potential for this to reverse as the Fed gets closer to ending rate hikes and other central banks play catch up.

- Both the ISM manufacturing and the nonmanufacturing surveys came in above expectations at 59.3 and 60.7 respectively. The nonmanufacturing survey remained above 60, which is an indicator of robust growth in the service sector of the economy. While markets continue to price a slowdown in growth with risk assets selling off, we are certainly not seeing this sentiment in the latest business surveys.

figure b



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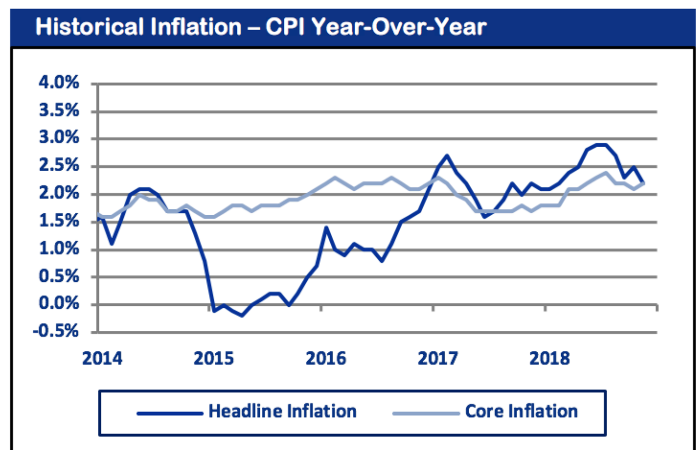

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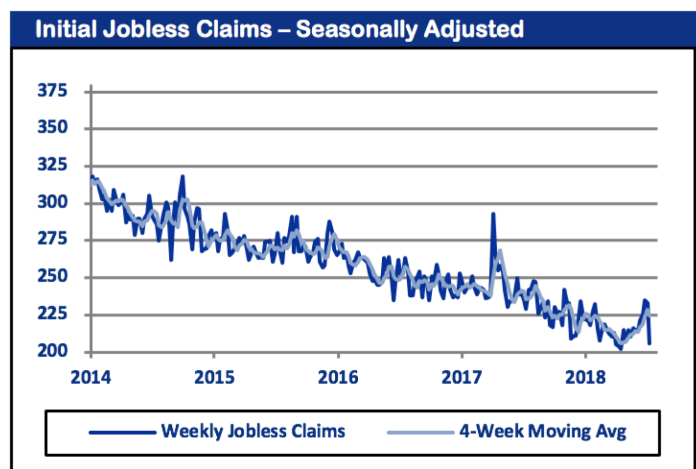

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	57.70	57.50	59.30	January 3 (Tuesday)
GDP annualized	3.50%	3.50%	3.50%	December 21 (Friday)
Unemployment rate	3.70%	3.70%	3.70%	January 4 (Friday)
Retail sales	0.10%	0.50%	0.80%	December 14 (Friday)
Consumer Price Index (YoY)	2.30%	2.50%	2.50%	December 12 (Tuesday)
U. Mich. Consumer Sentiment	98.30	98.30	97.50	December 21 (Friday)
Home Price Index (MoM)	0.09%	0.20%	0.33%	December 26 (Wednesday)

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.

S&P 500® Index

The S&P 500® Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value.

Chicago Board Options Exchange (CBOE) Volatility Index® (VIX® Index)

Created by the Chicago Board Options Exchange (CBOE), the Volatility Index®, or VIX®, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500® index options, it provides a measure of market risk and investors' sentiments.

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