Market
Update

(1/2019)

Allianz Investment Management LLC

January 2019 Market Update

Key Points

- December ended up being the worst month for equity markets since the Great Depression, with the S&P 500® Index down over 9%.
- Jittery investors began to price in increased recession risks as growth uncertainties continued to pile on.
- The Fed overlooked calls for a pause in rate hikes and lifted the policy rate to a range of 2.25%-2.50%.
- The risk-off environment pushed 10-year Treasury rates near their lowest levels of the year.
- Solid labor market data helped reassure investors the economy is not on the brink of a recession.

Outlook

GROWTH: The narrative around slowing growth has caught the full attention of market participants as asset prices have been ultrasensitive to any market signals of a slowdown in activity. Driving the growth slowdown fears has been an expanding list of uncertainties including tariffs with China, Fed rate hikes, declining corporate profits, and the latest government shutdown. While it's normal to see turbulent markets as psychological fears of an impending recession take hold, the risk-off sentiment appears to have gotten ahead of itself. Current economic indicators continue to look healthy and the latest report on the U.S. labor market confirms that. Looking ahead, it's unlikely we will witness fiscally charged GDP prints above 4% as in the second quarter of 2018, but there still may be some wind in the sails for growth as we head into 2019. That said, we're cognizant of the tremendous amount of uncertainties that still persist, but cannot ignore the solid fundamental backdrop that's still in place. As such, our forecast is for U.S. real GDP to moderately slow next year to a range of 2.30% to 2.70% centered on an expectation of 2.50%.

2019 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	2.30% - 2.70%

INTEREST RATES: Dark clouds engulfed markets resulting in declining Treasury yields across the board as safe haven-seeking investors weighed heavily on yield levels throughout December. The risk-off trade brought the 10-year U.S. Treasury to the lowest level since last January at 2.54%. However, the perfect storm that sent rates lower looks to be somewhat overdone as yields have already begun to revert back. For next year, we expect only a modest decline in growth, some additional rate hikes from the Fed, and continued progress on global trade. Against this backdrop there should be some modest upward pressure on rates, but we appreciate the uncertainties that exist and thus our U.S. 10-year Treasury forecast for 2019 is a slightly wider range of 2.80% - 3.40%.

FORECAST PERIOD	10-YEAR TREASURY YIELD
12 months	2.80 - 3.40%

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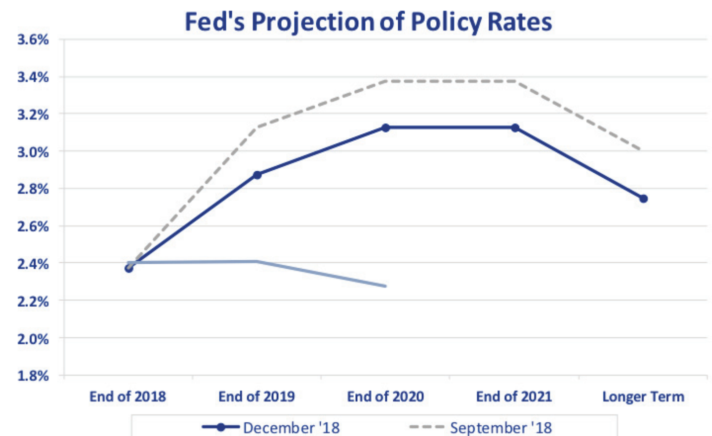
December 2018 Recap & Macro Themes

The Fed's prescription of fewer rate hikes in the forecast for 2019 wasn't enough to cure the latest head cold in the markets as risk assets performed poorly throughout the month of December. Equity markets had one of the worst Decembers on record, with the S&P 500® Index logging a negative 9.18% decline for the month. Partisan politics played a role in the equity weakness as politicians could not come to an agreement on a spending bill. The main contention remains the funding for a border wall and without the passage of a spending bill, the government will remain in a partial shutdown. This was just another layer of uncertainty investors had to contemplate as they navigated through a difficult final month of the year. The weakness in equities combined with the shallower path of rate hikes projected by the Fed has weighed heavily on rates, and the yield curve continued to flatten. As such, the yield on the 10-year Treasury fell all the way down to 2.54% on the first trading day of the new year and moved closer to inversion with the 3-month yield. Since the beginning of the latest equity rout in October, we have witnessed yields on both 10- and 30-year Treasuries drop nearly 70 basis points on volatility and growth concerns. Ultimately, investors began to ask themselves if the Fed will eventually take notice.

With December shaping up to be the worst month for equity markets since the Great Depression, many market participants were cringing at the thought of a rate hike from Chairman Powell's Fed. The drumbeat to pause the rate hiking campaign was coming from all directions. Regardless, the Fed ignored cries for a pause in the rate hiking cycle and moved policy rates up 25 basis points to a range of 2.25% - 2.50%. The economic backdrop was used to justify the rate move as the language in the statement reiterated the solid state of the current economy. Concurrently, the committee attempted to communicate a softer message toward the future path of monetary policy as they lowered the expected number of rate hikes in 2019 from three to two. While the Fed was walking a cautious line with regard to this meeting's statement, it was important for them to bring their dovish tone to the market in strides rather than all at once. If it wasn't already clear to investors, it should be now that the Fed is not here to support equity markets. However, we do expect the Fed to be more data-dependent and monitor financial conditions more closely as uncertainty around growth remains high.



Source: Bloomberg, Federal Reserve, Allianz Investment Management LLC

Market sentiment appeared exhausted following a string of negative headlines which included weaker manufacturing data, a surprise pre-announcement of weaker sales from Apple, and a continued government shutdown. Nonetheless, markets were finally able to shake off the latest cold as a blowout employment report helped reassure market participants that the economy is still performing quite well. Markets often tend to swing too far in one direction, and pricing in rate cuts was likely the tipping point as the solid labor market data helped stabilize equity markets and lift bond yields closer to reasonable levels.

All in all, the economy appears to still be on solid footing, but there is a tremendous amount of uncertainty still lingering - particularly with the government shutdown in its third week, China and U.S. trade tensions remaining high, and Fed policy still somewhat uncertain. We suspect 2019 will likely be characterized by modestly lower growth, a flatter yield curve, and elevated concern of a potential recession on the horizon.

Market Indicators *(figure a)*

- December was one for the books - however, a book that most will not willingly pick up to read, as the Dow and S&P posted monthly losses of 8.66% and 9.18% respectively. Uncertainty around future Fed policy, narratives of an abrupt slowdown of U.S. growth, and ongoing trade worries weighed heavily on equities throughout the month. Overall, equity performance in December was the worst since the Great Depression and resulted in the largest annual losses since 2008.

- The month of December was quite volatile by any standards as the VIX® Index was above 20 for the entire month, except the first day of trading. Compared to 2017, where the VIX® Index never rose above 20, it was one of the most volatile periods we have witnessed in some time. Uncertainty continues to be a driver of volatility and it appears this trend will likely continue in the near term.

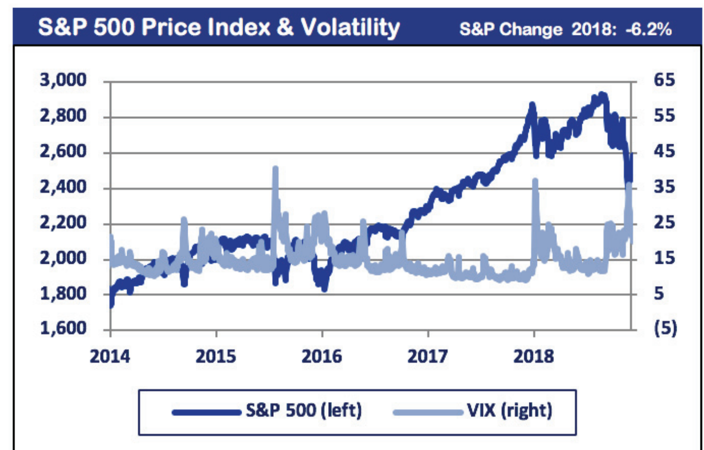
- Volatile market conditions caused U.S. Treasury yields to nosedive during the month as investors sought out safe haven assets. The 10-year U.S. Treasury went from a nearly 3% yield all the way down to 2.68%. By the end of the month, the curve had inverted at the 1-year versus 2-year, 3-year, 5-year, and 7-year points. The flight to quality trade during the month showed just how nervous investors had become about the near-term prospects of the U.S. economy.

- Oil prices remained under pressure for most of the month and pierced below $50 per barrel for the first time since 2017 on risks of a global economic slowdown. Increased production and healthy supplies of crude oil in the market continue to be a headwind for prices. All in all, the price of West Texas Intermediate crude oil dropped by over 10% in January, which ultimately helps the consumer, but at the expense of producers.

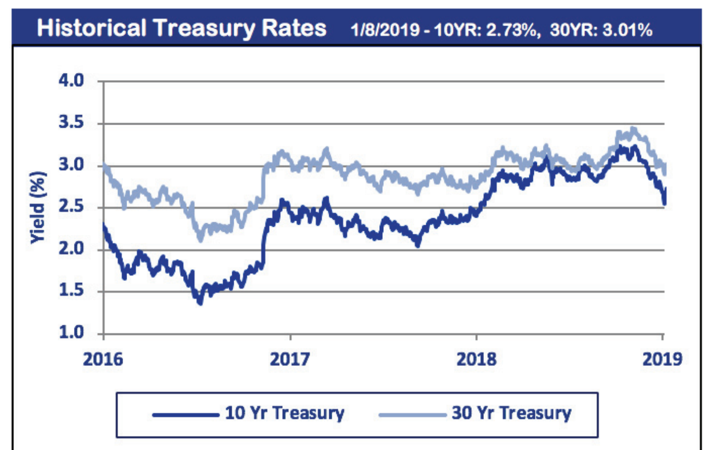
Economic Indicators *(figure b)*

- Consumer confidence, as measured by the Conference Board, declined for the second consecutive month in December. However, the University of Michigan's Sentiment survey remained elevated. Low energy prices and strong labor markets likely contributed to the upbeat sentiment for consumers. On balance, elevated sentiment was likely a tailwind for holiday spending going into the end of the year.

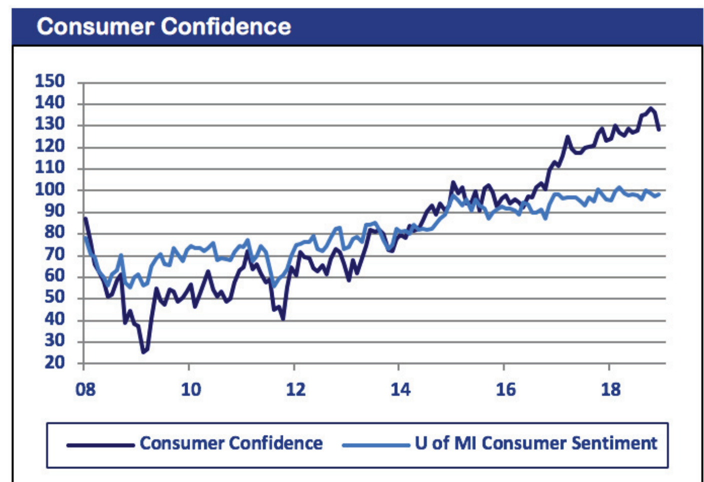
figure a



Sources: S&P, CBOE



Source: Bloomberg



Source: Bloomberg

Economic Indicators *(continued)*

- The third estimate for U.S. growth during the third quarter was one-tenth lower at 3.4%. The small revision was driven by minor revisions lower to both consumption and business fixed investment. Overall, the story remains the same as growth in the third and fourth quarters is expected to be above trend, while subsequent quarters are expected to slow.

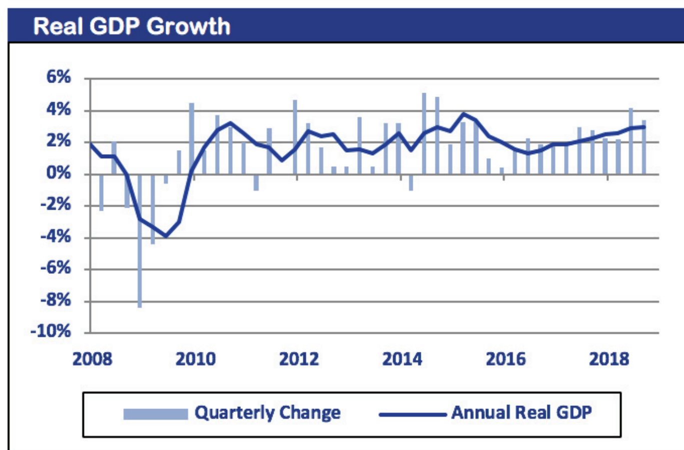
- The decline in energy prices certainly affected headline inflation data, as CPI was flat on a monthly basis and declined to 2.2% on an annualized basis. Core inflation, on the other hand, continued to move upward. Core CPI rose by 0.2%, lifting the annual figure up to 2.2%. Driving core inflation was an outsized 2.4% increase in used vehicle prices. Overall, the increase in core prices will make the Fed think twice before abandoning the rate hiking campaign in 2019.

- December's employment report was a blowout which brought reassurance to investors that the economy is still doing quite well. The headline payroll figure showed 312K jobs added to the economy. Average hourly earnings jumped by 0.4% in December, lifting the annual wage figure to 3.2%. The unemployment rate did go up to 3.9%, but this was primarily due to the participation rate climbing to a 5-year high at 63.1%. Overall, the employment picture remains very solid in the U.S. and will likely provide a solid backdrop for consumption and growth in the U.S. as we progress into 2019.

- The U.S. dollar index remained firm throughout the month as investors typically seek out safe haven currencies during periods of market turmoil. The U.S. dollar index peaked at an intraday high of 97.71 in mid-December, but has reverted lower since. The dollar could remain under pressure throughout 2019 as the number of expected rate hikes from the Fed continues to be questioned.

- The ISM Manufacturing index suffered the largest monthly decline in 10 years with the latest print of 54.1. The decline echoed weaker regional manufacturing surveys released earlier. While the relative decline on a monthly basis was significant, the overall level remains healthy and is consistent with a growing economy in the late innings of the cycle.

figure b



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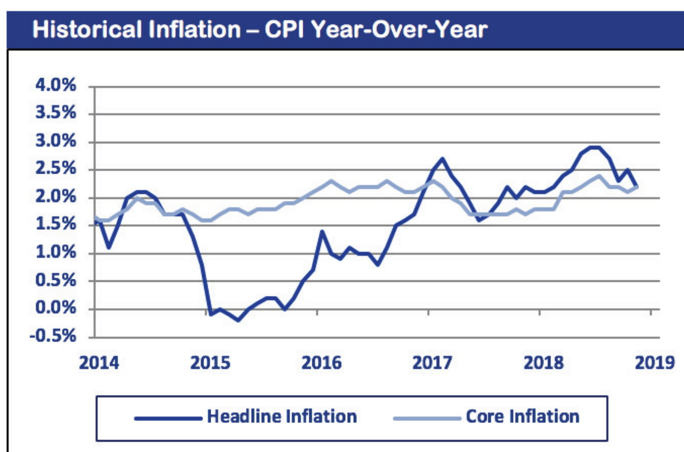

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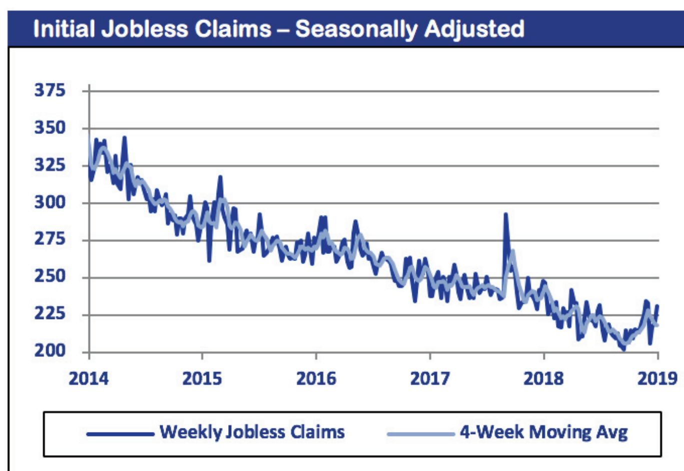

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	59.3	57.5	54.1	February 1 (Friday)
GDP annualized	3.5%	3.5%	3.4%	January 30 (Wednesday)
Unemployment rate	3.7%	3.7%	3.9%	February 1 (Friday)
Retail sales	1.1%	0.1%	0.2%	January 16 (Wednesday)
Consumer Price Index (YoY)	2.5%	2.2%	2.2%	January 11 (Friday)
U. Mich. Consumer Sentiment	97.5	97.4	98.3	January 18 (Friday)
Home Price Index (MoM)	0.7%	0.3%	0.4%	January 29 (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.

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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