Market Update

(2/2019)

Allianz Investment Management LLC

February 2019 Market Update

Key Points

- U.S. equities recorded their strongest January performance in three decades as recession fears have eased from late December.
- With limited economic data coming from the U.S., investors continue to weigh how insulated the U.S. is from the rest of the world economy.
- The message of patience from Chairman Powell's Fed, pertaining to monetary policy, was likely an appropriate move given the mounting uncertainties on the global front.
- Global interest rates continue to decline on poor economic data abroad and this continues to weigh on yields in the U.S.

Outlook

GROWTH: With the government shut down for most of January, economists had to rely on softer data points to project the trajectory of economic activity in the U.S. Adding less clarity to the outlook was the onslaught of negative economic data on the global front. One bright spot that continues to shine is the U.S. labor market as the latest employment report showed 304K jobs were added to the economy in January. This amount was well above the monthly pace required to keep the labor market steady, and while the unemployment rate did tick higher to 4.0%, we did see the labor force participation rate increase to the highest since 2013 at 63.2%. The healthy labor market is a strong signal for economic growth in U.S. as the economy in a large part is consumption-driven. The first reading on 4Q GDP for the U.S. will be released in late February and most market participants are looking for something north of 2.5%. Overall, it appears that the U.S. economy has been insulated from the weight of slowing growth in the global economy, but we will have a better picture as the delayed data starts to present itself.

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

INTEREST RATES: Despite the strong performance of risk assets and the swift V-shaped recovery in equity prices, interest rates have been relatively muted with the 10 year Treasury yield only slightly above the recent low of 2.55% in January. Much of this has been driven by the weight of falling global yields and market participants ruling out rate hikes for the remainder of the year. The change in tone from the Fed to one that exercises patience caught the market slightly off guard, and was enough to keep long-term yields from rising. We expect this wait-and-see mentality to persist during the first half of the year as uncertainties linger. As such, we continue to expect 1-2 more rate hikes this year, which should put some modest upward pressure on interest rates from current levels.

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

January 2019 Recap & Macro Themes

The “January barometer” is an old market theory around the hypothesis that equity performance in the month of January tends to foretell performance for the remainder of the year. While there are many instances in which this theory held untrue, it will be hard to argue in 2019 with equities recording their best January performance in three decades. Looking at the numbers, the S&P 500® Index finished the month up 7.87% and is now up over 15% from the low in late December. The complete reversal of sentiment has been driven by a combination of strong labor market data and the capitulation of the Fed, which now appears to be in a wait-and-see mode for the foreseeable future. Additionally, strong equity performance also brought on significant tightening of credit spreads in the corporate bond sector, with spreads coming in nearly 30 basis points in January. Despite the strong returns across the board, a considerable amount of uncertainty remains around growth as the U.S. and China continue to work out their differences on trade. Both sides met in January to negotiate and while it was reported that “a tremendous amount of progress has been made,” we have yet to see any sort of agreement made by either side. Overall, the developments on trade will be closely watched by market participants over the next 90 days as this likely remains one of the biggest risks to the U.S. economy.

Gridlock in Washington DC came to a head in January as the longest government shutdown in history has proved more problematic than previous episodes. Not only were government agency employees not getting paid, but many market participants who rely on economic data releases from various government agencies were left in the dark until the government could be reopened and data providers could catch up. After being shut down for 35 days the federal government temporarily reopened. President Trump and congressional leaders have come to an agreement to fund the government through February 15. Economically speaking this is good for the U.S. economy as government workers will be receiving back pay and overall, the effects on GDP appear to be minimal at this juncture.

Much of the government shutdown headlines were ignored as market participants focused on the Fed’s abruptly orchestrated messaging campaign to inform investors of their preference for patience when it comes to future policy rate hikes. The complete 180-degree shift from Chairman Powell’s Fed was likely an appropriate move given the mounting uncertainties on the global front. Additionally, with the government in partial shutdown and a good portion of economic data delayed, it makes sense to remain in a wait-and-see mode. Lastly, the collapse in crude oil prices during the fourth quarter should provide some comfort for Fed officials that inflation pressures may be subdued in the near term.

All in all, the elevated level of uncertainty will likely keep the Fed on hold for at least the first half of the year, but we still think the U.S. economy will perform well relative to the rest of the world. Accordingly, the Fed will likely have some more wood to chop in the second half of the year, leaving the potential for one or two rate hikes on the table for now.

With limited economic data coming from the U.S., global risks continued to weigh on investors’ minds and the question is whether or not the slowdown in global growth will have a material effect on the U.S. At this point in time, it doesn’t appear declining global growth is having much of an effect as risk assets in the U.S. continue to perform well. Now that the Fed appears to be on hold and equity markets have rebounded substantially, risk of a recession in 2019 is becoming more limited. In fact, the closely watched recession-indicating spread between the 10-year U.S. Treasury yield and the 3-month Treasury yield continues to be positive. With that being said, global interest rates continue to decline on poor economic data abroad, and this continues to weigh on yields in the U.S. as the 10-year Treasury yield remains exceptionally low. Looking ahead we will be monitoring the backlog of incoming economic data in the U.S. to ascertain how insulated the U.S. truly is from the global economy.

Market Indicators *(figure a)*

- Risk assets performed exceptionally well in January as equity prices displayed a V-shaped recovery. Following one of the worst December performances in history, equities rallied throughout January with the S&P 500® climbing nearly 8% from December's month-end. The Dow and NASDAQ had similar performances, climbing 7% and 9% respectively.

- After a very volatile December, volatility declined significantly in January and ended the month at 16.57. The VIX Index, a measure of volatility, remained below 20 for over 71% of the trading days in January. In comparison, December saw only 5% of its trading days at a volatility level below 20.

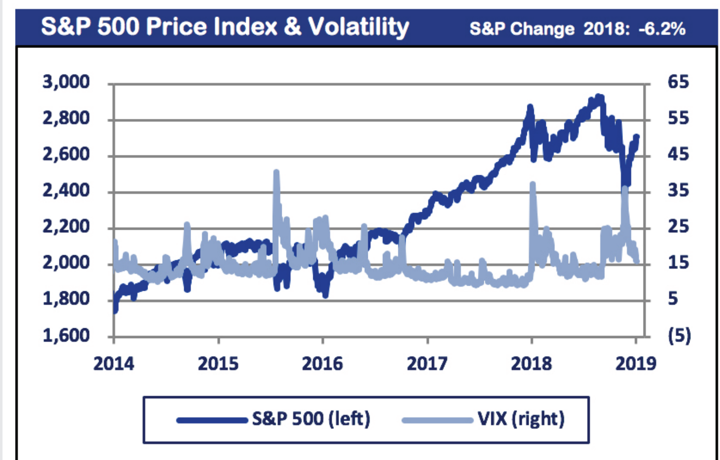
- Despite a turnaround in equity markets throughout January, rates overall remain subdued with the 10-year Treasury ending the month of January just under 2.63%. Dovish speak from the Fed has put downward pressure on rates as investors are pricing in fewer hikes.

- Oil prices recovered in January and posted the best January performance on record. The uptick comes after being under pressure for most of December and subsequently dipping below $50. More specifically, WTI crude oil jumped over 18% during the month and closed out the month just shy of $54 per barrel. That being said, oil prices are still sitting at historically lower levels and won't have much upward pressure as global growth concerns continue to weigh on prices.

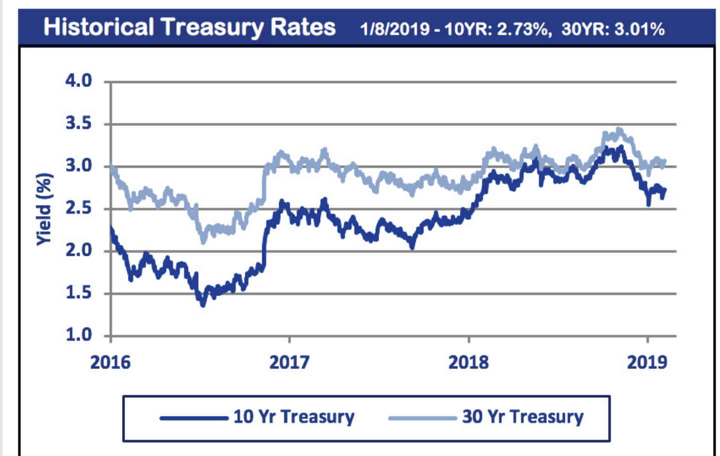
Economic Indicators *(figure b)*

- The final reading of consumer sentiment, as measured by the University of Michigan, came in at 91.2 and marked the lowest level since President Trump was elected. The decline is not surprising as the kick-the-can resolution approach to the government shutdown combined with market volatility has weighed on overall sentiment. The Conference Board's Consumer Confidence Survey told a similar story as it declined for a second consecutive month to 120.2. Again, the shutdown and market volatility were cited as the main drivers.

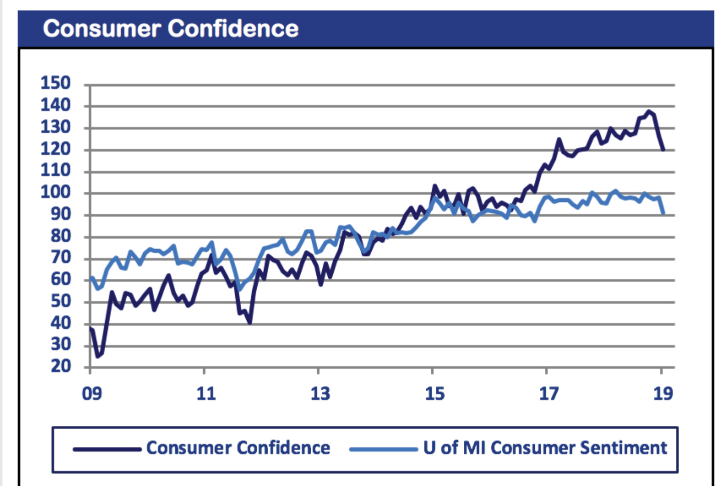
figure a



Sources: S&P, CBOE



Source: Bloomberg



Source: Bloomberg

Economic Indicators *(continued)*

- The government shutdown delayed the release of the advance reading for fourth-quarter GDP. Economists are looking for a 4Q GDP print close to 3%, but we will have to wait until February 28 for the first reading as the shutdown has push backed the data release by close to a month.

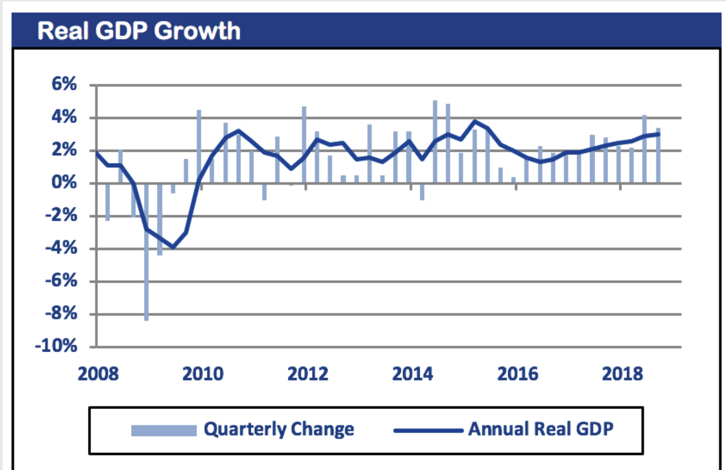
- CPI for December was right in line with consensus forecasts, with the headline figure declining 0.1% and core CPI posting a modest monthly increase of 0.2%. On an annualized basis, this is the first time core inflation has been above headline inflation since June of 2017, sitting at 2.2% and 1.9% respectively. Energy prices weighed on headline inflation and should continue to do so into the first few months of 2019. At the core level, increases in medical care and recreational categories helped lift core inflation by 0.2% for the third month in a row. Overall, core inflation should see modest upward pressure as wage growth continues to rise.

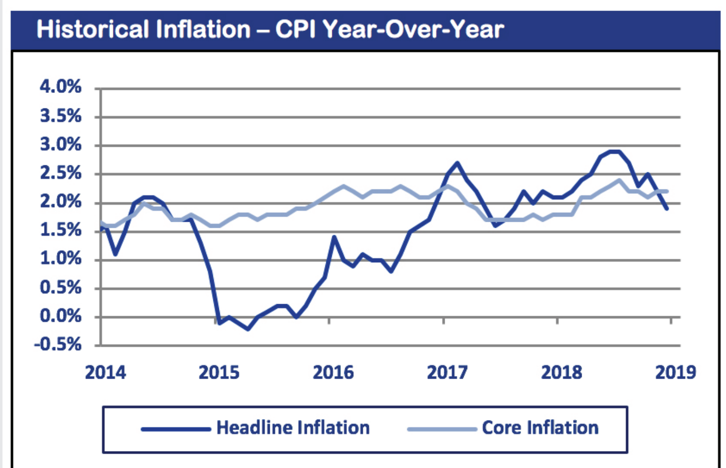
- The U.S. economy added a staggering 304K jobs during the month of January, but the outpaced figure was partially offset by a 90K downward revision to December's payroll figure. The unemployment rate ticked up to 4%, but more workers are coming into the labor force as the participation rate at 63.2% continues to drift higher. While there was a lot of noise in January's report, the important takeaway for us is that the labor market in the U.S. continues to look pretty solid.

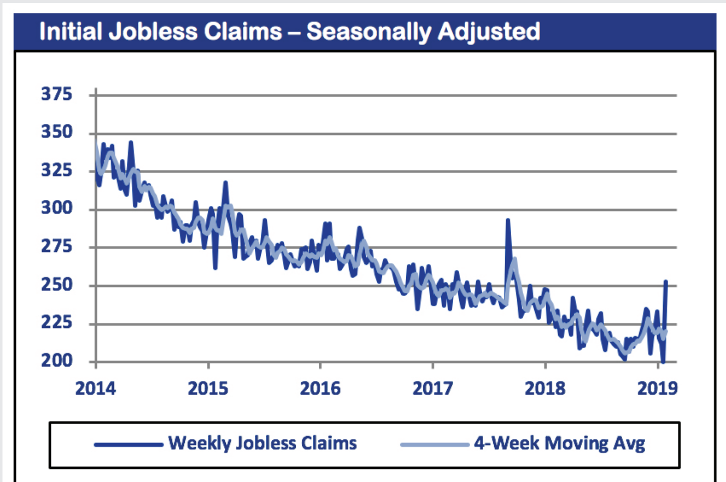
- The US Dollar Index was mixed throughout January but overall has remained at elevated levels in 2019. Driving the strong dollar has been the relatively better growth prospects for the U.S. when compared to other major economies. We expect this trend to continue so long as global economies remain weak.

- Despite showing signs of significant slowing in the manufacturing sector at the end of 2018, the ISM manufacturing figure rose to 56.6 in January and was well above expectations of 54.0. The elevated reading corresponds with solid growth in the sector and indicates that the economy may not be slowing as much as markets were pricing in last month. Within the data, new orders and production improved significantly while new export orders moderated slightly.

figure b







EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	54.10	54.00	56.60	March 1 (Friday)
GDP Annualized	3.50%	3.50%	3.40%	February 28 (Thursday)
Unemployment rate	3.90%	3.70%	3.70%	March 8 (Friday)
Retail sales	1.10%	0.10%	0.20%	February 14 (Thursday)
Consumer Price Index (YoY)	2.20%	1.90%	1.90%	February 13 (Wednesday)
U. Mich. Consumer Sentiment	98.30	96.80	90.70	February 15 (Friday)
Home Price Index (MoM)	0.42%	0.40%	0.30%	February 26 (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 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.

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 expectations of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500® index options, it provides measure of market risk and investors' sentiments.

The views expressed above reflect the views of Allianz Investment Management LLC, as of 2/2019. These views may change as market or other conditions change. This report is not intended and should not be used to provide financial advice and does not address or account for an individual's circumstances. Past performance does not guarantee future results and no forecast should be considered a guarantee either. Allianz Investment Management LLC is a registered investment adviser that is a wholly owned subsidiary of Allianz Life Insurance Company of North America. Allianz Life Insurance Company of New York is also a wholly owned subsidiary of Allianz Life Insurance Company of North America.

Products are issued by Allianz Life Insurance Company of North America, 5701 Golden Hills Drive, Minneapolis, MN 55416-1297. www.allianzlife.com. In New York, products are issued by Allianz Life Insurance Company of New York, 28 Liberty Street, 38th Floor, New York, NY 10005-1422. www.allianzlife.com/new-york. Variable products are distributed by their affiliate, Allianz Life Financial Services, LLC, member FINRA, 5701 Golden Hills Drive, Minneapolis, MN 55416-1297. Only Allianz Life Insurance Company of New York is authorized to offer annuities and life insurance in the state of New York.