Market Update

(4/2019)

Allianz Investment Management LLC

April 2019 Market Update

Key Points

- U.S. stocks had the strongest quarterly performance since 2009 with the S&P 500® gaining 13.07%.
- The 3-month Treasury bill yielded more than the 10-year Treasury for the first time since 2007.
- The Fed now expects to leave policy rates on hold for the rest of 2019, according to the latest summary of projections from the Federal Open Market Committee.
- Despite recession signals like the Treasury curve inverting, the U.S. economy still appears to be on solid footing as the labor market, business surveys, and consumption indicators are still fairly solid.

Outlook

GROWTH: The slowing growth narrative has clearly been a concern for market participants and the Fed alike, but the real question will be whether growth in the U.S. will slow below potential in 2019. There was a lot of noise filtering through the data during the first quarter, including the government shutdown, and like the Fed, we think investors need to remain patient until economic data from the second and third quarter can determine whether U.S. GDP can remain above potential. Looking back, the third revision to fourth-quarter GDP was revised lower from 2.6% to 2.2%, which indicates that the U.S. economy slowed a bit more than most investors expected at the end of last year. Much of the slowdown in the U.S. has been driven by the slowing global economy, which can be traced back to the ambiguity around trade policy. This uncertain environment causes firms to delay decisions on hiring or even making investments. As a result, we are lowering our forecast for growth in the U.S. by 0.3 percent, as the lingering uncertainty around global trade continues to weigh on growth.

2019 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	2.00% - 2.50%

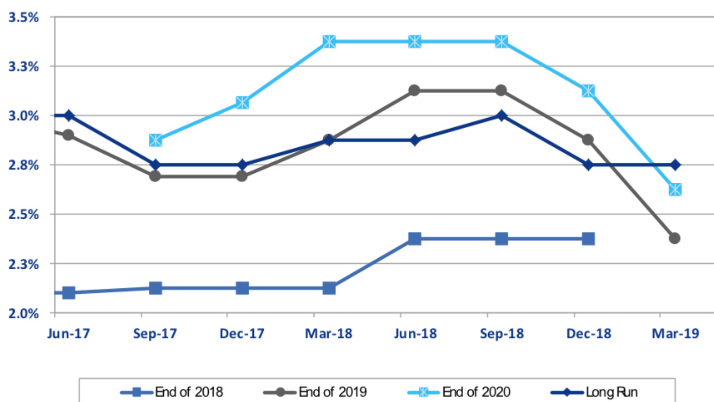
INTEREST RATES: After a few months of subdued levels, bond volatility surged in March following the release of the latest projections from the Fed. The communication was a dovish surprise for many investors, especially those who expected an additional rate hike later this year, as the Fed's projection had zero rate hikes in the forecast for 2019. The change in sentiment from the Fed caused a swift repricing of Treasury bonds, sending the 10-year Treasury yield 31 basis points lower for the month. In turn, the downward pressure on longer bond yields triggered the first inversion of the yield curve since 2007 as the 3-month yield was higher than the 10-year yield for a brief period at the end of March. With the inverted Treasury curve flashing a recession warning, investors began to price in a high probability of a rate cut from the Fed by the end of the year. We think the latest movement in rates is a bit overdone, but recognize what the Fed's dovish policy stance has done to interest rates. Thus, we now expect the 10-year Treasury to end the year in a range between 2.25% and 2.75%.

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

March 2019 Recap & Macro Themes

The dark clouds overhanging markets throughout the first quarter appear to be breaking apart as investors realize economic conditions were not as dire as markets had peen portraying earlier in the year. In fact, U.S. stocks had the strongest quarterly performance since 2009, with the S&P 500® gaining 13.07%. On the other hand, the bond market has certainly been signaling a gloomy outlook, with the Treasury curve inverting for the first time since the financial crisis and the rates market pricing in a high probability of a rate cut at the end of the year. Time will tell whether the inversion of the 3-month and 10-year Treasury yields was a signal for weaker economic activity ahead or simply an anomaly resulting from 10 years of being in a low rate environment.

Perhaps the largest driver behind the divergence between stocks and bonds was the unexpected dovish shift from Fed policy members. At the March Fed meeting, the Federal Open Market Committee released the latest forecast for policy rates through the so-called "dot plot." In the Summary of Economic Projections, the median dots for the year-end target of the Fed funds rate moved lower, leaving the committee no room for additional rate hikes later this year. The communication was a dovish surprise for investors who were expecting a rate hike later this year. The market consequently interpreted this change to mean the Fed was done raising rates in this cycle, which ultimately led to the Treasury curve inverting at the end of March.



Source: Bloomberg, Federal Reserve, Allianz Investment Management LLC

Recession fears have become somewhat of a fixation for investors since the beginning of the year. The recent inversion of the Treasury yields on the 3-month bill and the 10-year note has only provoked the debate even further. Research from the San Francisco Fed indicated that the inversion of yields between the 3-month bill and 10-year note is a consistent predictor of recessions. Accordingly, the spread between the 3-month bill and 10-year note was negative prior to each of the last seven recessions. In most instances, the inversion of the yield curve preceded a recession on average by about a year.

The debate among investors is whether the latest recession signal is a false positive or something investors should focus more closely on. Admittedly, there has been a string of softer economic data during the first quarter, but nothing that suggests a recession is on the immediate horizon. Employment data remains fairly robust with the three-month average job additions at 180K and jobless claims currently at a 49-year low. Business surveys, while somewhat weaker, still remain in expansionary territory with the ISM manufacturing and nonmanufacturing indexes both hovering in the mid-fifties. All in all, the incoming economic data, while noisy, is reflective of a modest slowdown in growth. Whether or not growth continues to slow significantly further is the question investors should be asking.

Regardless of the side you take in the debate, signals of slowing growth are apparent and the inversion of the yield curve is an unwelcome reminder to investors that the possibility of a recession is edging higher.

Market Indicators *(figure a)*

- The S&P, NASDAQ, and Dow equity indexes continued their rally throughout March with all three indexes gaining over the month. Easing trade tensions combined with dovish rhetoric from the Fed, specifically regarding future rate hikes, pushed equities higher. Strong equity performance is characteristic during the later stages of the Fed's hiking cycle as the economy is typically performing at its peak.

- Volatility spiked modestly throughout the month of March; however, it ended only slightly higher than where it had started. Driving the intermittent spikes was dovish speak from the Fed. Overall, volatility has been subdued through 2019, especially from its December high of 36.

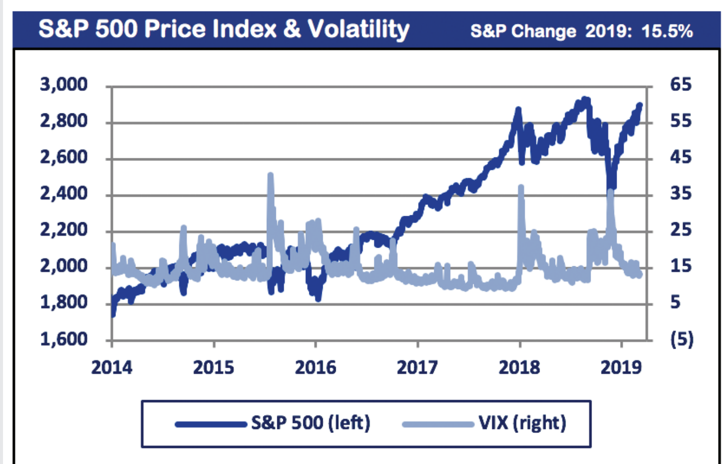
- The overly dovish tone from the Fed's March meeting weighed on rates throughout the month. Specifically, driving the shift lower was the Fed's decision to forecast no rate hikes for the remainder of 2019. Overall, Treasurys declined across the curve with the 10-year falling the most throughout the month at 31 bps.

- Energy prices climbed in March as the price of West Texas Intermediate crude oil rose over 5% during the month. OPEC production cuts continue to put upward pressure on the oil complex despite the concerns around slowing global growth. The next decision on whether to extend or end production cuts is likely to be pushed out until June, which suggests the upward price momentum could continue.

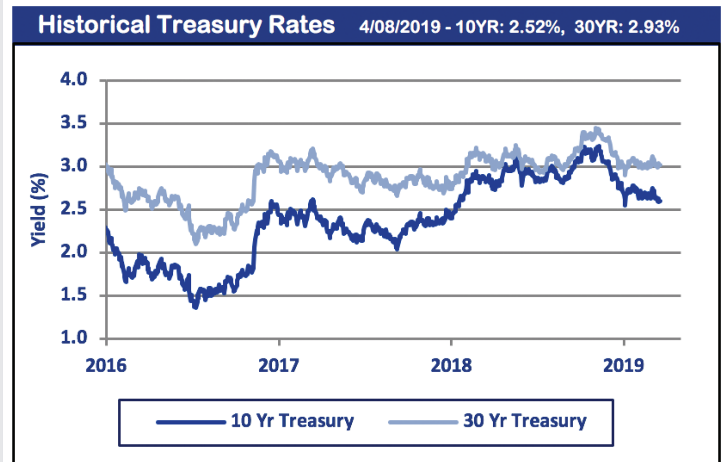
Economic Indicators *(figure b)*

- The gauge of confidence from the consumer was rather mixed in March as the Conference Board's Index on consumer confidence declined, while the University of Michigan's consumer sentiment index surprisingly gained. In the University of Michigan survey, consumers were upbeat about the improvement in personal finances. However, this didn't quite coincide with respondents to the Conference Board's survey who indicated they were not as upbeat about the current conditions. Overall, consumer confidence remains fairly elevated, but we will be watching to see if these measures are more in sync in the coming months.

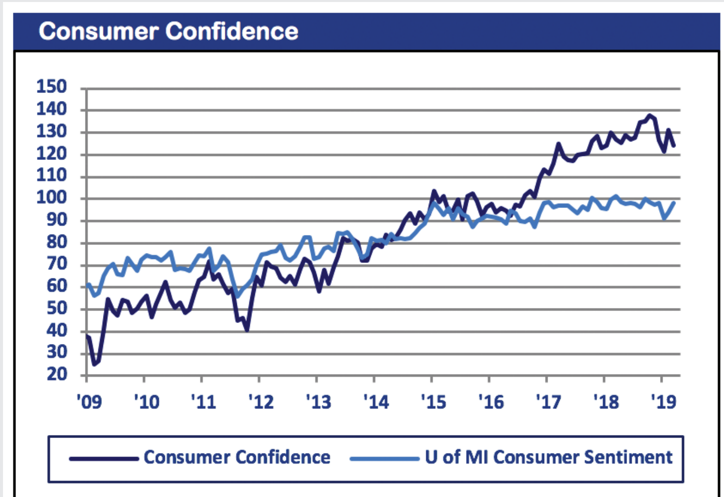
figure a



Sources: S&P, CBOE



Source: Bloomberg



Source: Bloomberg

Economic Indicators *(continued)*

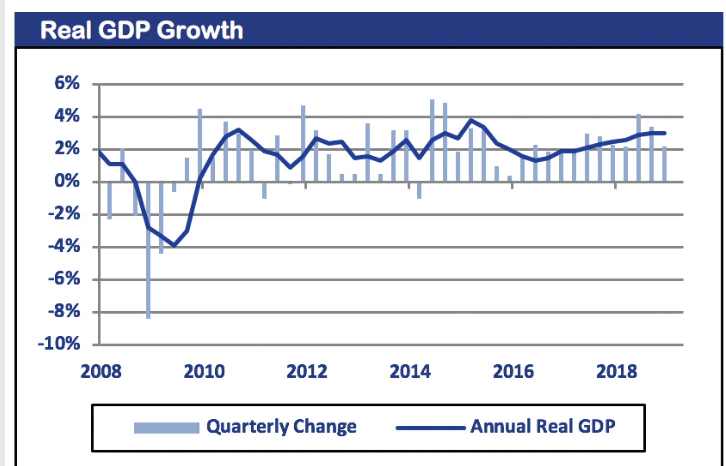
- Fourth-quarter GDP was revised lower from 2.6% to 2.2%, putting the annualized change at 3% for 2018. There were a number of headwinds challenging growth in the first quarter which include the government shutdown, the polar vortex, trade with China, and Brexit. Looking ahead we will be monitoring the incoming data to see whether the U.S. economy is slowing as much as the global economy.

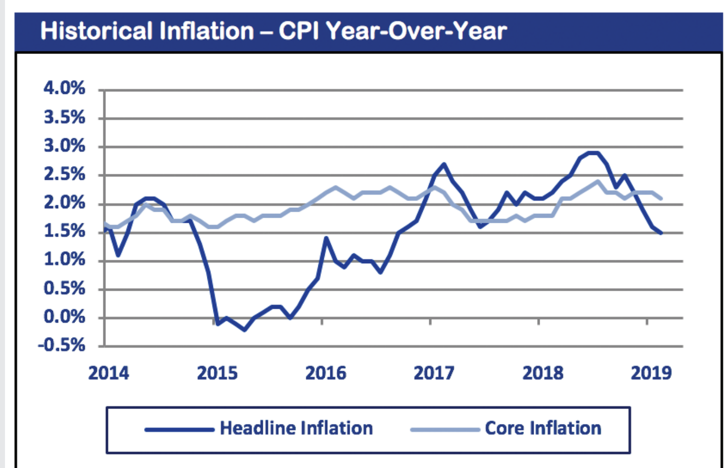
- Rising energy prices during the month of February helped push headline CPI higher as it rose in line with expectations by 0.2%. Opposing, core CPI only rose by 0.1% for the month, as a 0.7% decline in used vehicle prices weighed on the index. On an annualized basis, both headline and core CPI declined by 0.1% to 1.5% and 2.1% respectively. With inflation levels remaining steady, this should provide further runway for the Fed to stay committed to being patient with monetary policy.

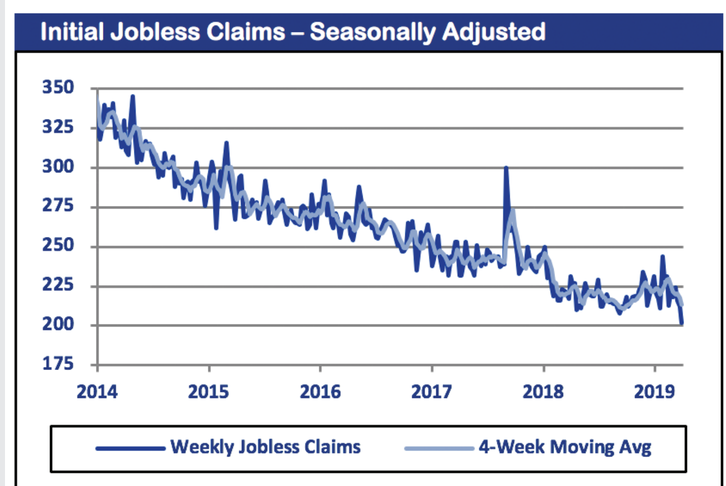
- March's payroll number was a huge sigh of relief for investors as job additions rebounded significantly from the low level last month. Favorable weather during March helped the economy add 196K jobs for the month. With the three-month average of payroll additions around 180K, February's gloomy figure should easily be forgotten. That said, average hourly earnings were somewhat softer than expected, coming in at a monthly gain of 0.1%. Overall, the report dovetails very well into the Fed's current thinking as the labor market conditions remain solid with the unemployment rate below 4% and signs of inflation remain muted.

- The March ISM surveys were mixed with the nonmanufacturing sector falling to a 20-month low and the manufacturing sector rebounding. The nonmanufacturing index disappointed, coming in at 56.1. Declines in business activity, new orders, and deliveries drove the index lower. The manufacturing sector, however, surprised to the upside and came in at 55.3 versus 54.5. Driving the uptick was an increase in new orders. The ISM surveys are becoming increasingly important and scrutinized as investors look for additional signs of a slowdown.

figure b







EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	54.2	54.5	55.3	May 1 (Wednesday)
GDP Annualized	2.6%	2.3%	2.2%	April 26 (Friday)
Unemployment rate	3.8%	3.8%	3.8%	May 3 (Friday)
Retail sales	0.7%	0.2%	-0.2%	April 18 (Thursday)
Consumer Price Index (YoY)	1.6%	1.6%	1.5%	April 10 (Wednesday)
U. Mich. Consumer Sentiment	93.8	95.6	97.8	April 26 (Friday)
Home Price Index (MoM)	0.2%	0.3%	0.1%	April 30 (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.

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