Market Update

(5/2019)

Allianz Investment Management LLC

# May 2019 Market Update

## Key Points

- The labor market continued to tighten with the unemployment rate dropping to 3.6% and marked the lowest reading since December of 1969
- There was no clear signal from the Fed for the next move in policy rates as they appear committed to their wait-and-see policy stance
- U.S. GDP for the first quarter of 3.2% was significantly higher than expectations and a full percentage point above fourth quarter growth
- The Goldilocks environment of moderate growth, steady interest rates, and low inflation has helped propel equity markets to record highs

## Outlook

**GROWTH:** The latest estimate on first quarter GDP for the U.S. may have derailed the slowing growth narrative for the time being as the 3.2% print was well ahead of surveyed economists' expectations of 2.3%. Anecdotally, we continue to see a theme taking shape in which the U.S. economy remains somewhat isolated from the slowing growth pressures abroad. Admittedly, there was some potential borrowed growth in the latest GDP data as much of the increase in growth was driven by an inventory build that will likely be a drag during the second quarter. On the other hand, solid labor market conditions continue to buoy the consumer's ability to spend and there is potential for consumption to pick up in the second quarter relative to the first. It's likely we have yet to witness the aftermath of fading fiscal stimulus from last year. All things considered, we still expect growth to slow from the near 3% level of 2018 to a rate closer to potential growth for the U.S. economy.

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

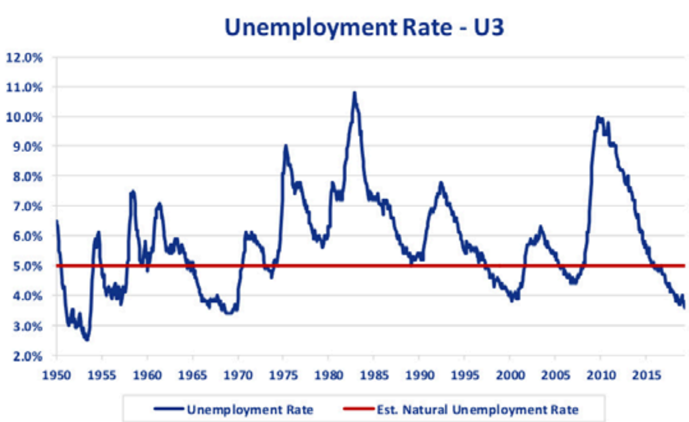
**INTEREST RATES:** For the most part interest rates in the U.S. have succumbed to the downward pressure of global rates. Despite better-than-expected growth in the U.S. and a tightening labor market, U.S. interest rates remained relatively anchored to global rates. The 10-year Treasury yield traded in a fairly narrow range for most of April and ended the month near 2.50%. Absent a pickup in global growth, and with a Fed decisively insisting upon keeping policy rates unchanged, we see little reason for U.S. rates to move substantially higher from here. Our forecast for the 10-year Treasury yield is predicated on the Fed remaining patient with regard to monetary policy for the remainder of the year. Therefore, we continue to expect the 10-year Treasury to be within our range of 2.25% to 2.75%, centered around 2.50%, at the end of 2019.

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

## April 2019 Recap & Macro Themes

Here we are, a mere four months following the worst equity rout since February of 2009 and stocks have already roared back to record highs. The strong performance of risk assets continued throughout April as a Goldilocks environment of steady interest rates, moderate growth, and low inflation began setting the table for the strong rally. However, with rising labor costs potentially squeezing margins and other late-cycle headwinds around the corner, the catalyst for the next leg up in equities is becoming more difficult to spot.

The U.S. economy doesn't appear to be swimming upstream anymore as rebounding economic data was evidenced through the better-than-expected GDP report for the first quarter and the solid employment report in April. Following a brief hiatus in February, the U.S. labor market has come booming back with the headline figure showing 263k jobs added during the month of April. In turn, the unemployment rate has dropped to 3.6% and marked the lowest reading since December of 1969.

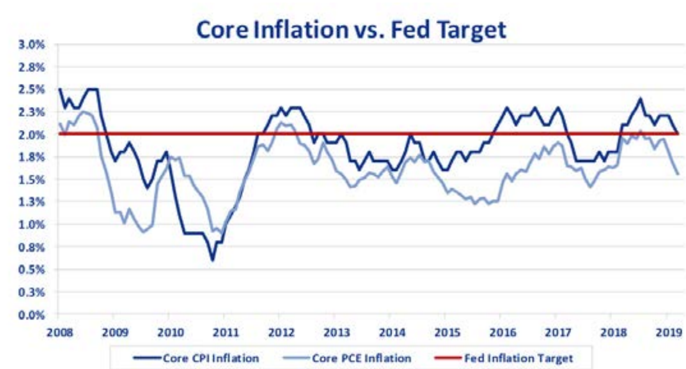



Source: Bloomberg, Allianz Investment Management LLC

The Bureau of Economic Analysis' first pass at estimating Q1 GDP was well above expectations, coming in at 3.2%. This was a full percentage point above fourth quarter GDP of 2.2% and was a sign that growth in the U.S. may not slow as much as some investors had anticipated. While underlying details show much of the acceleration was driven by an inventory build and a smaller drag from imports, we expect this to reverse in the second quarter and consumption spending to pick up again.

Following the latest FOMC meeting, the Fed appears tactically committed to holding interest rates steady for the remainder of the year as growth in the U.S. has slowed less than expected. Though there was no expectation for a rate move in either direction, many investors, including us, were eager to see whether Chairman Powell would throw cold water over the President's latest call for the Fed to move rates lower by one percentage point. Market participants continue to expect the next move in the main policy rate to be lower, but the reiterated patient stance of the Fed may leave both the President and market participants waiting longer for a rate cut. Ultimately, the Fed hasn't tipped their hand to the direction they intend to move policy rates next, leaving market participants to instead take cues from incoming economic data to anticipate their next move.

If investors are taking cues from incoming inflation data, they may want to think twice as the Fed, for the most part, has largely downplayed inflation when it has been slightly above or below their 2% target. The "old school" train of thought has always been that tighter labor markets lead to rising wages that eventually create a cost-push inflationary environment, but this phenomenon has been absent for most of this business cycle.




*Source: Bloomberg, Allianz Investment Management LLC*

As such, we continue to expect some asymmetry around the Fed's target of 2% which indicates the Fed will have little reaction to changes of inflation over the medium term. Considering the current state of the economy and the fact that markets have rebounded significantly, we find the bar fairly high for Chairman Powell to begin nudging rates lower, but then again, the Fed has been prone to policy mistakes in the past, and who is to say this time will be different?

## **Market Indicators** *(figure a)*

- The S&P, NASDAQ, and Dow equity indices moved higher in April with both the S&P and NASDAQ surpassing their historical highs of 2018. First quarter corporate earnings coupled with a higher than expected initial reading on Q1 GDP pushed equities higher throughout the month.

- Volatility was subdued throughout April as the VIX Index sat below 15 for the entire month. This is not surprising as equity markets reached historic highs throughout the month. Steadily increasing equity markets are often associated with lower levels of volatility. Thus, it would not be out of the ordinary for volatility to remain low if equity markets continue to trend higher in the coming months.

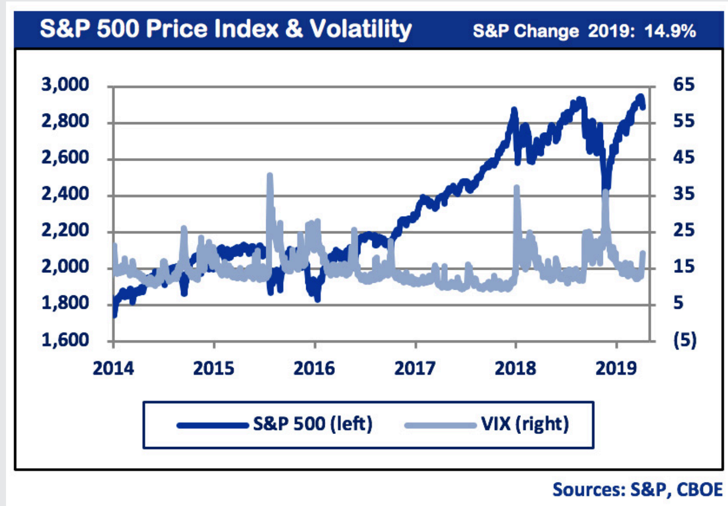
- Treasury yields edged higher throughout the month; however, lackluster inflation data coupled with a patient Fed pushed yields lower at the end of April. Given that the market is currently tilted toward a rate cut, we have difficulty imagining Treasury yields shifting significantly higher without a material change in inflation.

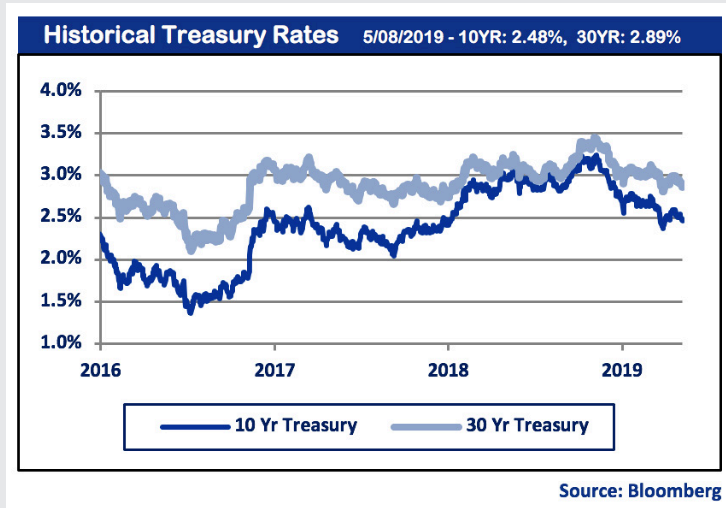
- The price of West Texas Intermediate crude reached a nearly six-month high in April after President Trump announced that the U.S. would not extend sanction waivers on oil imports from Iran after May 2. The uptick, however, did not last as oil prices waned at the end of April following increased crude supply out of Russia and pressure from the President on OPEC to produce more oil in an effort to keep prices low.

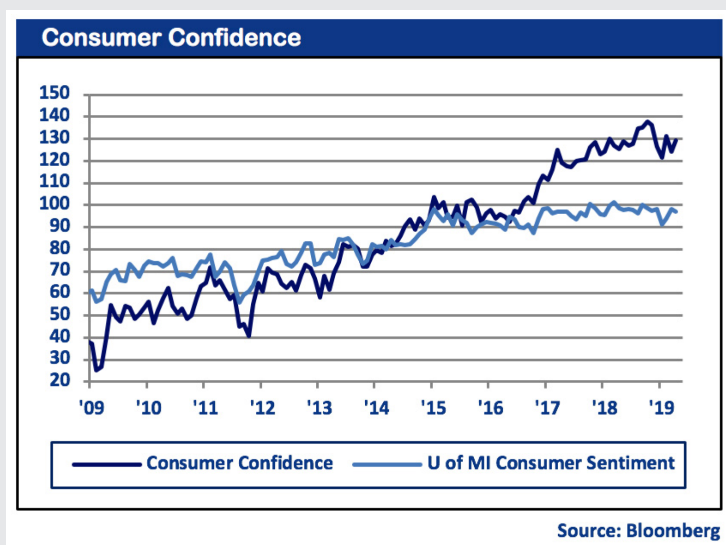
## **Economic Indicators** *(figure b)*

- The Conference Board's measure of consumer confidence indicated an upbeat sentiment from the consumer as the index rose from 124.2 to 129.2 during the month of April. The elevated confidence is a positive sign that consumption will be higher in Q2 relative to the weaker data that was witnessed in Q1. Overall, the current level of confidence is consistent with a healthy growing economy and indicates recession risks have receded further. Contrastingly, the final reading of consumer sentiment, as measured by the University of Michigan, declined in April with the index shifting from 98.4 to 97.2. Both the current conditions and consumer expectations components of the index declined month-over-month.

*figure a*



## **Economic Indicators** *(continued)*

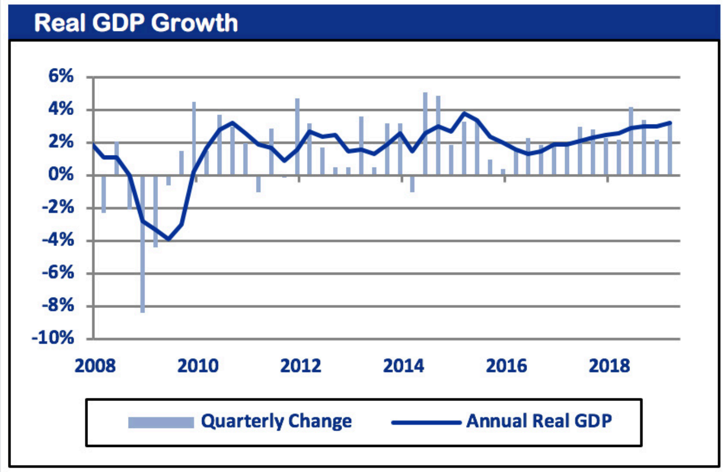
- First quarter GDP surprised to the upside and came in at 3.2% compared to survey estimates of 2.3%. However, looking deeper into the data revealed not as optimistic of a picture. Pushing growth higher was a combination of an uptick in inventories and a lower trade deficit. However, consumption and business investment figures came in at muted levels of 1.2% and 2.7%, respectively. Despite a strong initial reading for first quarter GDP, the market remains concerned about the sustainability of growth, given that the driving factors for this quarter's uptick were likely a one-off.

- Headline CPI rose sharply during the month of March as the 0.4% monthly gain was primarily driven by the rise in gasoline prices. As a result, the annual inflation rate measured by the CPI rose from 1.5% to 1.9%. Core inflation, on the other hand, rose by a mere 0.1% for the month. Coincidently, the Bureau of Labor Statistics changed their methodology on how they calculate apparel prices, which led to the largest monthly decline of apparel prices ever recorded.

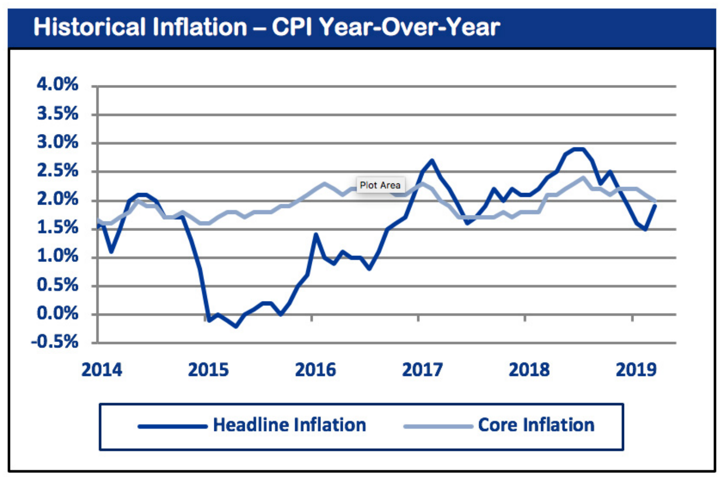
- The U.S. labor market made a roaring comeback in April with the headline figure showing 263k jobs were added during the month. In turn, the unemployment rate dropped to 3.6%. However, any investors looking for inflation were left disappointed as average hourly earnings increased by a modest 0.2%, which left the annualized change in wages at 3.2%. Although payroll additions continued to strengthen in April, wage inflation has yet to make a meaningful appearance. Overall, April's labor market report extends the runway for the Fed to remain patient when it comes to changing monetary policy.

- Both the ISM manufacturing and non-manufacturing indices drifted lower during the month of April. We are somewhat bewildered by the surveys as the data seems to contradict the level of economic activity estimated through the recent labor market report. That being said, it's likely the effects of slowing global trade are finally showing up in the U.S. data. At any rate, we will be watching both surveys closely in the coming months to determine if economic activity is expected to slow further.

*figure b*




Source: Bloomberg

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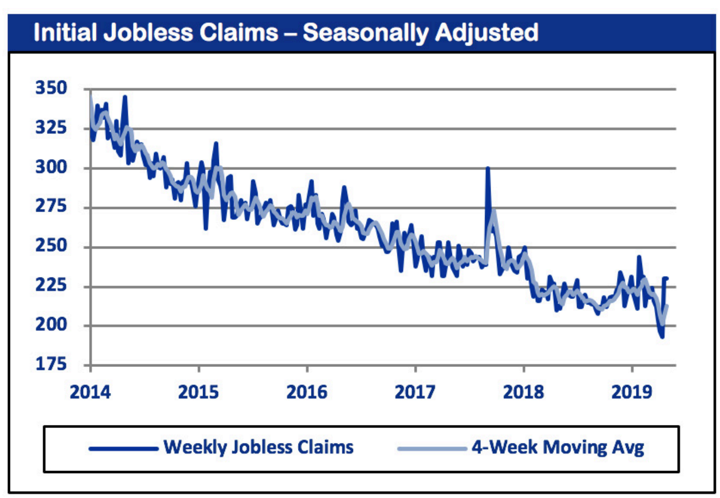


Source: Bloomberg

| EVENT | Previous | Survey | Actual | Next |
|---|---|---|---|---|
| ISM Manufacturing Index | 55.3 | 55 | 52.8 | June 3 (Monday) |
| GDP Annualized | 2.2% | 2.3% | 3.2% | May 30 (Thursday) |
| Unemployment rate | 3.8% | 3.8% | 3.6% | June 7 (Friday) |
| Retail sales | -0.2% | 1.0% | 1.6% | May 15 (Wednesday) |
| Consumer Price Index (YoY) | 1.5% | 1.8% | 1.9% | May 10 (Friday) |
| U. Mich. Consumer Sentiment | 96.9 | 97 | 97.2 | May 17 (Friday) |
| Home Price Index (MoM) | 0.09% | 0.20% | 0.20% | May 28 (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.