Market Update

(6/2019)

Allianz Investment Management LLC

June 2019 Market Update

Key Points

- Tensions between the U.S. and China escalated to a new level in May as President Trump raised tariffs on $200 billion of Chinese imports from 10% to 25%
- Market participants are betting on a rate cut as soon as July with Fed funds futures showing that the probability of a rate cut is greater than 80%
- The U.S. Treasury market witnessed a swift repricing of the curve during the month as the 10-year Treasury yield dropped nearly 40 basis points
- Overall, trade discussions are likely to continue to be a drag on growth until an acceptable agreement is reached

Outlook

GROWTH: Growth in the U.S. has yet to show signs of faltering as the latest estimate on first quarter GDP came in at 3.1%. Much of the volatility and changes in market sentiment have largely been driven by headlines crossing between the U.S. and China on trade. For the most part, data in the U.S. has been relatively good and consumer sentiment remains quite elevated. We acknowledge the weakness that has come through the manufacturing sector with the latest ISM data registering a two-year low, but we suspect some of that softness can be attributed to the uncertainty around global trade. While much of the attention from investors has been focused on trade disputes and the potential for a slowing economy, we need to see further evidence to confirm the downward bias in growth, but a prolonged period without an agreement will ultimately weigh on growth. Therefore, absent an exogenous shock in the market from escalating trade tensions, we expect growth in the U.S. to remain within our range of 2.00% to 2.50% for 2019.

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

INTEREST RATES: Rising expectations for rate cuts from the Fed bled their way into the U.S. Treasury market as we witnessed a swift repricing of the curve during the month of May. There was a dramatic downward shift across the curve with Treasury yields between 2 and 10 years dropping by an average of 40 basis points. Declining yields on U.S. Treasuries is resulting from a combination of several factors. First, fears of escalating tariffs and a prolonged trade war between the U.S. and China has greater potential to slow growth and ultimately continues to increase the odds of Fed rate cuts. In addition, real yields continue to decline as inflation continues to show no sign of picking up despite low levels of unemployment. Overall, we have decided to lower our forecasted range for the 10-year Treasury yield by 25 basis points to reflect the shift in market sentiment and the increased bias towards rate cuts from the Fed later this year.

FORECAST PERIOD	10-YEAR TREASURY YIELD
End of 2019	2.00% - 2.50%

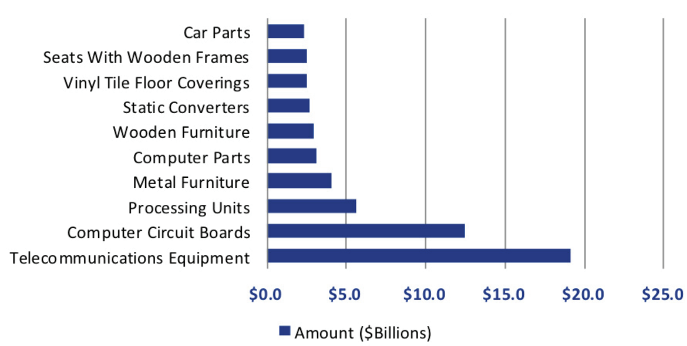
May 2019 Recap & Macro Themes

Markets faced a challenging month as headlines on the trade situation between the U.S. and China crossed back and forth causing more noise and volatility rather than clear direction on where things stand. Geopolitics were the dominating theme in the month of May as the U.S. and China appear to be at an impasse in resolving their differences over trade. The U.S. ultimately raised tariffs on $200 billion of imported Chinese goods from 10% to 25%. Fears of further escalating tariffs leading to slowing growth continue to weigh on markets. As a result, interest rates have declined and the 10-year Treasury yield has dropped to the lowest level since 2017.

The trade war between the U.S. and China escalated to a new level in May as President Trump raised tariffs on $200 billion of Chinese imports from 10% to 25%. The basis for the increase appears to be the result of the Chinese backing away from agreements made in earlier negotiations. In the short run, the impact of increased tariffs will likely have a larger effect on growth in China rather than in the U.S. Nonetheless, rising prices on imported Chinese goods have the potential to raise costs for consumers in the event businesses decide to pass along those additional costs. In any event, the trade discussions are likely to continue to be a drag on growth until an acceptable agreement is reached.

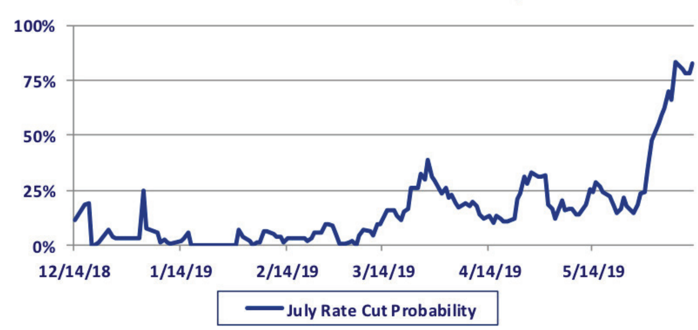
The uncertainty around trade between the U.S. and China is one reason that the Fed has stayed on the sidelines in 2019, and their patient stance is likely to persist in the near term based on the latest Fed minutes. The minutes from the latest Fed meeting reiterated the Fed's preference for patience when it comes to making monetary policy decisions. Specifically, the minutes revealed that the Fed felt their current patient approach would be "appropriate for some time." With regards to the economy, the committee highlighted the strength of the labor market and also discussed the decline in inflation below their 2% target. However, the minutes also attributed a portion of that inflation softness to "idiosyncratic factors that seemed likely to have only transitory effects on inflation." Finally, the minutes discussed a staff presentation that weighed potential scenarios for the future composition of the Fed's balance sheet, including one where the Fed held mostly short-dated Treasuries. Overall, the market is at odds with the Fed as market participants are betting on a rate cut as soon as July with Fed funds futures showing the probability of a rate cut is greater than 80%. With recent Fed speak indicating most members of the Fed are split on the rate cut discussion, we suspect there will need to be a stronger shift in the language at the June Federal Open Market Committee meeting for a July rate cut to come to fruition.

Top 10 Import Items From China Facing 25% Tariff



Source: Bloomberg, USTR, Allianz Investment Management LLC

Fed Rate Cut Probability



Source: Bloomberg, Allianz Investment Management LLC

Market Indicators *(figure a)*

- Major equity indices spent most of the month of May in the red with the S&P 500, Dow Jones, and the Nasdaq all down more than 6% during the month. Heightened trade tensions and increased tariffs on imported Chinese goods was the culprit. Equities clearly have a negative reaction to tariffs, but a more dovish Fed combined with increased expectations for rate cuts has helped support equity prices in recent weeks.

- The CBOE Volatility Index (VIX) rose above 20 for the first time since January as angst among market participants grew on the back of rising trade tensions. While the VIX has settled down somewhat from the elevated levels in May, we expect volatility to remain high as trade uncertainties persist.

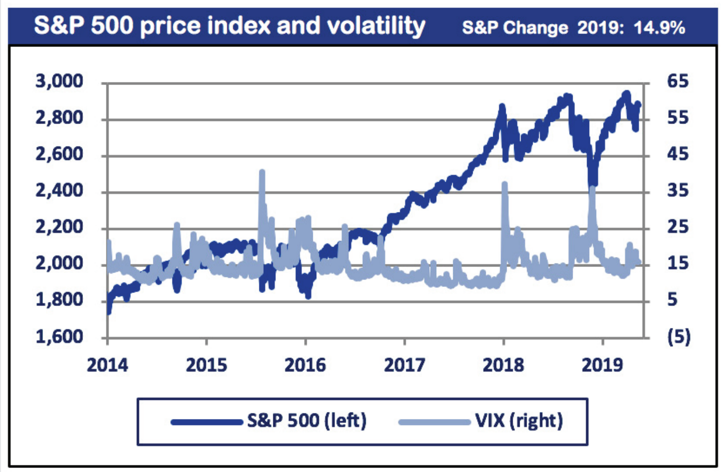
- The U.S. Treasury curve migrated significantly lower during the month of May as investors dramatically priced in the likelihood of rate cuts from the Fed. The 10-year U.S. Treasury yield dropped nearly 40 basis points during the month to a low point of 2.12%. Additionally, the sharp decline in long-term interest rates inverted the yield curve at the 3-month and 10-year points, which is a strong recessionary signal for market participants.

- Oversupply concerns coupled with increased trade tensions weighed on crude oil prices in May. The price of West Texas Intermediate Crude declined by 16% over the month to the lowest level since February. Lower oil prices should translate to lower gasoline prices at the pump, which ultimately benefits the consumer, but the swift decline of oil prices in May is another signal that investors are worried about a slowing economy.

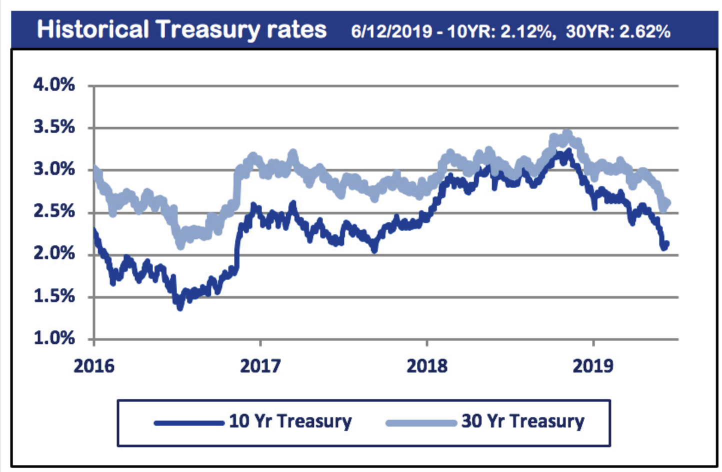
Economic Indicators *(figure b)*

- Despite increased market volatility over trade, consumer sentiment data released for May still paints a rosy picture from consumers. Consumer confidence, as measured by the Conference Board, climbed to its highest level since last November. The University of Michigan consumer sentiment reading also remained elevated at 100. Overall, both readings were strong, however increasing concerns around growth prospects combined with escalating trade tensions will likely weigh on sentiment going forward.

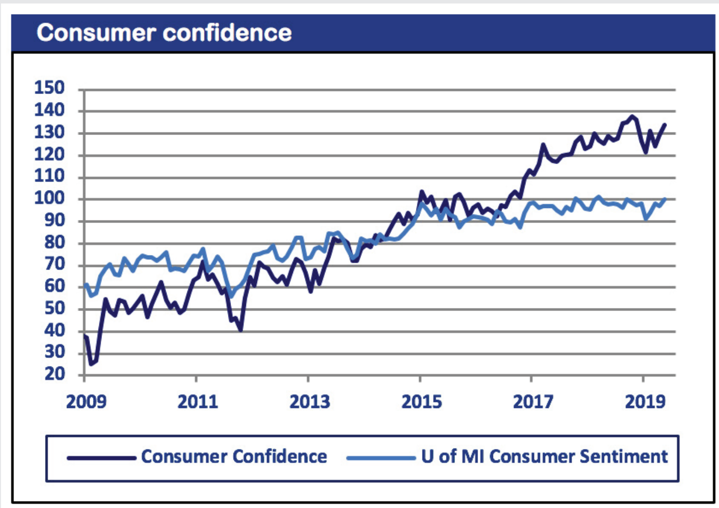
figure a



Sources: S&P, CBOE



Source: Bloomberg



Source: Bloomberg

Economic Indicators *(continued)*

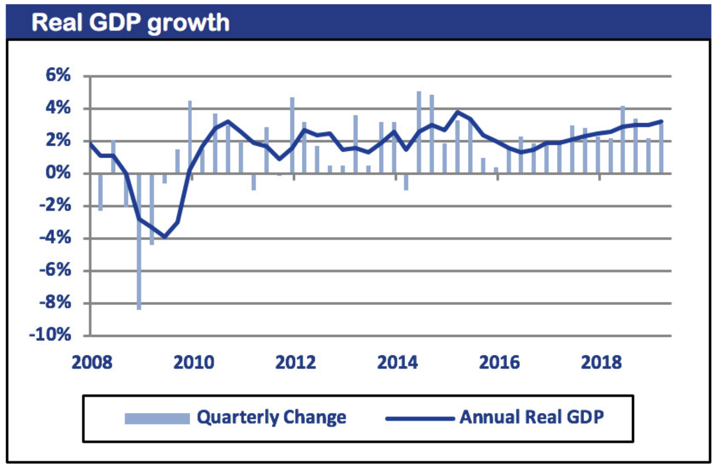
- The second estimate for first-quarter growth was revised lower by 0.1% to 3.1%. Within the details, consumer spending was revised upward to 1.3%, but still somewhat depressed. Most of the growth in the first quarter was derived from a build in inventories, and there is a widely held expectation among investors that a payback will likely flow through the second-quarter GDP print. On balance, the first half of the year looks pretty positive, but it's the second half of the year that investors have become more worried about.

- A tighter labor market and rising wages in the economy has had little effect on inflation data as CPI failed to meet expectations again. Headline consumer prices rose by 0.3% month-over-month, while core consumer prices rose by a modest 0.1%. Both figures fell short of estimates by 0.1%. Core goods prices such as apparel and used cars weighed on the index. The subdued inflation data will likely allow the Fed to keep rates steady for longer as there is less reason to hike rates.

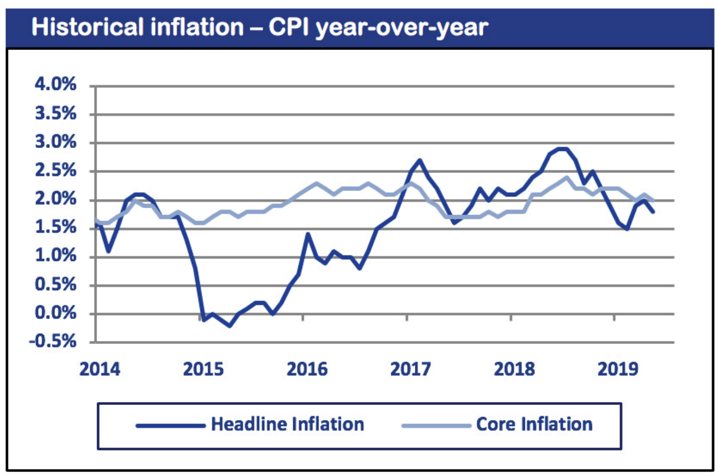
- The U.S. economy added a mere 75k jobs during the month of May, which was 100k below Wall Street expectations. Additionally, the prior two months' figures were revised downward by 75k, indicating the labor market has lost some steam. While much of the attention from investors has been focused on trade disputes and the potential for a slowing economy, the disappointing employment report provides some evidence that the end of the business cycle is upon us and economic activity is slowing.

- While the manufacturing sector has faltered as of late, businesses surveyed in the non-manufacturing sector continue to remain upbeat. The latest ISM manufacturing index declined to the lowest level in two years at 52.1. Trade disputes and tariffs have clearly become a headwind for the sector as uncertainty remains elevated. On the other hand, the ISM non-manufacturing index rose unexpectedly to 56.9, which helps ease concerns that growth is falling off a cliff. Overall, the data suggests growth will be slowing, but not as quickly as the manufacturing sector suggests.

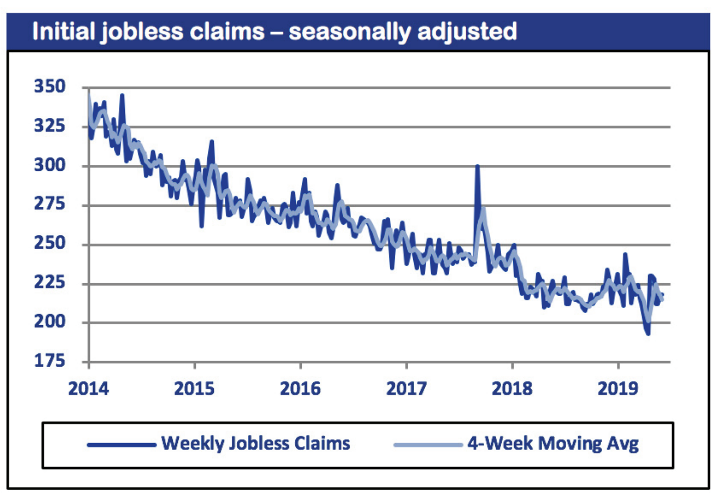
figure b



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	52.8	53.0	52.1	July 1 (Monday)
GDP Annualized	3.2%	3.0%	3.1%	June 27 (Thursday)
Unemployment rate	3.6%	3.6%	3.6%	July 5 (Friday)
Retail sales	1.6%	0.2%	-0.2%	June 14 (Friday)
Consumer Price Index (YoY)	2.0%	2.1%	2.0%	July 11 (Thursday)
U. Mich. Consumer Sentiment	102.4	101.5	100.0	June 14 (Friday)
Home Price Index (MoM)	0.2%	0.5%	0.1%	June 25 (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.