Market Update

(7/2019)

Allianz Investment Management LLC

July 2019 Market Update

Key Points

- Patience is no longer a virtue for Fed Chairman Powell as the increased uncertainty has moved the Fed closer to implementing easier monetary policy
- The dovish Fed meeting helped lift the Dow Jones Industrial Average and the S&P 500 reached new all-time highs in June
- Pressure remained on U.S. rates as the 10-year Treasury dropped below 2% for the first time since 2016
- The amount of negative-yielding debt across the globe surpassed $13.0 trillion as the scarcity of high quality assets has become more apparent

Outlook

GROWTH: While the official second quarter GDP data has yet to be released, signs of slowing growth have become evident in the latest business surveys from the Institute for Supply Management. It appears as if the disruption of global supply chains from trade uncertainty have started to take hold and growth in the U.S. may have begun to pull back. Most economists are expecting second quarter growth to be weaker than the first with the primary reason being the strong inventory build in the first quarter that will likely be a detractor to growth in the second quarter results. However, we suspect some of the uncertainty around global trade will likely weigh on growth in the near term. In addition, given that economic momentum has slowed abroad, it's a widely held expectation that those headwinds will spillover into the U.S. Overall, we still expect growth for the year to be within our range of 2.00% to 2.50% with subsequent quarters coming in weaker than the first.

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

INTEREST RATES: Rates have been on a declining trajectory since their peak in November of 2018 with the 10-year Treasury yield falling over 100 basis points over that period. The combination of muted inflation pressures, deteriorating economic growth abroad and central banks moving back towards easing monetary policies has pushed longer-term interest rates lower. The Treasury yield curve at the 3-month and 10-year point has been inverted since May which is a strong signal to the Fed that short-term policy rates are likely too high. We expect the bias for the Fed to begin cutting rates to continue to pick up through the remainder of the year which should take some pressure of longer-term rates in the second half of this year. Consequently, we still expect the 10-year Treasury to finish the year within our range of 2.00% to 2.50%.

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

June 2019 Recap and Macro Themes

Patience is no longer a virtue for Fed Chairman Powell as the increased uncertainty around global trade and weakening data in the manufacturing sector has pushed the committee to take a more dovish stance on interest rate policy for the remainder of the year. It appears that market participants have nudged the Fed closer to the idea of "insurance" rate cuts in order to extend the current economic expansion. Market expectations for a rate cut at the July 31 meeting are currently at 100%, but it's unclear to investors whether the Fed will implement a 50 basis point cut or tactfully move policy rates lower by only 25 basis points and make further cuts later in the year. At any rate, equity markets cheered the dovish tilt out of the Fed meeting as the Dow Jones Industrial Average and the S&P 500 reached new all-time highs in June.

While equity investors applauded the idea of "insurance" rate cuts from the Fed, bond investors have likely been facing a challenging environment in search for yield from high quality assets. Bond yields around the globe continued to drop in June as central banks, including the ECB and the Fed, signaled the possibility of implementing more accommodative monetary policy. As a result, the 10-year Treasury dropped below 2% for the first time since 2016 and the amount of negative-yielding debt across the globe reached $13.0 trillion for the first time. This level surpassed the previous high back in 2016 and is particularly worrisome as the scarcity of high quality assets is becoming more apparent.

Source: Bloomberg, Allianz Investment Management LLC

Geopolitical uncertainty has been the dominating theme in recent months and there was an overabundance of headlines traded back and forth between the U.S. and China throughout the month. Most importantly, market participants were eager to learn the outcome between the scheduled meeting between President Trump and President Xi Jingping at the G-20 summit to gauge where the trade war between the U.S. and China is headed. Surprisingly, the meeting between Presidents concluded with the most favorable outcome where both leaders agreed to a temporary truce on increasing tariffs while both sides resume the negotiating process. With little expectation of a trade deal coming out of the meeting, the result was highly favorable and equity markets reacted accordingly by rallying to new highs. Relations between the U.S. and China have not been the only ones under stress lately as tensions escalated further with Iran last month. Reports surfaced that a U.S. drone was shot down over the Strait of Hormuz by Iran. At this point the U.S. has withheld from retaliating with airstrikes, but nonetheless tensions in the region remain very high. The increased tensions with Iran have spilled over to energy markets as the price of WTI crude oil has climbed nearly 10% in June. Despite the de-escalation of trade tensions with China, the tense situation between the U.S. and Iran is a stark reminder of how fragile the geopolitical front really is.

Overall, the recent developments in June won't make it easy for Chairman Powell or the other Fed members as they embark on a course correction in the direction of monetary policy. Equity markets are at all-time highs, the unemployment rate is near the cycle-low, yet bond markets are behaving like a recession is on the horizon. The idea of "insurance" rate cuts may be a difficult proposition for some policy makers to grasp, but markets are signaling that rate cuts are required in order to sustain the current economic expansion. We'll see at the end of the month if the Fed fulfills the markets wishes.

Market Indicators *(figure a)*

- Equities posted one of the best Junes on record as the S&P 500 and the Dow Jones Industrial Average erased all of their losses from the month of May. Much of the gains can be attributed to the dovish commentary from the Fed and the high probability of rate cuts in the coming months. In addition, the potential for increased tariffs with China has been taken off the table. To the extent the Fed carries through with rate cuts, we expect equities will remain supported.

- Volatility measured by the CBOE VIX Index declined over the month of June as dovish Fed commentary lifted the possibility of rate cuts and the U.S. agreed to a temporary tariff truce with China. Overall, the VIX Index dropped by nearly 5% to 15.08, but not quite to the low levels we witnessed in April.

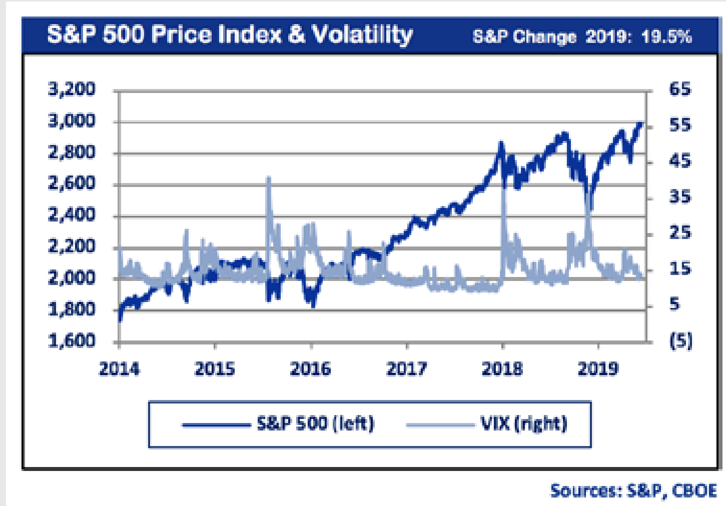
- Treasury yields remained well anchored by the decline in global yields during the month of June. With both the German and French sovereign 10 year bond yields in negative territory, there has been a slow momentum for U.S. Treasury yields to drift lower. Consequently, the 10 year Treasury yield dipped below 2% for the first time since 2016. With inflation expectations in check and growth beginning to slow it is difficult to see a path for higher rates at this time.

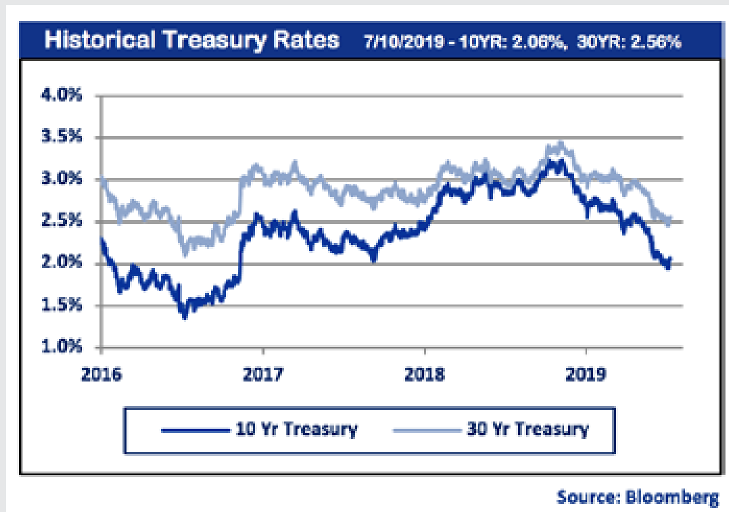
- The price of West Texas Intermediate Crude oil rebounded last month as heightened geopolitical tensions between the U.S. and Iran were the driving factor. Oil prices rose to nearly $60 per barrel following the airstrike on a U.S. drone. In addition, OPEC has agreed to curb production over the coming year in order to bring balance back to the market. We suspect the combination of factors will support oil prices for the time being.

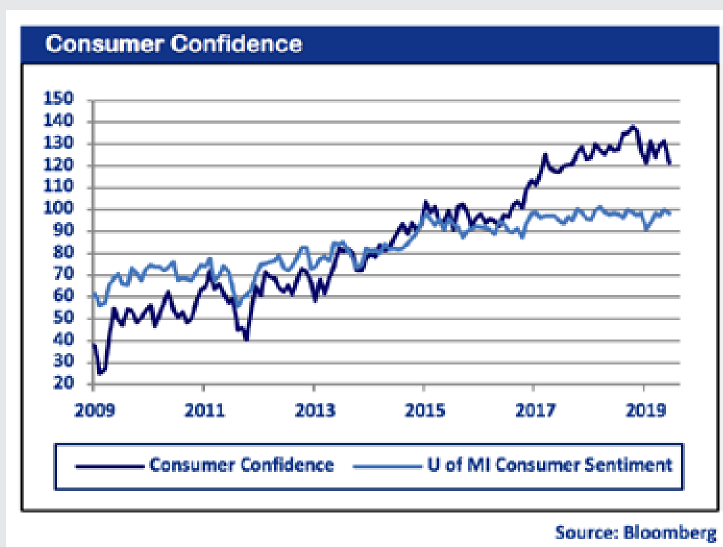
Economic Indicators *(figure b)*

- Surveys on consumer sentiment were all over the board this week which makes it difficult to pinpoint an accurate reading on consumer's attitudes. The Conference Board's index on consumer confidence dropped nearly 10 points to the lowest level since 2017. Some of this weakness could be driven by the escalating trade tensions, but it's really unclear at this point. On the other hand, the University of Michigan's survey on consumer sentiment rose to 98.2 and still indicates strong positive sentiment from the consumer. Taken together, it's difficult to get a read on where sentiment is headed.

figure a







Economic Indicators *(continued)*

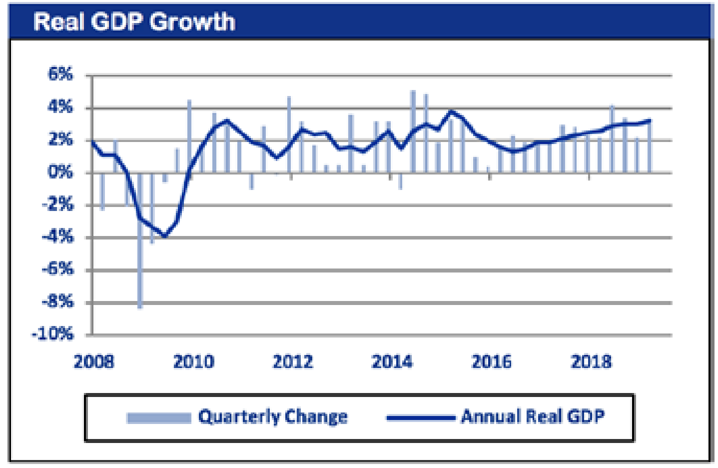
- The third reading on first quarter GDP came in unchanged as there were only minor adjustments to the data that were mostly offsetting. What matters going forward is how the second half of the year will shake out and expectations for slowing growth have been a dominant theme throughout the first half of the year. For example, the inventory build that helped lift GDP in Q1 is likely going to be a detractor in Q2. However, most market participants are trying to ascertain how much the elevated trade tensions are affecting current quarter growth.

- Even with a solid economy and low unemployment, inflation continues to remain unresponsive as core consumer prices measured by the CPI rose by a mere 0.1% in May. In addition, falling energy prices kept a lid on headline CPI as it also rose by only 0.1%. On an annualized basis, headline and core CPI came in at 1.8% and 2.0% respectively. The bottom line is that weaker inflation prints provide additional reasoning for the Fed to contemplate cutting the Fed funds rate, but we will have to wait until the end of July to see what the committee ultimately does.

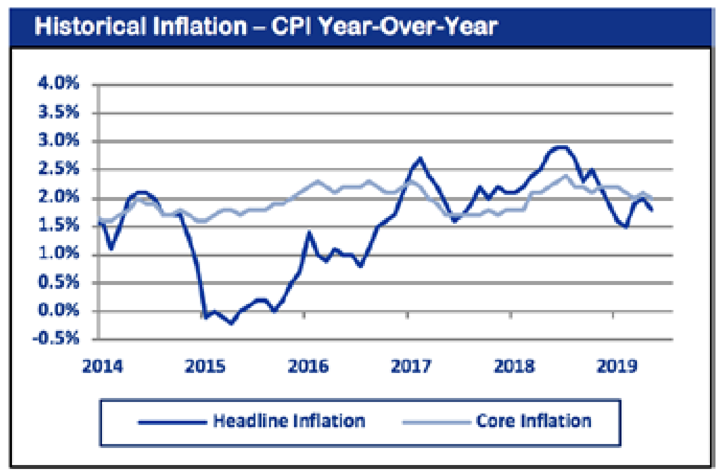
- Nonfarm payrolls surprised to the upside for June as the report showed the economy added 224k jobs. The unemployment rate and labor force participation rates were little changed at 3.7% and 62.9%, respectively. Average hourly earnings increased 0.2% month-over-month while the average work week was unchanged at 34.4 hours. Overall, the solid labor market report will be a hot-button topic of debate amongst Fed members at the upcoming meeting in July as they decide whether to cut rates or remain on hold.

- The results within the latest ISM surveys continue to suggest the economy is slowing as the manufacturing index dropped to 51.7 and the non-manufacturing index dropped by nearly 2 points to 55.1. Overall, both surveys indicate the economy remains in expansionary territory. However, many investors are watching the line in the sand of 50.0 on the manufacturing survey as a reading below that level would indicate an economy that is in a recession.

figure b



Source: Bloomberg



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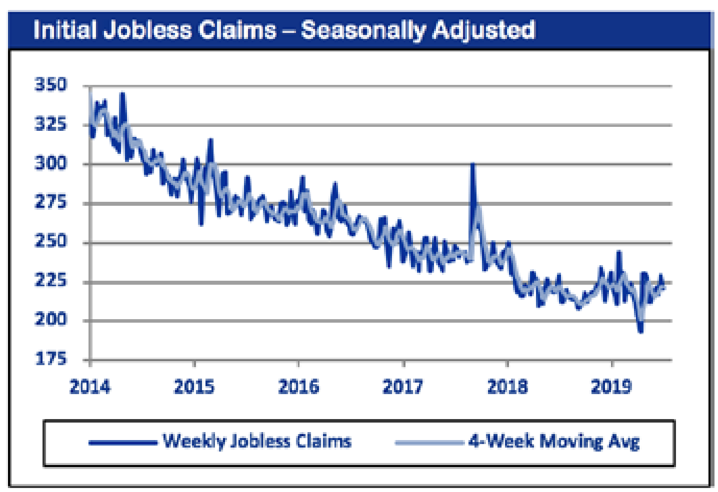

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	52.1	51.0	51.7	August 1 (Thursday)
GDP Annualized	3.1%	3.2%	3.1%	July 26 (Friday)
Unemployment rate	3.6%	3.6%	3.7%	August 2 (Friday)
Retail sales	0.3%	0.6%	0.5%	July 16 (Tuesday)
Consumer Price Index (YoY)	2.0%	1.9%	1.8%	July 11 (Thursday)
U. Mich. Consumer Sentiment	97.9	97.9	98.2	July 19 (Friday)
Home Price Index (MoM)	0.3%	0.1%	0.0%	July 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.