Market Update

(8/2019)

Allianz Investment Management LLC

August 2019 Market Update

Key points

- The Fed cut policy rates for the first time in over a decade and deemed the 25 basis point “insurance” cut as a pre-emptive measure to maintain economic performance.
- Growth has been slowing, particularly from business investment, but consumer spending has kept the wind in the sails of the U.S. economy.
- Equity markets rose to all-time highs in July, but the fanfare was short-lived as new tariff threats from President Trump escalated trade tensions with China to a new level.
- While some Fed members were reluctant to cut rates against the current economic backdrop, it’s likely we will see further easing down the road.

Outlook

GROWTH: Despite growth for the second quarter coming in stronger than expected at 2.1%, emergent signs of a precipitous slowdown in growth both globally and on the domestic front have begun to take hold. Something particularly worrisome to investors and us alike has been the deteriorating data coming from business surveys on both the manufacturing nonmanufacturing sectors. Within the latest GDP data we witnessed a sharp decline in business investment, and we believe this is likely a direct result of the ongoing trade disputes. Specifically, the high level of uncertainty and disruptions to global supply chains has caused business managers to delay investment decisions or put them off completely. On a positive note, consumer spending has been quite strong with personal consumption rising to the highest level since 2017 at 4.3% and has, in a large part, kept the wind in the sails of the U.S. economy. On balance, we expect stronger growth during the first half of the year to act as a buoy for weaker growth in the second half and therefore put GDP within our projected range of 2.00% to 2.50%.

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

INTEREST RATES: The perfect storm is brewing in the U.S. rates market as the combination of central bank easing, flight-to-quality, slowing growth, and negative global rates has put significant downward pressure on bond yields. The 10-year Treasury dropped to the lowest level since 2016 as investors fear there is no end in sight to the ongoing trade war with China. The Federal Reserve lowered policy rates by 25 basis points in July, but we, along with most market participants, expect more rate cuts will be coming in light of the escalating trade tensions with China. Additionally, President Trump’s decision to apply more pressure to China through increased tariff proposals has spooked investors and led to a strong flight-to-quality trade in U.S. Treasuries. Overall, this perfect storm for the rates market has pushed yields below our year-end target for the time being, but at this point we expect yields will revert back to our forecasted range.

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

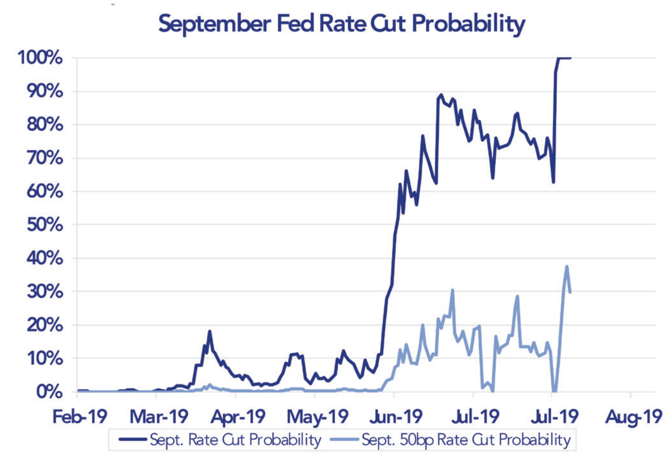
August 2019 recap and macro themes

Milestones were made in July as the S&P 500 closed above 3,000 and the Dow Jones Industrial Average closed above 27,000 for the first time in history. The positive sentiment was drawn from a dovish stance from the Fed, economic data that held up better domestically rather than abroad, and a start to the corporate earnings season that was generally better than expected. Overall, there was a good stretch where trade tensions had simmered down, but investors were swiftly reminded how fast the tables can turn as tensions with China boiled over again.

For most of July, the much anticipated Fed meeting was all that market participants were talking about. Going into the meeting, most investors were fairly certain the Fed would embark on a series of rate cuts to provide economic "insurance" in an environment where the growth outlook has become more uncertain. What was vastly debated was how deep the cuts needed to be for the first cut in policy rates in over a decade. In order to "sustain" the current economic expansion, the committee ultimately made the decision to cut rates by 25 basis points. While some Fed officials felt the action was inappropriate at this time as two members of the committee dissented in favor of no change in policy, we think cutting policy rates for the first time in over a decade was an appropriate decision in light of the increased downside risks and the desire to extend the current economic expansion.

Following the statement release, Chairman Powell had a difficult time relaying the Fed's message at the press conference following the FOMC meeting. Specifically, he referred to the latest change in policy as a "mid-cycle" rate cut, and investors interpreted that to mean that this wasn't the start to an easing cycle. However, he did indicate the Fed would "adjust policy to a somewhat more accommodative stance over time," which leads us to believe there will likely be another 25bps cut coming later this year. Although market participants received what they asked for in the form of a rate cut, they were ultimately left disappointed as their desire for stronger commitment from the Fed for further easing was left unfulfilled.

Most investors thought the Fed meeting was going to be the highlight of the summer before coasting into the summer doldrums. However, President Trump quickly changed that narrative when he announced that the U.S. would impose 10% tariffs on the remaining $300 billion of Chinese imports starting on September 1. As a result, interest rates plunged and the 10-year Treasury dropped to the lowest level since 2016. In turn, the tariff escalation sent equities spiraling lower and volatility to its highest level since May. Overall, the recent escalation of the trade war with China overshadowed the outcome of the Fed meeting and left many investors expecting more rate cuts to come soon.



Source: Bloomberg, Allianz Investment Management LLC

So where do we go from here? The economy is slowing, downside risks are present, and there is a strong desire to steer the economy away from a deep recession. Clearly, the market's desire for additional easing from the Fed has perked up as trade tensions with China have started to heat up again. However, Chairman Powell has some work in front of him to extract a consensus view in favor of further pre-emptive easing from the committee. Nonetheless, we expect the committee to continue with their tactical measures until they strike a balance between economic uncertainty and the current economic backdrop.

Market indicators *(figure a)*

Equities continued their rally from June as the S&P 500, Dow Jones Industrial Average, and the NASDAQ indices all posted record highs in July. Much of the gains can be attributed to the dovish commentary coming from Fed members as they positioned themselves throughout the month to ease monetary policy in July and potentially beyond. Unfortunately for investors, those records were short lived as President Trump reignited the trade dispute with China. Going forward we believe that further rate cuts can help support equities, but we also remain cognizant of the volatility that the trade tension can quickly bring.

Volatility, as measured by the CBOE VIX Index, was mostly muted in July with the exception of the last week during the month. More specifically, the Fed's press conference following its rate decision combined with trade threats from President Trump sent the VIX Index soaring at the end of July and into early August. Given market uncertainty and ever-looming trade concerns in the U.S. and abroad, we expect volatility to remain elevated for some time to come.

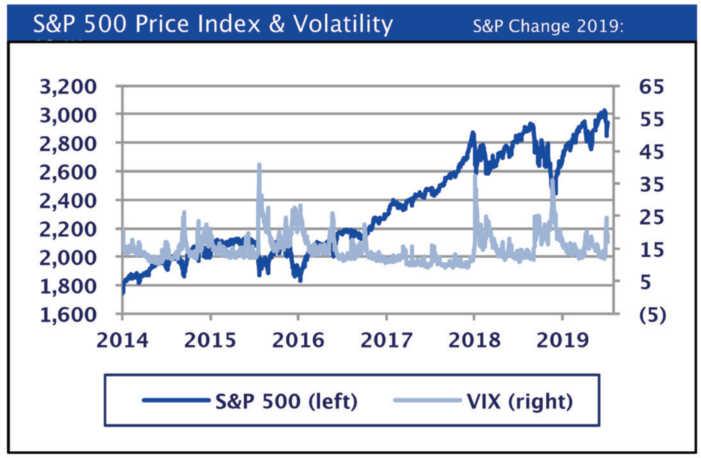
The Treasury curve moved quite a bit throughout the month of July as investors positioned themselves for an expected rate cut from the Fed. Driving the fluctuations in the curve was the market trying to interpret whether the Fed would cut 25 or 50 bps as misaligned commentary from the Fed left the market divided. Going forward we expect there to be further downward pressure on the front-end of the curve as market participants expect the Fed will likely cut again this year.

Tensions between the U.S. and Iran lifted the price of oil above $60 per barrel during the first half of July. However, increased concerns about global growth left investors questioning the future demand outlook for oil and ultimately pushed oil back below $60. We expect volatility in the oil markets to continue as the rift between Iran and the U.S. continues.

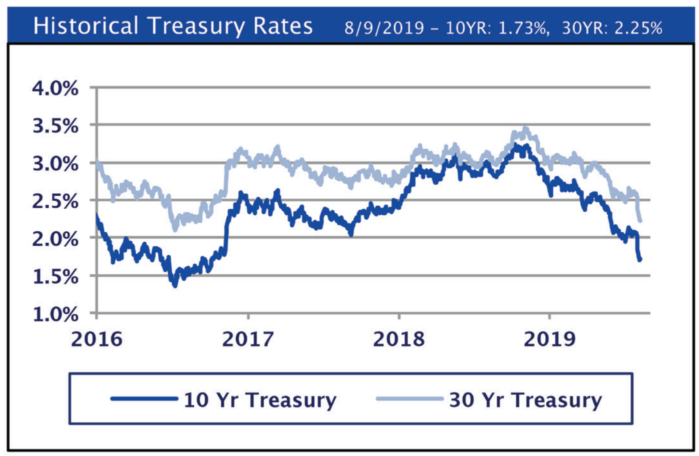
Economic indicators *(figure b)*

The latest data on consumer confidence highlighted how upbeat consumers have been despite ongoing trade tensions and market volatility. The Conference Board's index on consumer confidence rose to the highest level this year at 135.7 and was near the cyclical high set in 2018. The data coincides with what we have seen in the latest GDP data as the consumer is currently driving growth in the U.S. economy. As long as the labor market remains healthy and wages continue to rise, we would expect consumption to remain solid.

figure a



Sources: S&P, CBOE



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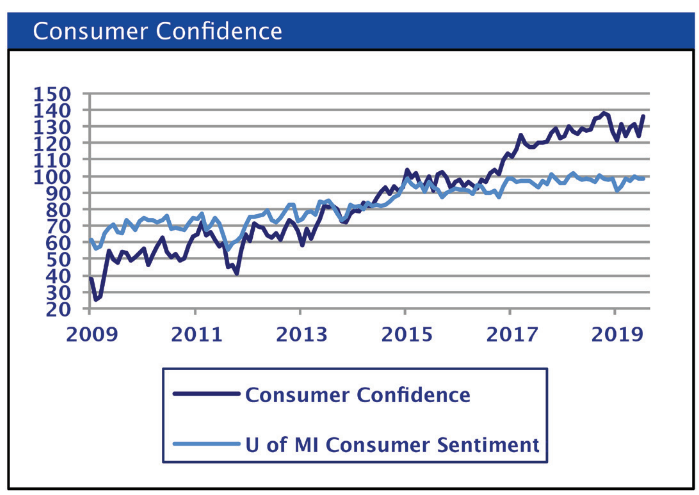


Source: Bloomberg

Economic indicators *(continued)*

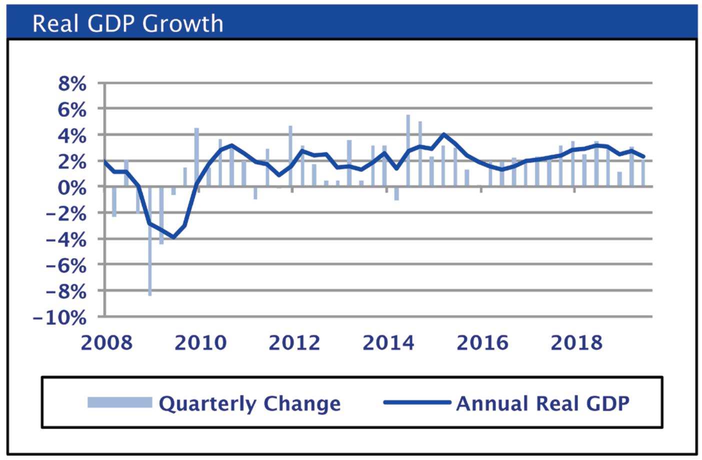
Growth in the U.S. came in stronger than expected for the second quarter advance reading. Real GDP was measured at 2.1% versus a consensus expectation of 1.8%. Carrying the brunt of the weight was a surge in consumer spending, which increased from 1.1% in the first quarter to 4.3% in the second quarter. Admittedly, business investment slowed but was not all that surprising given the amount of uncertainty the trade disputes have caused throughout the quarter.

Headline CPI increased 0.1% while Core CPI, which removes the volatile food and energy categories, increased 0.3% in June. The uptick in Core CPI marked the largest increase since January of 2018 and brought the year-over-year figure to 2.1%. Interestingly, the increase came just after the Fed had signaled that they were willing to ease monetary policy. Although core CPI rebounded in June, the overall inflation trend has been relatively muted and thus supported the Fed's decision to cut rates by 25 bp.

The U.S. economy added 164k jobs during the month of July, which was right on top of consensus estimates of 165k. Wage growth came in stronger than expected at 0.3% and lifted the annualized change in wages to 3.2%. However, we have yet to see rising wages translate into stronger inflation data. At this point it appears like global trade tensions haven't taken a toll on the U.S. labor market yet, but if trade escalation continues to ramp up we could certainly see a different outcome.

The results from the latest ISM surveys show further deterioration within the manufacturing and nonmanufacturing sectors during the month of July. More specifically, the manufacturing index dropped to 51.2 and the nonmanufacturing index slid to 53.7, marking declines of 0.5 and 1.4 respectively. Both surveys continue to inch closer to the closely monitored 50.0 level as a reading below that level would designate that the economy has entered into recessionary territory.

figure b



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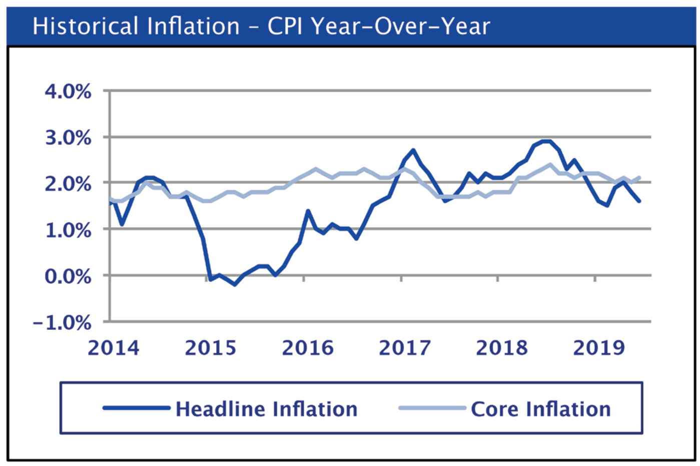

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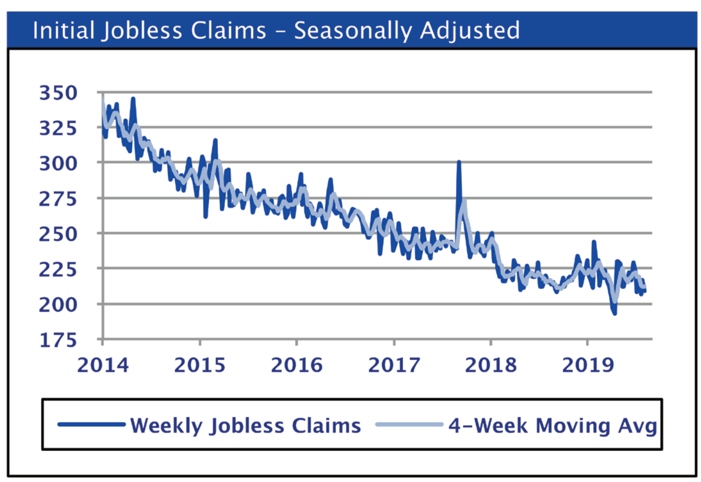

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	51.7	52	51.2	September 3 (Tuesday)
GDP Annualized	3.1%	1.8%	2.1%	August 29 (Thursday)
Unemployment rate	3.7%	3.6%	3.7%	September 6 (Friday)
Retail sales	0.5%	0.2%	0.4%	August 15 (Thursday)
Consumer Price Index (YoY)	1.8%	1.6%	1.6%	August 13 (Tuesday)
U. Mich. Consumer Sentiment	98.2	98.8	98.4	August 16 (Friday)
Home Price Index (MoM)	0.0%	0.2%	0.1%	August 27 (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.