Market Update

(9/2019)

Allianz Investment Management LLC

September 2019 Market Update

Key points

- We have entered an unprecedented investment yield environment, resulting from high levels of uncertainty and growing negative yielding debt abroad
- The 10-year Treasury yield declined by 50 basis points during the month of August as escalating trade tensions stoked recession fears in the bond market
- Rising trade tensions and associated market jitters have led bond investors to price in more aggressive central bank easing from the Fed
- The Fed has recognized the downside risks and is committed to "act as appropriate to sustain the expansion," but they have yet to commit to a preset course for policy rates

Outlook

GROWTH: The latest update on second quarter GDP continues to portray a diverging economy in which consumption remains strong while business investment continues to decline. The official estimate of second quarter GDP was revised lower to 2.0% from 2.10% in the latest update. Within the details, personal consumption was revised higher to 4.7% while fixed investment fell by 1.1%. It's clear the uncertainty surrounding the trade war between the U.S. and China continues to weigh on business investment. Particularly, there is some notable softness in the manufacturing sector as the ISM manufacturing Index fell below 50 for the first time since 2016, which indicates activity is declining in the economy. For now, it appears the consumer is still the linchpin to the U.S. economy, but looking ahead we will be watching closely for any signs that consumer spending is slowing. As such, we still remain constructive on U.S. growth and expect 2019 to finish within our forecasted range of 2.00% to 2.50%.

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

INTEREST RATES: The month of August was particularly difficult for yield investors as rates declined throughout the month to historic lows. The 10-year Treasury yield fell below 1.50% and the 30-year Treasury yield fell below 2.00% as increased trade tensions have stirred recession fears in global bond markets. The amount of negative yielding debt surpassed $17 trillion in August and was certainly a factor weighing on interest rates in the U.S. In addition, recession fears have led many investors to expect drastic changes to monetary policy from central banks in the form of additional rate cuts and quantitative easing, which have also put downward pressure on U.S. interest rates. The bottom line is that the current backdrop has led to a tremendous amount of uncertainty in the market, and investors will look to safe-haven assets like U.S. Treasuries until some clarity comes back to the market. In light of the recent developments, we have lowered our expected target range for the 10-year U.S. Treasury yield to 1.50% to 2.00% for the end of 2019.

FORECAST PERIOD	10-YEAR TREASURY YIELD
End of 2019	1.50% - 2.00%

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August 2019 recap and macro themes

Markets spent most of the month whipsawing back and forth as Tweets and headlines on the trade war with China continued to stoke angst among investors. As a result, equities endured a volatile month and ultimately finished in negative territory. The increased volatility drove investors into safe-haven assets such as U.S. Treasuries which, in turn, sent yields to record lows. Falling below 1.50%, the 10-year Treasury yield was at the lowest level since 2016 and the 30-year Treasury yield dropped below 2.00% for the first time in history! Market participants continued to be unimpressed with the progress, or lack thereof, on trade discussions between the U.S. and China. That being said, we have yet to see any material effects on the economy as consumer spending continues to underpin the U.S. economy for now.

With 10-year Treasury yields declining 50 basis points during the month of August, we suspect many of our readers are wondering what is going on with interest rates in the U.S. as the relentless drop in rates appears to have no end in sight. The reality is there has been a perfect storm brewing in the U.S. rates market. Fears of slowing growth, increased trade tensions, negative yields abroad, muted inflation, and central banks easing monetary policies have all led to a flight to quality in Treasuries that has driven yields to impressively low levels. Furthermore, the MOVE Index, which tracks bond market volatility, has risen to its highest level since 2016. Nonetheless, the race to the bottom has even drawn investor's attention to the notion of potential negative rates in the U.S.

Escalating trade tensions and market jitters have led bond investors to price in more aggressive central bank easing from the Fed. Yet the release of the minutes from the July FOMC meeting and the commentary from the Jackson Hole meeting, where a host of Fed members opined on the current state of monetary policy, portrayed a more divided committee on the future path of policy rates. While reaching a consensus for a "mid-cycle" adjustment in monetary policy in July, a couple Fed members were in favor of a 50-basis-point rate cut, while several other members lobbied for no change in current policy rates. Fed Chairman Powell Indicated the Fed, "will act as appropriate to sustain the expansion." However, with so much uncertainty surrounding the downside risks, the committee ultimately preferred not establishing monetary policy on a preset course. On balance, we do expect further rate cuts from the Fed, however the path of rate cuts may not be as aggressive as investors originally thought.

As bonds rallied across the curve, many investors would have expected a steeper fear sell-off in equities, but that has not been the case through the month of August. Even with all the flight-to-quality buying in U.S. Treasuries, the S&P 500 Index declined just 1.81% over the month. Perhaps the bifurcated views on the economy between bond and equity investors are the culprit, but we think it's worth pointing out the attractiveness of the near 2% dividend yield on the S&P 500 versus a 10-year Treasury yield close to 1.60%. At any rate, bond investors appear to have a more pessimistic view of the outlook for the U.S. economy.

Source: Bloomberg, Allianz Investment Management LLC

Consequently, we have entered an unprecedented investment yield environment resulting from expectations of slowing growth and the expansion of easier monetary policy. Going forward, the bar will be high for central bankers as they weigh policy decisions tied to an uncertain outlook. In the event central banks fail to deliver the stimulus the market is expecting, we could see some modest upward pressure on yields. On the other hand, if the economy deteriorates further, central banks may be forced to act more swiftly, which could send yields to depths we have yet to see.

Market indicators *(figure a)*

Like interest rates, equities remained under pressure throughout most of August as anxiety over escalating trade tensions took hold. While the decline in equity prices was not as pronounced as interest rates, there was still some considerable volatility throughout the month. In addition, with the Fed vowing to provide support to sustain the economic expansion, the impact on equity prices was likely contained. Despite all the noise, the overall economic backdrop still remains constructive and equity prices are reflecting that.

Volatility remained elevated throughout the month of August as headline-driven news on the U.S. and China trade negotiations continued to swing asset prices. The turbulence was enough to lift the VIX Index to the highest reading since early January at 24.81. While the spike in volatility wasn't to the magnitude of previous equity routs, we did take notice that equity volatility remained high for a considerable part of the month. Looking ahead, we expect higher levels of volatility to remain in place until some of the uncertainty in the market can be removed.

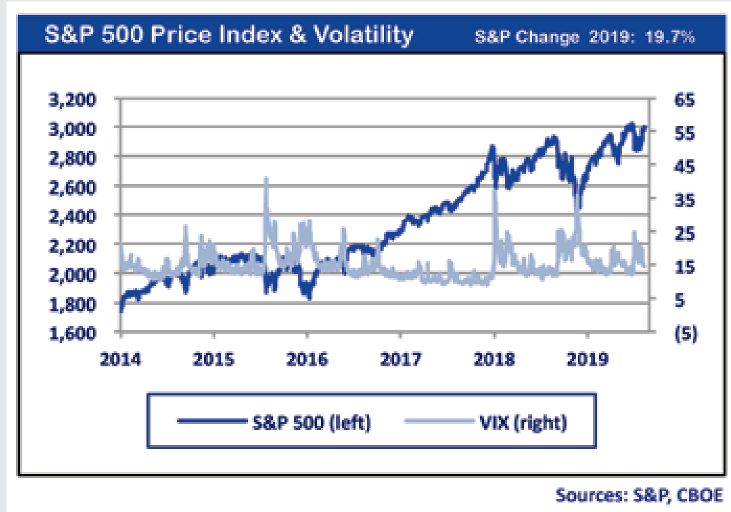
The Treasury curve flattened throughout August as safe-haven seeking investors piled into long-dated Treasuries, ultimately sending the 30-year Treasury yield to the lowest level ever. Negative yielding bonds in Europe continue to weigh on U.S. rates, and the prospect of the ECB starting their bond buying program again has exacerbated the situation. While there is tremendous uncertainty surrounding the direction of rates, the result will be partially dependent on the amount of monetary stimulus central banks deliver.

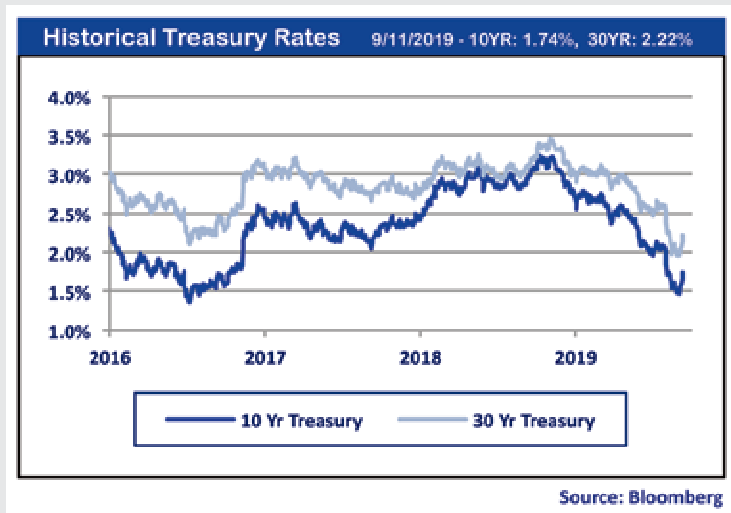
Oil prices were pulled in different directions throughout August, but fears of a global economic slowdown outweighed any improvement in the supply side of the equation. The price of West Texas Intermediate crude oil ended the month 5.94% lower at around $55/barrel. The bottom line is that the latest move lower in oil prices doesn't appear large enough to signal a broader slowdown in the economy at this time.

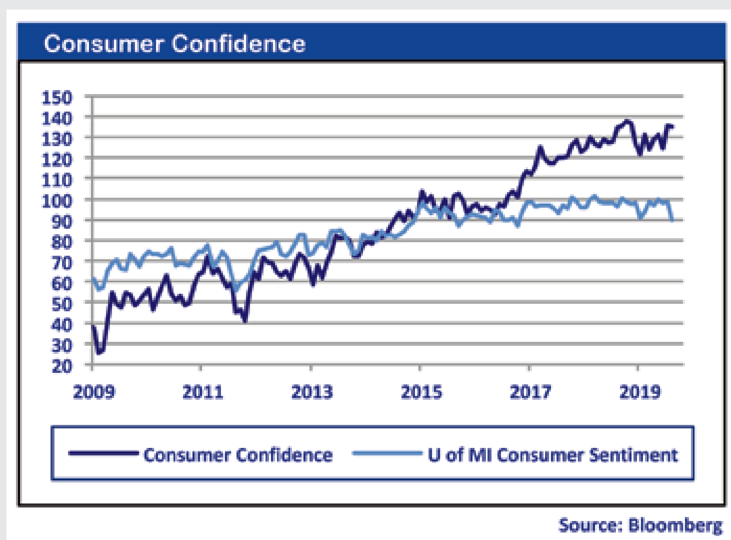
Economic indicators

Measures of consumer confidence deteriorated in August as the Conference Board's index of consumer confidence fell slightly to 135.1 and the University of Michigan's index on consumer sentiment dropped to the lowest level since 2016 at 89.8. The decline in sentiment is a sign that consumers are becoming increasingly worried about the trade war and the proposed tariffs. Further declines in consumer confidence will likely increase the odds that a recession is on the horizon.

figure a







Economic indicators *(figure b)*

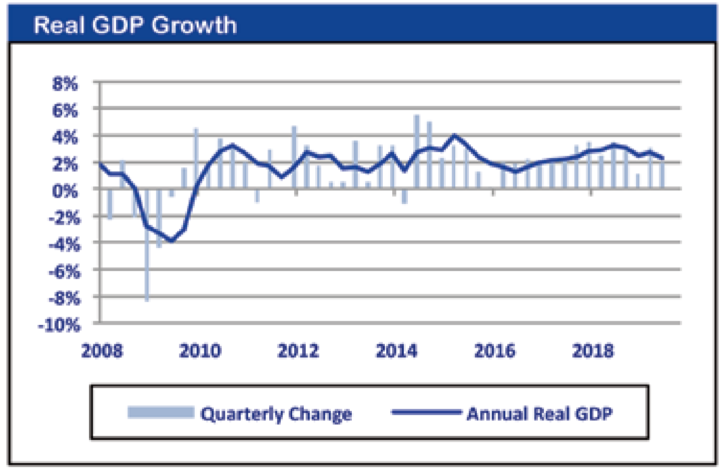
The second revision to second quarter GDP came in one-tenth of a percent lower at 2.0%. Compared to the first quarter, we have witnessed a noticeable slowdown in business investment, which we think can be attributed to the ongoing uncertainty surrounding trade between the U.S. and its trading partners. On the contrary, personal consumption has been very strong in the second quarter, with the latest revision moving up to 4.7%. So far, trade concerns have yet to have an impact on consumers, but this will be something to watch closely in the coming months.

There appears to be some nascent signs of inflation as the latest CPI data indicated that consumer prices have moved back into an upward trajectory. Headline CPI rose by 0.3% in July and lifted the annualized figure to 1.8%. Core CPI also posted a solid increase of 0.3% for the month and subsequently lifted core CPI to 2.2% annually. The back-to-back readings of 0.3% in core CPI failed to move the needle in the bond market as investors shrugged off the strong inflation data and continued to focus on the slowing growth abroad.

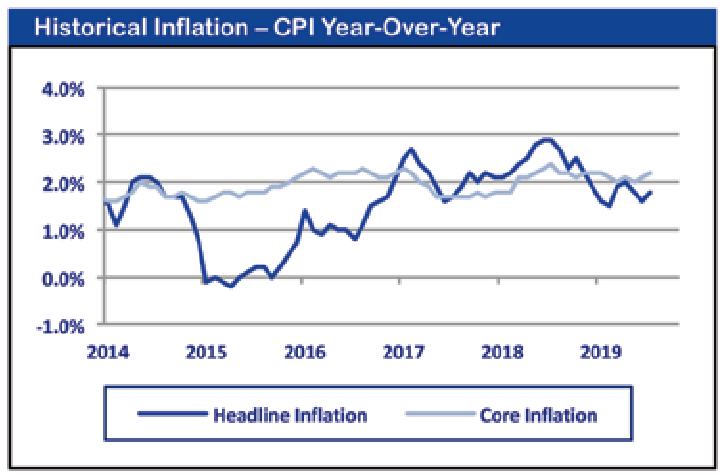
Signs of maturing labor market growth were evident in the most recent employment report as monthly payroll additions slowed below forecasted levels. The addition of only 130k jobs was below expectations of 160k, but still enough to indicate the labor market is tightening. With jobless claims remaining low and the unemployment rate at 3.7%, it's not apparent whether companies have purposely slowed down hiring or there simply aren't enough qualified workers to meet the demand. On the bright side, wages continue to look robust with average hourly earnings increasing by 0.3% or more over the last four months. Overall, this will likely help support consumption for the remainder of the year.

Forward-looking barometers on the economy gave mixed signals as the ISM manufacturing index dropped below 50 to 49.1 for the first time since 2016. A level below 50 indicates activity is declining in the economy. On the other hand, the non-manufacturing index jumped by almost 3 points to 56.4 and eased investor concerns that a widespread slowdown in the economy has yet to take hold.

figure b



Source: Bloomberg



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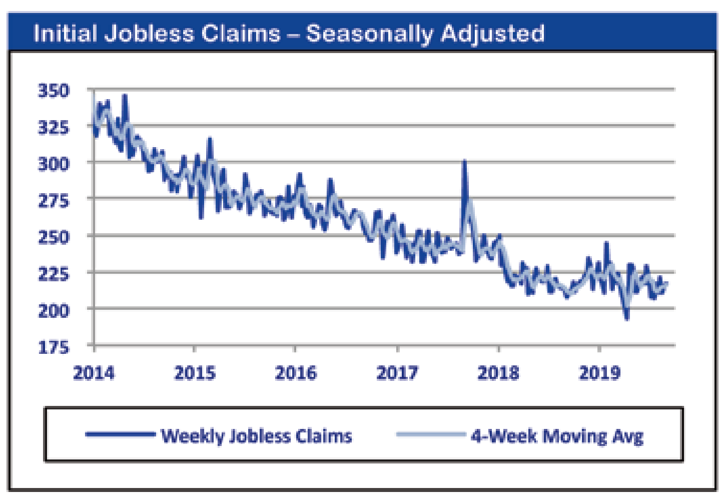

Source: Bloomberg

NOTABLE EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	51.2	51.3	49.1	October 1 (Tuesday)
GDP Annualized	2.1%	2.0%	2.0%	September 26 (Thursday)
Unemployment rate	3.7%	3.7%	3.7%	October 4 (Friday)
Retail sales	0.4%	0.3%	0.7%	September 13 (Friday)
Consumer Price Index (YoY)	1.6%	1.7%	1.8%	September 12 (Thursday)
U. Mich. Consumer Sentiment	92.1	92.4	89.8	September 13 (Friday)
Home Price Index (MoM)	0.14%	0.10%	0.04%	September 24 (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.