Market Update

(10/2019)

Allianz Investment Management LLC

# October 2019 Market Update

## Key points

- Treasury yields have whipsawed recently as investors are at odds with the present situation of the economy and the potential downside risks
- A divided Fed continued with their mid-cycle adjustment to policy rates by cutting the Fed funds target by 25 basis points
- Headline risks continue to drive markets, and equities fared well during September as the rhetoric surrounding the U.S.-China trade negotiations has turned positive
- Recent stress in the short-term funding markets has caused the Fed to intervene with temporary open market funding operations, but the recent development isn't viewed as a systemic concern

## Outlook

**GROWTH:** The third reading on U.S. GDP for the second quarter was unrevised at 2.0%. Softer business investment continues to be offset by stronger household consumption. Recent economic data suggests it is likely this narrative will play out for the remainder of the year. Most notable has been the weakening of recent business survey data with both the ISM Manufacturing Index and the ISM Nonmanufacturing Index declining substantially in recent months. These surveys are certainly pointing to slower growth down the road, but we have yet to see this weakness spill over to the labor market. As long as the consumer remains employed and has the wherewithal to spend, we would expect the U.S. economy to continue along its current expansion. As such, we remain committed to our expectation for 2019 real GDP for the U.S. economy to be within our forecasted range of 2.00% to 2.50%.

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

**INTEREST RATES:** Over the past two months, we have witnessed some abnormally large swings in the direction of interest rates. The 10-year Treasury has been whipsawed from the 2% level down to 1.50% and back up to 1.90% by the middle of September. The bottom line is there is a tremendous amount of uncertainty that has built up in the markets which has been driven by a multitude of factors. Central banks have pledged to support economic growth to the extent they can, but they have been reluctant to meet market expectations for monetary stimulus. Both the Fed and the ECB cut rates in September, but market participants were expecting more than what was delivered. In turn, we saw interest rates fluctuate dramatically as investors weigh the timing of monetary stimulus with the expectations of slowing growth. While the Fed has yet to come to a consensus on when to end policy easing, it is likely we will see an additional rate cut before year end. On balance, we still expect the 10-year Treasury to remain within our forecasted range at year end as further easing has already been priced into the market.

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

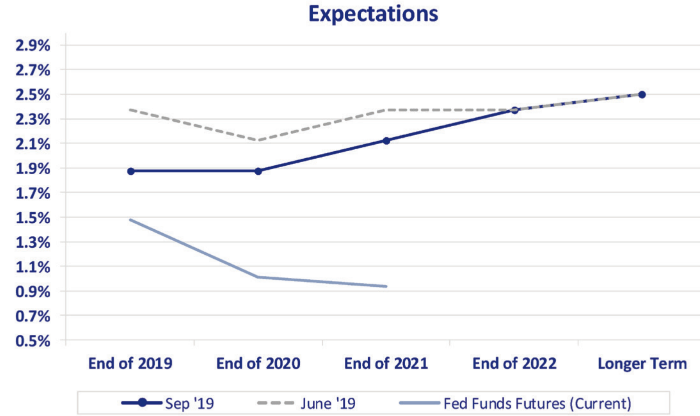
## September 2019 recap and macro themes

Historically speaking, the month of September has not fared well for equity investors as returns on average have been negative for that month. However, support from the Federal Reserve along with positive rhetoric on the trade front helped bring positive equity returns during the month of September. In addition, we witnessed yields on U.S. Treasuries rebound sharply over a very short time span. The 10-year Treasury yield was at 1.43% at the beginning of the month and swiftly rose to 1.90% by mid-September. Overall, the narrative hasn't changed in that investors still fear the end of the business cycle is near. However, what the economic data showed us in September was the strength and resilience of the U.S. consumer, which continues to be the wind in the sails of the U.S. economy.

Regarding the Fed, a rate cut at the September meeting was virtually a shoo-in as most market participants had already priced a 25 basis point rate cut as a foregone conclusion. What mattered more to investors was how the dot projections were going to play out and what sort of guidance Chairman Powell would provide with regards to his mid-cycle rate cut. When assessing the current backdrop, the bifurcated U.S. economy, in which slowing business investment is being offset by strong consumer spending, made it difficult for the committee to make a clear commitment to further easing. Most noteworthy, there was much division among Fed members as to whether rate cuts were warranted against this backdrop as three Fed officials dissented, two were in favor of not cutting, and one in favor of a 50bps cut . Within the Summary of Economic Projections, the dot-plot indicated the path for future rate cuts is shallower than the market expects, with median dots showing no cuts through 2020. However, we would caution that some dots are more important than others. While it's recognized that downside risks remain present, the divided Fed has yet to come to a consensus on a committed path for rate cuts. Thus, with future rate cuts priced into the market with conviction, it feels like we are setting up for the Fed to disappoint market expectations.

On the other hand, the story catching the most attention last month came from the inconspicuous repo funding market. For those of you who are not familiar, the repo funding market is where banks and other firms on Wall Street lend high-quality securities like Treasuries as collateral in exchange for cash to fund short-term obligations. Resulting from a combination of large tax payments and bond settlements, there was a shortage of cash on dealer balance sheets, which ultimately put swift upward pressure on short-term funding rates. The overnight borrowing rate spiked to 10% before the Fed ultimately stepped in to provide emergency liquidity through its own repo program. While some investors are quick to draw similarities to the liquidity episode during the financial crisis, it's important to note that banks are too well capitalized today to make this episode a broader concern. Overall, we don't believe there is a systemic concern for banks to attain short-term liquidity, but we do believe the Fed will likely need to address some structural changes to their balance sheet in the near future.

**Fed's Projection of Policy Rates vs. Market Expectations**




*Source: Bloomberg, Federal Reserve, Allianz Investment Management LLC*

Looking forward, we still expect the rest of 2019 to be characterized by modestly lower growth, a flatter yield curve, political uncertainty, and continued recession concerns. Signs of slowing growth have already emerged in recent business surveys as trade tensions between the U.S. and China are driving uncertainty. However, U.S. growth remains buoyed by solid household consumption, and until we see some material deterioration within the labor market, we expect the economy to remain in good shape.

## Market indicators *(figure a)*

Equity investors were the clear winners during the month of September as positive economic data on the consumer coupled with fresh monetary easing from the Fed helped support equity prices. The rhetoric surrounding the U.S.-China trade negotiations has turned positive, which has given investors some hope that some progress or an agreement can be reached during the next round of negotiations. Overall, despite ongoing end-of-cycle pessimism priced into the rates market, equities have remained elevated and will likely remain so until an impending recession is upon us.

Volatility was subdued for most of September as the VIX Index remained below 20 for most of the month. Favorable market conditions and incoming economic data left most investors feeling upbeat about the current environment. As a result, equity swings were minimal and volatility remained in check. That being said, headline risks continue to be a driving factor on volatility, and we expect those risks to remain in place for the foreseeable future.

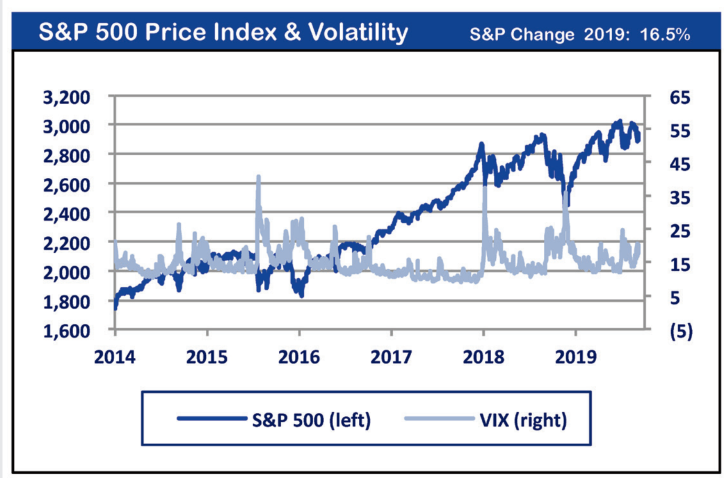
The decline in Treasury yields came to a halt in September as the 10-year Treasury rose from a low of 1.43% all the way back to 1.90% by mid-month. Since then, rates have drifted lower on risk-related headlines. Going forward, we expect U.S. yields to remain under pressure due to the effects of negative yields abroad, end-of-cycle angst, and increased geopolitical tensions.

Crude oil prices took a rollercoaster ride in September as the Iranian attack on crucial Saudi oil infrastructure sent oil prices surging past $63 per barrel on West Texas Intermediate crude. The spike in prices reversed relatively quickly once market participants realized the speed at which lost supply could be regained and that world energy consumers are not beholden to the Kingdom's oil supply as much as they were in the past. Overall, increased geopolitical tensions should support prices, but declining demand still remains a concern.

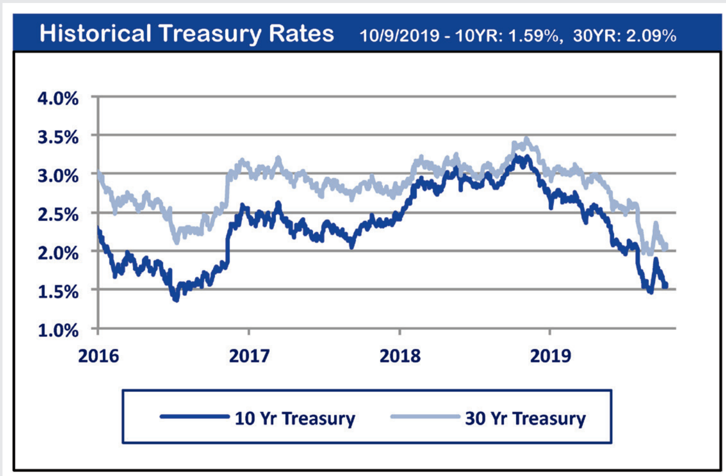
## Economic indicators

The Conference Board's Index on consumer confidence plunged in September to 125.1, suggesting that geopolitical headlines are beginning to take a toll. The data coincides with the drop in consumer sentiment late this summer in the University of Michigan's survey. However, the latest data from the University of Michigan showed a modest uptick in consumer sentiment to 93.2 for September. Overall, the level of consumer confidence remains healthy, but it appears that geopolitical tensions are starting to weigh on the consumer.

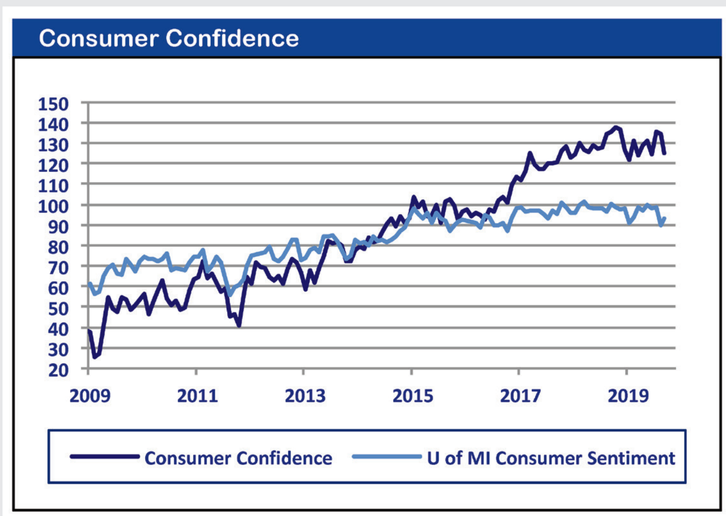
*figure a*




Sources: S&P, CBOE




Source: Bloomberg




Source: Bloomberg

## **Economic indicators** *(figure b)*

The ISM nonmanufacturing index declined to the lowest level since 2016 at 52.6 and was primarily driven by new orders plummeting from 60.3 to 53.7, along with further weakness within the employment component of the index. Essentially, this report is telling us that the uncertainty surrounding the global economy, and the manufacturing sector in particular, has started to spill over to the broader service sector. The weaker readings on both the manufacturing and nonmanufacturing surveys are signaling that slower economic growth lies ahead, and markets have responded with a knee-jerk reaction over the past few weeks.

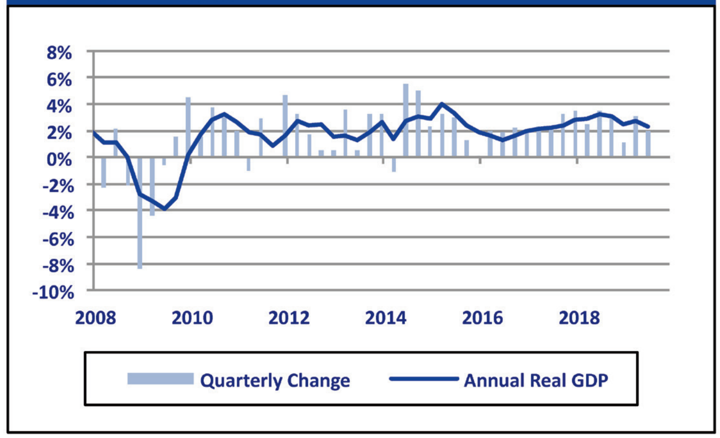
For the third consecutive month, core CPI has produced a 0.3% increase, which hasn't happened in over two decades. Furthermore, core CPI on an annualized basis rose to 2.4% and is the highest since 2008. Headline inflation rose by only 0.1% and was largely dragged down by the decline in energy prices. That said, the recent acceleration of inflation will be tough for the bond market to ignore. Additionally, if the Fed wasn't worried about inflation in recent months, today's results will likely catch their attention. Either way, we still expect a 25bp cut from the Fed next week.

Albeit slower than previous months' data, job additions to the U.S. economy remain healthy as the latest employment report showed 136k payroll additions in September. More notably, the unemployment rate dropped to a 50-year low at 3.5% despite no change in the labor force participation rate. However, average hourly earnings were muted with no increase in wages during the month of September. Overall, the labor market remains healthy, but investors will be watching closely for any signs of deterioration.

For all the increased attention on the slowing pace of hiring in the job market, there doesn't appear to be an exodus of jobs in the labor market. The number of initial jobless claims came in at 208k for the second week of September and is a strong indication that companies are not increasing the amount of layoffs. It is more likely companies are experiencing difficulty finding skilled workers to fill vacant positions, which is leading to lower payroll additions on a monthly basis. At any rate, claims data support the notion that the labor market remains in solid shape.

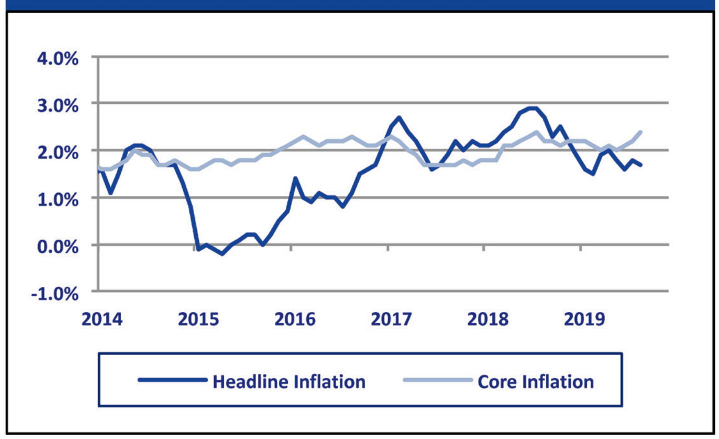
*figure b*

Real GDP Growth



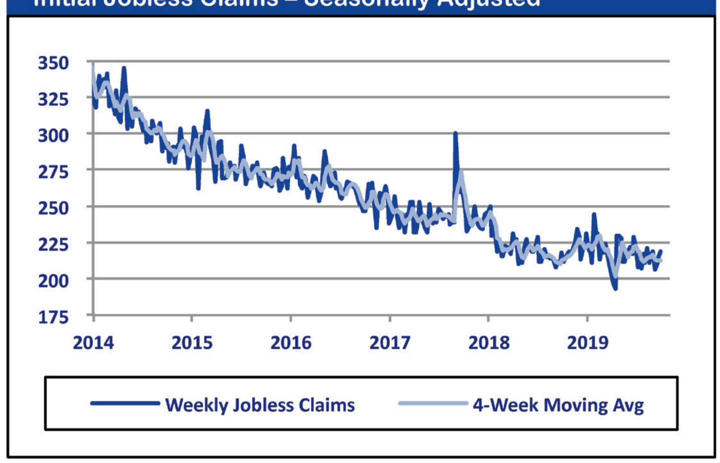

Source: Bloomberg

Historical Inflation – CPI Year-Over-Year




Source: Bloomberg

Initial Jobless Claims – Seasonally Adjusted




Source: Bloomberg

| NOTABLE EVENT | Previous | Survey | Actual | Next |
|---|---|---|---|---|
| ISM Manufacturing Index | 50.0 | 49.1 | 47.8 | November 1 (Friday) |
| GDP Annualized | 2.0% | 2.0% | 2.0% | October 30 (Wednesday) |
| Unemployment rate | 3.7% | 3.7% | 3.5% | November 1 (Friday) |
| Retail sales | 0.8% | 0.2% | 0.4% | October 16 (Wednesday) |
| Consumer Price Index (YoY) | 1.8% | 1.8% | 1.7% | October 10 (Thursday) |
| U. Mich. Consumer Sentiment | 92.0 | 92.1 | 93.2 | October 11 (Friday) |
| Home Price Index (MoM) | 0.06% | 0.10% | 0.02% | October 29 (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.