Market Update

(11/2019)

Allianz Investment Management LLC

November 2019 Market Update

Key points

- As expected, the Fed decided to cut the Fed funds target to a range of 1.50% to 1.75%
- Equities reached higher highs in October with both the S&P 500 and NASDAQ indices reaching new record highs
- The widely watched spread between the 3-month and 10-year Treasuries turned positive, indicating that the curve is no longer inverted for the first time in months
- Christine Lagarde officially took over as president of the European Central Bank, joining other global central bankers as they weigh policy decisions against an uncertain market backdrop

Outlook

GROWTH: The initial reading for third quarter U.S. GDP surprised to the upside, coming in at 1.9%. Once again, consumer strength propelled growth higher while declining business investment remained a detracting factor. It's clear that the trade disputes between the U.S. and China continued to play a role on the business investment side while the consumer appeared indifferent. However, given the recent momentum between the U.S. and China on coming to a "phase one" trade agreement, it's plausible that business investment could rebound and support growth going forward. Additionally, October's strong labor report supports the notion that the consumer will continue to have the wherewithal to spend, which is particularly important heading into the holiday season. Thus, we continue to expect that 2019 real GDP for the U.S. economy will 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: Interest rates remained volatile for the third month in a row as trade-related headlines, Fed speak, and better than expected corporate earnings drove the rate swings. More specifically, the 10-year Treasury yield again fell to 1.50% before rising above 1.80% and ultimately closing out the month at just over 1.69%. In anticipation of the Fed rate cut, the front-end of the Treasury curve fell and the widely watched spread between the 3-month and 10-year Treasuries turned positive, indicating that the curve is no longer inverted for the first time in months. This is important as it suggests the likeliness of a near-term recession has declined slightly. Overall, we still expect the 10-year Treasury to remain within our forecasted range at year end as the probability of additional easing is unlikely and trade tensions appear to be simmering.

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

October 2019 recap and macro themes

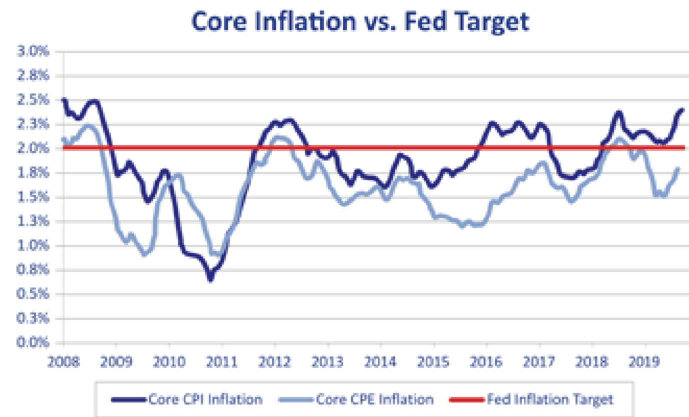
Fortunately for investors, the way in which October began is not how it concluded as equity markets reached new all-time highs, volatility retracted to average lows, the Fed followed through with an additional rate cut, and fears of an economic recession appeared to dissipate on the backing of better-than-expected corporate earnings and modestly improved economic data.

The major event of the month was the Fed meeting and resulting Fed statement and speech from Fed Chairman Powell. As expected, the Fed decided to cut the Fed funds target to a range of 1.50% to 1.75%. Initial market reaction was minimal as most of the commentary from Fed officials leading up to the meeting offered little pushback to another rate cut, ultimately leading investors to price in a high probability of the cut happening before it actually occurred. While this rate cut was the latest installment in a series of cuts to sustain the economic expansion, most investors were keenly interested in whether or not this was the end to the Fed's insurance rate cuts. Without explicitly stating, the Fed appears to be on hold from cutting rates further in the near term, as some of the downside risks that provoked the series of rate cuts look to be somewhat contained.

Additionally, The FOMC statement was nearly unchanged with the only, yet important, change being the Fed's removal of the wording "act as appropriate" and instead replacing it with "assess the appropriate path." Although subtle, this change was likely intended to soften market participant's expectations for future rate cuts.

Furthermore, Chairman Powel was especially transparent regarding inflation at his speech following the rate decision. Specially citing, "We just touched 2% core inflation ... Just touched it for a few months and then we've fallen back. So I think we would need to see a really significant move up in inflation that's persistent before we would consider raising rates to address inflation concerns."

Thus, at a minimum we expect the Fed to be on pause unless the market environment materially changes or inflation substantially accelerates to warrant policy action in either direction.



Source: Bloomberg, Allianz Investment Managment LLC

Across the pond, Mario Draghi officially passed the torch over to Christine Lagarde, who began her new role as president of the European Central Bank. Unfortunately for Largarde, she faces a much divided European Central Bank (ECB) as, just last month, the members agreed to resume government bond purchases despite one-third of the voters opposing the action, marking the largest dissent in Draghi's tenure. As such, investors will be patiently waiting to see if Lagarde is able to corral the ECB members in an effort to obtain a consensus view on policy going forward. Nevertheless, it's evident that global central bankers will have their hands full as they weigh policy decisions against an uncertain market backdrop.

Overall, we remain optimistic about the market environment as we move closer toward year end. Supporting this view has been the better-than-expected economic data and corporate earnings releases, which have reduced fears of a near-term economic recession. Furthermore, we suspect consumer strength will continue to offset weak business investment, especially given the most recent labor report. Additionally, the Fed followed through with an additional rate hike this month that should help to support the ongoing expansion. That being said, we do remain cognizant of the risks to this view, which include further deterioration within the manufacturing sector, the trade dispute between the U.S. and China reigniting, and weakening of the labor market, which would negatively weigh on consumer sentiment.

Market indicators *(figure a)*

Equities reached higher highs in October, with both the S&P 500 and NASDAQ indices surpassing their highs from this past July. Continued momentum on trade discussions between the U.S. and China coupled with better-than-expected corporate earnings pushed equities higher. Given the economic backdrop and progress on the trade front, we expect equities will continue to move higher sans any unexpected market turmoil.

Volatility spiked above 20 at the beginning of October following the weak ISM Manufacturing print, but declined for the remainder of the month on positive economic data and better-than-expected corporate earnings releases. Overall, this is not surprising given the upward momentum of the equity market.

Treasury yield volatility continued into October as investors began the month in risk-off mode, opting for safe-haven assets like U.S. Treasuries. However, trade-related optimism quickly turned investor sentiment around and rates increased as a result. Overall, the Treasury curve steepened over the month and the spread between the 3-month and 10-year Treasuries turned positive, signifying that the yield curve is no longer inverted for the first time in months.

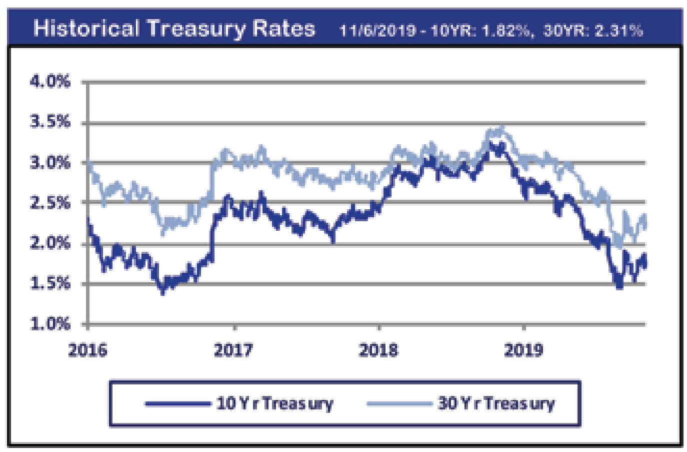
Crude oil prices continued their rollercoaster ride into October as economic data continued to drive oil prices. Ultimately, crude oil ended the month nearly unchanged at just over $54 per barrel. Overall, oil demand still remains a concern, but the potential for a "phase one" trade deal between the U.S. and China should support increased economic activity and ultimately support oil demand going forward.

Economic indicators *(figure b)*

Consumer confidence continues to remain elevated as surveys released by both the Conference Board and University of Michigan indicate that sentiment remains at historically high levels, albeit more volatile in recent months. The tight labor market, low gas prices, and strength of the equity market have been the main drivers of consumer optimism. That being said, ongoing uncertainty driven by the trade dispute between the U.S. and China has been noted by consumers as a concern. Overall, we expect consumer sentiment to remain healthy going into the holiday season.

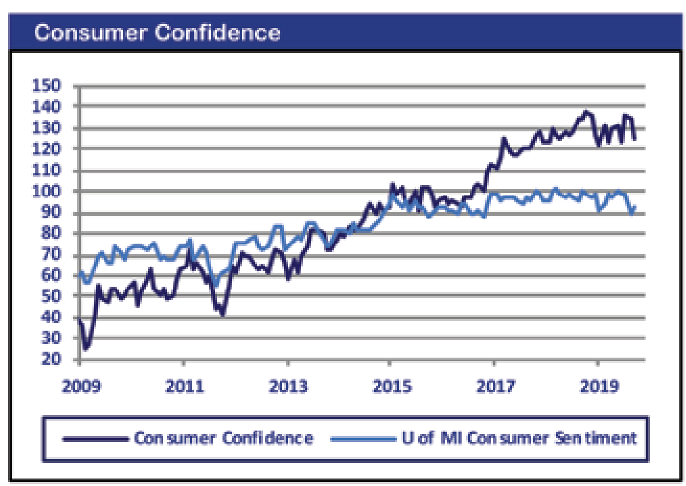
figure a

Sources: S&P, CBOE



Source: Bloomberg

figure b



Source: Bloomberg

Economic indicators *(continued)*

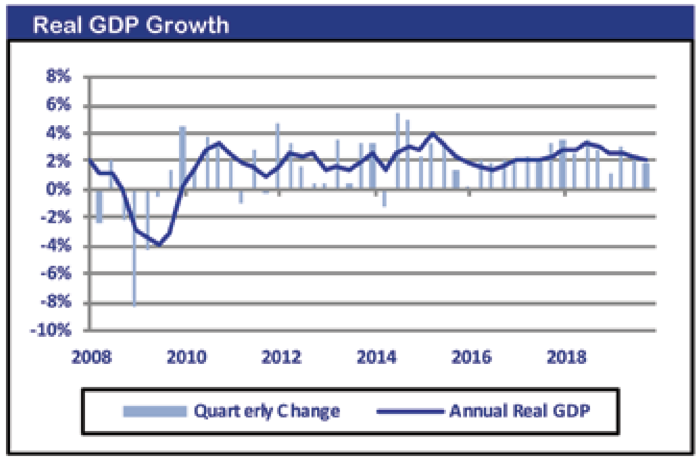
Trade war effects on GDP in the third quarter were not as bad as some economists estimated as the initial reading on 3Q GDP came in at 1.9% versus an estimate of 1.6%. Once again, driving the growth was consumption with the latest quarter growing by 2.9%. Business investment declined again as trade uncertainty remains a headwind. Overall, growth in the U.S. is holding up well, and the latest report should keep the Fed from cutting rates again this year.

The latest survey on manufacturing from the ISM moved higher to 48.3, but is still below the key expansion level of 50. Clearly the ongoing trade dispute with China has had a lasting effect on the sector, as this is the third month in a row that ISM manufacturing has been below 50. Meanwhile, the nonmanufacturing index still remains in expansionary territory at 54.7%, providing some optimism that growth exists in areas outside of manufacturing. With the positive momentum in trade discussions, we suspect that manufacturing could improve in the coming months.

Inflation measured by the Consumer Price Index was relatively muted compared to the last three months. Headline CPI was flat for the month as energy prices continued to weigh on inflation. The blistering pace of core inflation also came to a halt in September as core CPI rose by only 0.1%. On an annualized basis, core inflation remained at 2.4% while headline CPI dipped to 1.7%. On balance, the cooling of core inflation data in September is a sign that consumers may not be facing the brunt of increased tariffs yet.

With the GM autoworkers on strike during October, many investors expected a lot of noise in the recent payroll data. The bar was set quite low, with most economists projecting only 85k jobs to be added in October. However, the Bureau of Labor Statistics reported 128k payrolls were added and a 2-month upward revision of 95k. Additionally, average hourly earnings grew at 0.2% and the participation rate ticked higher to 63.3%. The unemployment rate edged up to 3.6%, but still remains near a 50-year low. Overall, the latest labor market data should put to rest the notion that hiring is abruptly slowing and should reassure investors that the strength of the labor market remains intact.

figure b (continued)



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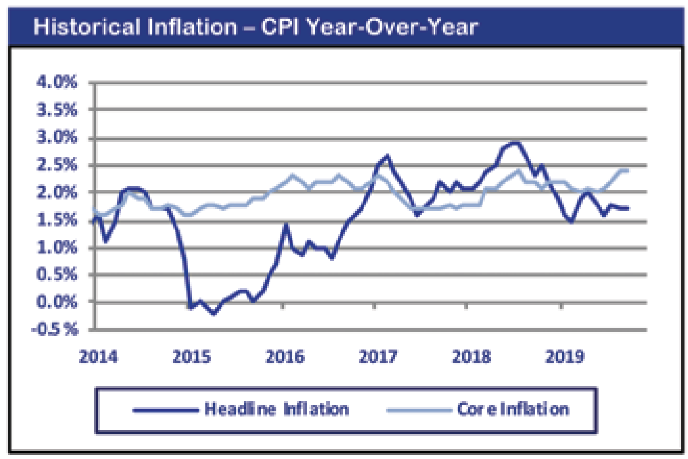

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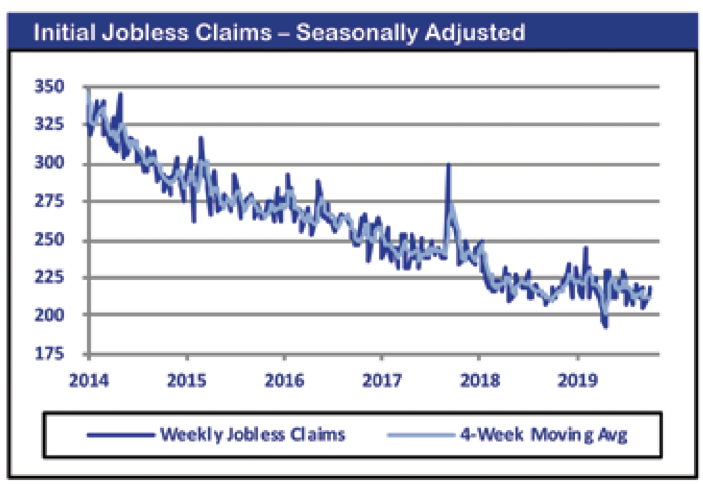

Source: Bloomberg

Note: Initial jobless claims amounts listed are in thousands

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	47.8	48.9	48.3	December 2 (Monday)
GDP Annualized	2.0%	1.6%	1.9%	November 27 (Wednesday)
Unemployment rate	3.5%	3.6%	3.6%	December 6 (Friday)
Retail sales	0.6%	0.3%	-0.3%	November 15 (Friday)
Consumer Price Index (YoY)	1.7%	1.8%	1.7%	November 13 (Wednesday)
U. Mich. Consumer Sentiment	96	96	95.5	November 22 (Friday)
Home Price Index (MoM)	0.04%	-0.1%	-0.2%	November 26 (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.