Market Update

(12/2019)

Allianz Investment Management LLC

December 2019 Market Update

Key points

- Positive momentum on trade discussions with China lifted equity indexes to new all-time highs
- Recession risks have receded and the weakness in manufacturing appears to be bottoming
- The consumer is heading into the holiday spending season with elevated confidence and the wherewithal to spend
- We are cautiously optimistic with the current state of the economy as we head into the New Year

Outlook

GROWTH: Economic growth for the third quarter was revised upward from 1.9% to 2.1%, which is another sign the economy is chugging along at a better pace than previously thought. The modest upward revision resulted from a build up of inventories, but it remains to be seen whether this was a result of trade war stockpiling or preparation for a strong holiday season of consumer spending. The effects of the trade war have been felt across the manufacturing sector, but the solid labor market has helped fuel consumption and kept growth from declining further. With GDP for the third quarter coming in slightly above potential growth for the economy, we are fairly confident 2019 real GDP will fall within our expected forecasted range.

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

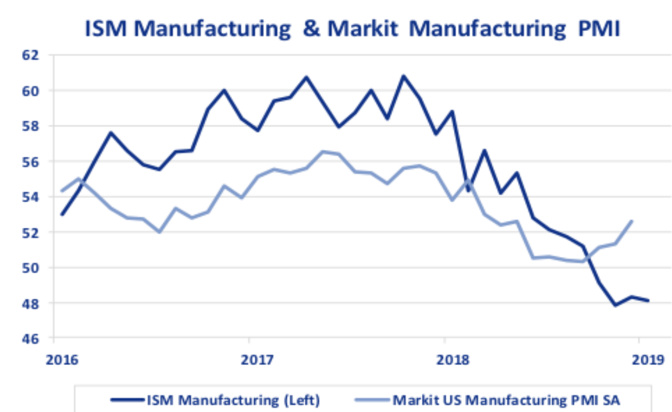
INTEREST RATES: As trade-related angst has diminished, interest rates appear to have bottomed. The Fed has concluded their mid-cycle adjustment and signaled that policy rates will be on hold for the foreseeable future. As a result, the Treasury curve is no longer inverted at the 3-month and 10-year point, which signals a near-term recession is not as likely. The 10-year Treasury has been range bound since last summer and has had a difficult time rising back above 2%. Global rates continue to be a big driver of rates in the U.S., and negative yields abroad continue to act as an anchor to U.S. rates. Overall, we still expect the 10-year Treasury yield to end 2019 within our expected range.

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

November 2019 recap and macro themes

The month of November was primarily dominated by trade related headlines as the consensus narrative was building toward the possibility of a phase one trade deal between the U.S. and China. Over the past two years, the U.S. has imposed 25% tariffs on $250 billion of Chinese imports and 15% tariffs on an additional $110 billion of goods. With a December 15 deadline for new tariffs to be put in place, investors were eager to see some progress made on the trade negotiations. An expectation of some tariffs being rolled back helped fuel equity markets to new all-time highs. Market sentiment has improved remarkably from a few months ago, and we have to suspect that many investors have ultimately backed away from the doom-and-gloom scenario as trade discussions have progressed, corporate earnings were upbeat, and economic data appears to be bottoming. Overall, against this backdrop where an immediate recession is off the table, we could envision further marginal upward pressure on both rates and equities.

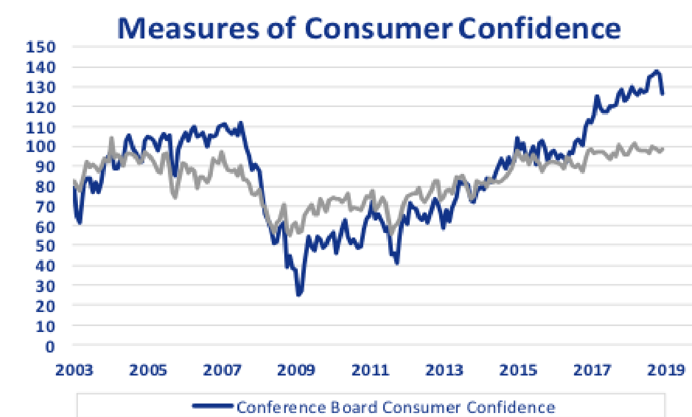
Trade headlines aside, there have been nascent signals that global manufacturing weakness has started to form a bottom with the PMI data ticking higher in November. The manufacturing PMI figure surprised to the upside in November, coming in at 52.6 from 51.3. A PMI Index with a reading above 50 is generally considered to indicate expansion within the sector. Interestingly, while other manufacturing data has suggested the sector may be contracting, the PMI index suggests manufacturing is



Source: Bloomberg, Allianz Investment Management LLC

rebounding with its last three prints increasing month-over-month. Overall, the PMI data is a welcomed sign that activity in the manufacturing sector may have bottomed recently.

Despite the weakness witnessed in the manufacturing sector, consumption in the U.S. has remained quite resilient, and in a large part has kept overall growth in the economy running at trend. The holiday season is upon us, and the consumer is equipped to spend as measures of consumer sentiment have rose to the highest level since July. The University of Michigan Consumer Sentiment Index rose to 96.8 in the final reading of November and was much improved from the weaker readings last summer. Concerns over trade and tariffs have declined from a consumer perspective, and in addition, it appears the recent impeachment hearings have had no bearing on consumers' attitude. Against a backdrop of low gas prices, low unemployment, and an elevated stock market, we would expect healthy consumer sentiment to remain the norm. Consequently, we expect some strong holiday sales results to underpin growth output for the fourth quarter.



Heading into the New Year, we are cautiously optimistic with the state of the overall economy. While there are some downside risks still present, recent Fed easing, positive rhetoric on global trade, and a well-equipped consumer creates a path to extend the current expansion beyond what was previously thought.

Market indicators *(figure a)*

Equities continued their climb in November with all major U.S. indexes edging higher over the month. Better than expected earnings data coupled with a supportive Fed helped to bolster equities higher. We expect equities to remain positive going into year-end as significant trade progress combined with the positive backdrop of the U.S. economy should support equities.

Despite continued trade tension between the U.S. and China, as well as impeachment headlines, volatility was subdued throughout November with the VIX Index trading between a range of 11.54 to 13.13 over the month.

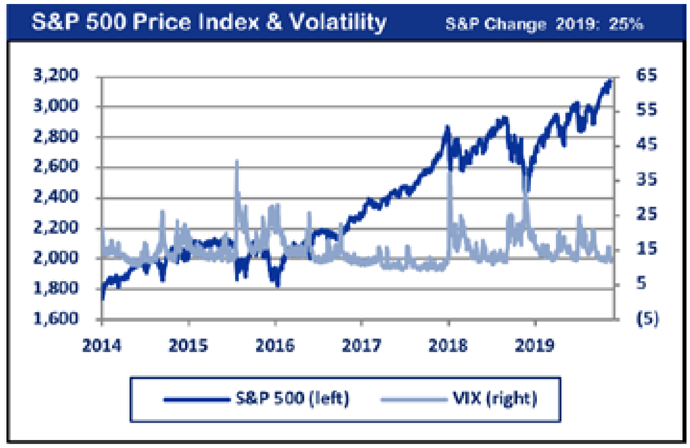
Treasury yields across the curve edged higher in November as investors appetite for riskier assets increased. With recession risks diminishing and trade discussions between the U.S. and China progressing, we expect there to be upward pressure on Treasury rates. However, we remain cognizant of the global yield environment and the spillover effect it could have on U.S. interest rates.

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.

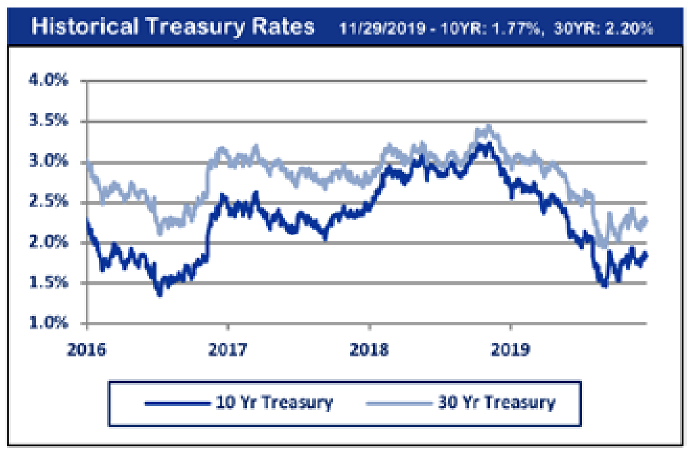
Economic indicators *(figure b)*

Consumer sentiment remained positive going into the holiday season with the final reading for the University of Michigan Consumer Sentiment Index rising to 96.8. Consumer confidence, however, unexpectedly edged lower in November to 125.5 and marked the index's fourth consecutive decline. That being said, we aren't too concerned as the index remains at historically high levels. Overall, with concerns over trade and tariffs declining, equities reaching higher highs, and the labor market continuing to remain tight, we expect the consumer strength to persist pending no material changes to the economic backdrop.

figure a

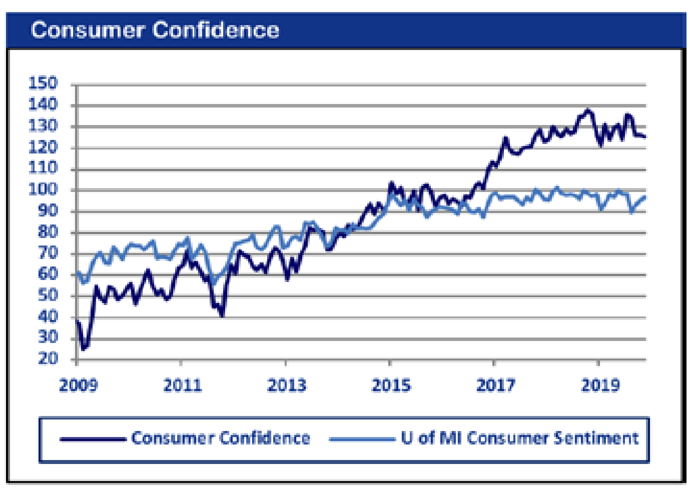


Sources: S&P, CBOE



Source: Bloomberg

figure b



Source: Bloomberg

Economic indicators *(continued)*

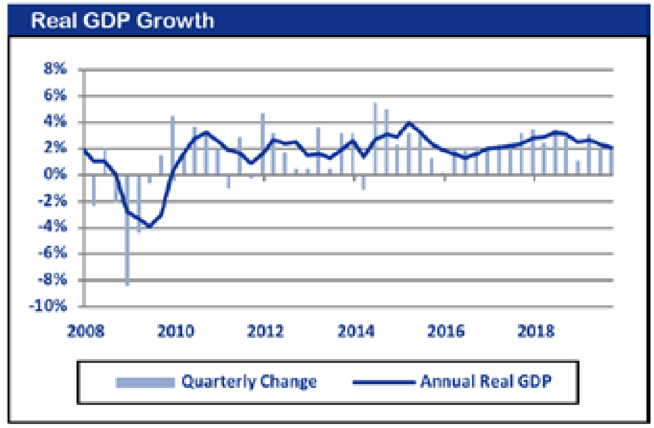
The second revision of third quarter GDP edged higher to an annualized rate of 2.1% from 1.9% as inventories increased. Business investment declined, however, at a smaller percentage than originally estimated. Overall, the progress between the U.S. and China should assist in driving growth higher.

The ISM Non-Manufacturing index rebounded in October to a level of 54.7 from a prior reading of 52.6. This reading comes in contrast with the manufacturing sector, which has entered into contractionary territory in recent months. More specifically, ISM manufacturing slowed further in November with the PMI falling to 48.1%. Furthermore, the release marked the fourth consecutive reading below 50. Overall, we expect trade will continue to weigh on the sector until the U.S. and China are able to finally come to terms on a phase one agreement.

Headline inflation data surged by 0.4% as energy prices drove most of the increase. Excluding food and energy, core inflation rose by 0.2%. Additionally, within the details, most of the underlying components exhibited more volatility than usual. Apparel prices fell 1.8% while medical costs offset the decline and rose by 1%. Taken together, core inflation dropped slightly to a 2.3% annualized pace. In our view, it's likely going to take a stronger and more sustained core inflation figure to entice the Fed to move policy rates, which appear to be on hold for the foreseeable future.

November's employment report far exceeded expectations as payrolls came in 88k higher than estimates at 266k. Part of the gain came from GM autoworkers, who returned to work after being on strike for the last four weeks. Additionally, the healthcare and professional and technical services sectors also saw prominent job gains. Average hourly earnings came in higher than expected at 3.1% year-over-year. The unemployment rate returned to 3.5%. Overall, November's report suggests that the labor market remains strong and helps support the Fed's current stance of policy accommodation.

figure b (continued)



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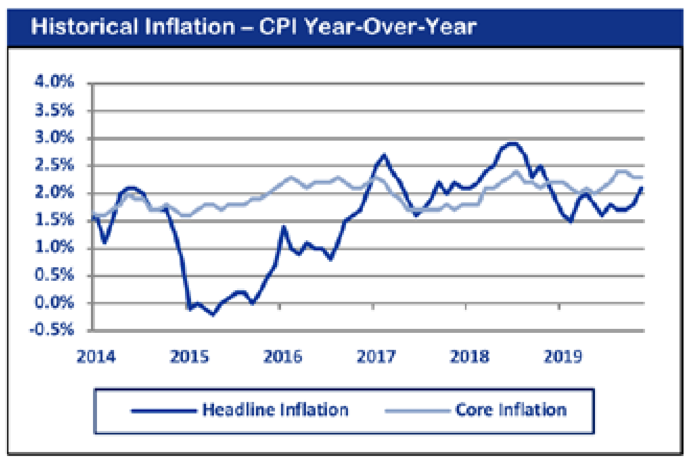

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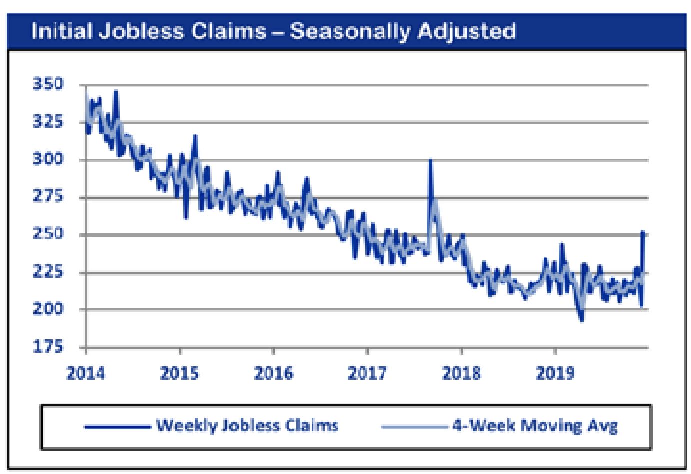

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	48.3	49.2	48.1	Friday, January 03, 2020
GDP Annualized	1.9%	1.9%	2.1%	Friday, December 20, 2019
Unemployment Rate	3.6%	3.6%	3.5%	Friday, January 10, 2020
Retail Sales	-0.3%	0.2%	0.3%	Friday, December 13, 2019
Consumer Price Index (YoY)	1.8%	2.0%	2.1%	Tuesday, January 14, 2020
U. Mich. Consumer Sentiment	96.8	97.0	99.2	Friday, December 20, 2019
Home Price Index (MoM)	0.15%	0.30%	0.36%	Tuesday, December 31, 2019

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.