Market Update

(1/2020)

Allianz Investment Management LLC

January 2020 Market Update

Key points

- 2019 was an impressive year for many asset price returns, but looking forward we are expecting a more mediocre environment when it comes to asset price gains.
- December marked an important milestone in the process of trade resolution between the U.S. and China as phase one of a trade deal was agreed upon.
- Consumption continues to propel the U.S. economy near trend pace and the outlook for next year isn't much different as consumers continue to be employed and well-equipped to spend.
- The Fed has completed their "mid-cycle adjustment" and has signaled that they will remain on the sidelines in 2020 with regards to changes in policy rates.

Outlook

GROWTH: The strength in the U.S. economy continues to be drawn from the forces of the consumer as negative affects from trade uncertainty have failed to derail the economy. The low unemployment rate and strength of the U.S. workforce has given consumers the ability to spend. Personal spending grew at an annualized pace of 3.2% in the third quarter according to the latest release on third-quarter GDP. Personal consumption was slightly below the 4.6% annualized increase in the second quarter, but nonetheless, still a strong increase for the quarter. Against the headwinds of an aging population and subdued business investment in the late innings of the business cycle, we still expect the economy to grow close to its potential at 2.0%. Therefore, our outlook for 2020 real GDP is expected to be within the range of 1.60% and 2.10%.

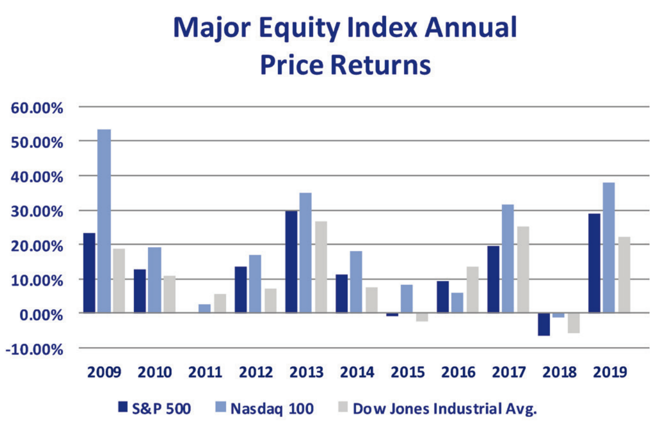
2020 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	1.60%-2.10%

INTEREST RATES: While it has been noted that progress has been made with regards to trade negotiations between the U.S. and China, there are some lingering risks on the geopolitical front that have kept a lid on U.S. interest rates. For now the front end of the curve will be anchored as the Fed is unlikely to make any changes to policy rates in 2020. However, direction and magnitude of change in long-term rates will likely be dictated by the progression of the U.S. economy versus the outlook. We still believe long-term rates are below their fundamental levels as factors such as negative interest rates abroad and risks associated to global trade continue to weigh on outright levels. Therefore, with a fairly benign outlook expected for the U.S. economy, we expect 10-year yields to trade mostly range-bound in 2020 with our end of year forecast of 1.50% to 2.00%.

FORECAST PERIOD	10-YEAR TREASURY YIELD
End of 2020	1.50% - 2.00%

December 2019 Recap and Macro Themes

As we reflect back on 2019, there was a continuous narrative that revolved around the escalating trade tensions with China and the elevated uncertainty that ensued. Fortunately, for investors, those risks diminished as the Fed injected a shot of monetary stimulus in the second half of the year and ultimately, a recession was averted. The Fed's abrupt shift in policy during 2019 provoked investors' risk appetite and led to outsized gains for equities in the face of slowing global growth and the ongoing trade war between the U.S. and China. Last year the S&P 500® Index gained the most since 2013 with a nearly 29% return while the Nasdaq 100® Index was up the most since 2009 with a return of almost 38%. All in all, 2019 was an impressive year for asset price returns, but looking forward we expect a more benign environment with asset prices yielding to a smaller range.

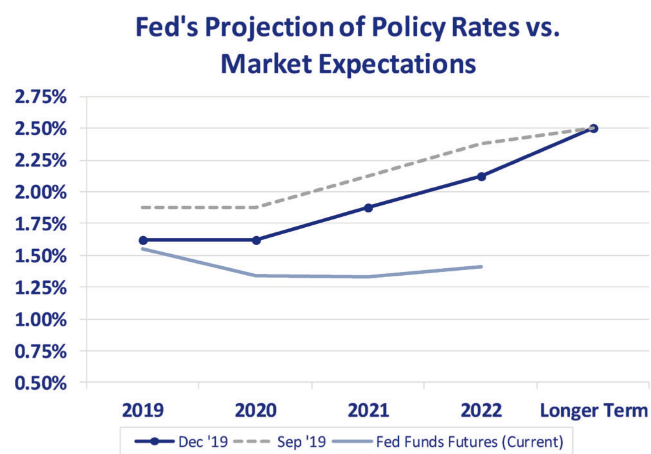


Source: Bloomberg, Allianz Investment Management LLC

Regarding the trade war, December marked an important milestone in the process of trade resolution between the U.S. and China as phase one of a deal was agreed upon. Within the deal, tariffs on the first tranche of $250 billion would eventually be dropped from 30% to 25%. Tariffs on the second tranche of $120 billion would go down from 15% to 7.5%. Lastly, the third tranche of $150 billion that was going to have 15% tariffs imposed on December 15 was suspended. While it appears that both sides could take away small wins from the first phase of the deal, the bigger impact should come from added stability and certainty over the long run.

Ultimately, investors were likely looking for a larger rollback of the tariffs in place, but the important takeaway here is that both sides were willing to de-escalate. The resulting compromise helped propel equity prices to new all-time highs in December and immediate recession fears have been tabled for the time being.

The Fed concluded the year by leaving policy rates unchanged in December and crystalized the view that a high hurdle is in place for the next change in policy rates. Prior to the meeting, commentary from Fed officials set the tone as Powell previously stated, "monetary policy is in a good place," and most officials agree that the current stance of monetary policy is "appropriate." With the high hurdle for a change in monetary policy in place, we think the Fed is likely to sit on their hands for the foreseeable future barring a material change in the economic outlook. For instance, the latest Summary of Economic Projections showed the Fed's forecast for policy rates as unchanged for 2020. Despite the market pricing in one cut, we view the "mid-cycle adjustment" has concluded and we don't expect any changes to policy rates through 2020.



Source: Bloomberg, Federal Reserve, Allianz Investment Management LLC

Generally speaking, we are cautiously optimistic with the state of the economy going forward as recent Fed easing, de-escalating trade tensions, and a well-equipped consumer are likely to extend the current expansion.

Market indicators *(figure a)*

Equities continued their rally into December with the S&P, Dow, and NASDAQ indices all gaining over the month. The positive economic backdrop of the U.S. economy and the anticipated phase one trade deal between the U.S. and China helped boost equities higher. Going forward these two themes should continue to support U.S. equities.

Volatility, as measured by the VIX Index, was slightly elevated at the beginning of December but mostly subdued for the remainder of the month. This isn't surprising as trade headlines, which have been driving a majority of the volatility recently, turned positive as trade tensions between the U.S. and China de-escalated.

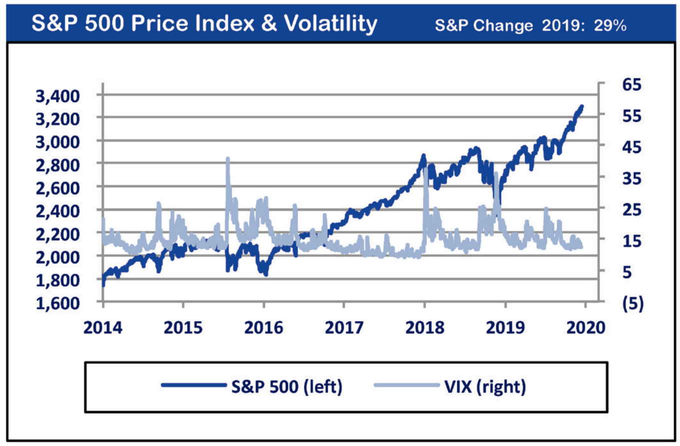
The 10-year point of the Treasury rate curve moved higher as fears of a trade war dissolved almost entirely. Additionally, the front end of the curve edged lower and we expect this was likely due to the Fed buying Treasury bills at a pace of $60 billion per month during the fourth quarter. Overall, the Treasury curve steepened in December and we expect this trend to continue as long-term rates drift marginally higher on positive economic sentiment.

Crude oil prices moved higher throughout December before ultimately ending the month at $61.06 per barrel. In sync with other risk assets, oil prices moved higher on news of a trade truce between the U.S. and China. Going forward we expect price gains to be relatively muted given the increase of supplies in the U.S. However, geopolitics in the Mid-East that lead to sustained supply shocks would support prices.

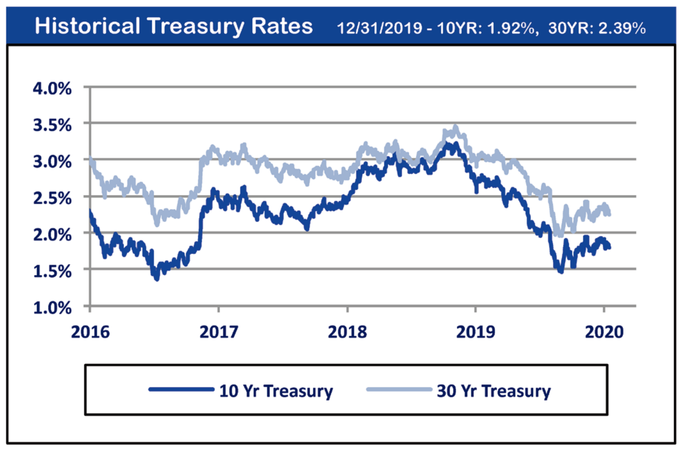
Economic indicators *(figure b)*

The final reading on consumer sentiment from the University of Michigan came in at 99.3. Despite elevated partisan politics and the impeachment of President Trump, consumers remain confident in the economy. However, consumer confidence, as measured by the Conference Board, unexpectedly declined in December with the index falling to 126.5. The data suggests that consumers feel better than they once did about the current situation, but are now more concerned about the outlook of the market. Overall, this isn't too concerning as the index still remains at historical high levels and we continue to expect solid consumption in the U.S. economy in 2020.

figure a

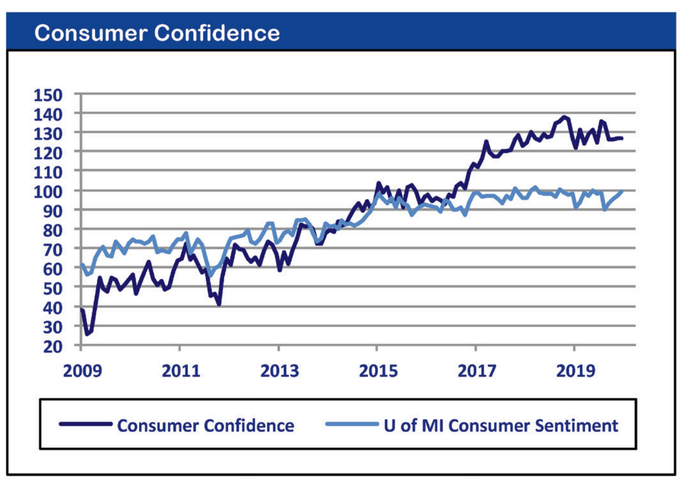


Sources: S&P, CBOE



Source: Bloomberg

figure b



Source: Bloomberg

Economic indicators *(continued)*

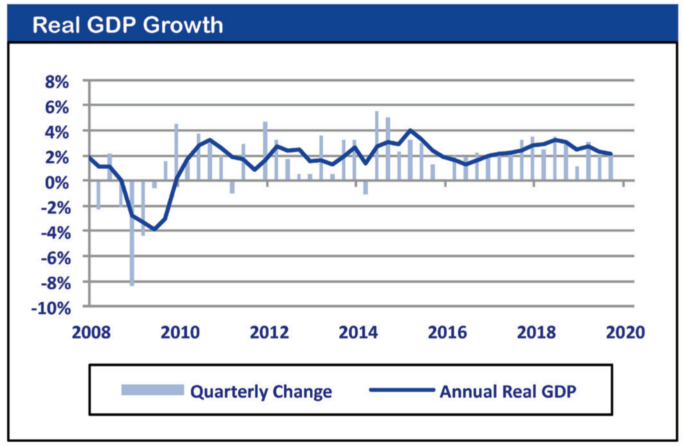
The third estimate for GDP in the third quarter came in unchanged at 2.1%. Additionally, the YoY figure was also unchanged at 2.1%. Within the data there were marginal but offsetting revisions. Consumption was revised upward while the accumulated inventories mentioned during the last release were revised lower. Overall, third quarter GDP growth was better than originally expected as the strong labor market continues to support consumer strength.

The non-manufacturing and manufacturing sectors continued their divergence in December as the ISM Non-Manufacturing Index remained in expansionary territory while the manufacturing sector continued to contract. More specifically, the ISM Non-Manufacturing headline figure increased from 53.9 to 55 while the ISM Manufacturing Index fell to 47.2. In total, December's report highlights that the non-manufacturing sector has retained its strength and avoided any negative spillover from global trade tensions.

Data on the strength of consumer prices fell short of expectations at the end of the year with December's headline CPI figure at 0.2% and the core CPI figure at only 0.1%. However, on an annualized basis both headline and core CPI finished the year at 2.3%. The gap between core CPI and core PCE has now widened to 65 basis points, the highest since 2016. Inflation pressures coming through CPI have yet to show up in the Fed's preferred measure of inflation, core PCE, and it's unlikely to influence Fed decisions until that gap narrows.

Non-farm payrolls added for December were slightly below expectations at 145k, but still signaled a tightening labor market. While disappointing on the headline, today's payroll miss is unlikely to change the outlook for the U.S. economy as the results are consistent with economic output chugging along at trend pace. Despite anecdotal evidence of companies offering higher wages in search of qualified workers, wage gains were mostly muted in December leaving the annualized wage growth at 2.9%. Overall, December's report may be a precursor to what we can expect in 2020, an economy extending the current expansion at a moderate pace.

figure b (continued)



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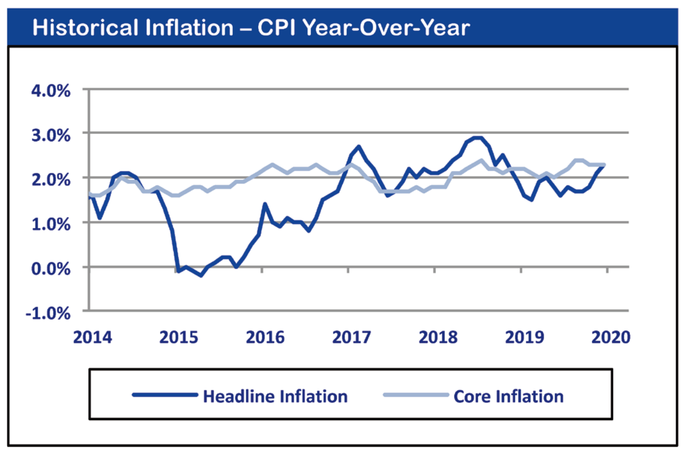
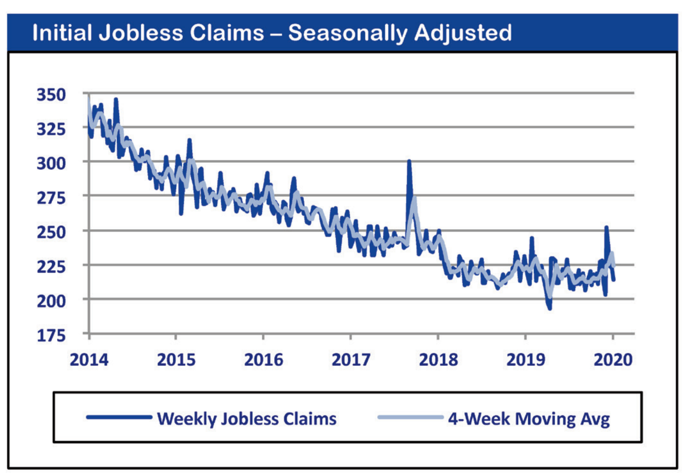


Source: Bloomberg



Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	48.1	49.0	47.2	Monday, February 03, 2020
GDP Annualized	2.1%	2.1%	2.1%	Thursday, January 30, 2020
Unemployment Rate	3.5%	3.5%	3.5%	Friday, February 07, 2020
Retail Sales	0.4%	0.5%	0.2%	Thursday, January 16, 2020
Consumer Price Index (YoY)	2.1%	2.4%	2.3%	Thursday, February 13, 2020
U. Mich. Consumer Sentiment	99.2	99.2	99.3	Friday, January 17, 2020
Home Price Index (MoM)	0.35%	0.30%	0.43%	Tuesday, January 28, 2020

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.