Market Update

(2/2020)

Allianz Investment Management LLC

February 2020 Market Update

Key points

- 2020 was off to a good start until the coronavirus outbreak proved to be a significant macro headwind for the first quarter.
- The reflation of global growth will have to wait as the world economy deals with the fallout from the coronavirus outbreak.
- Uncertainty encompassing the viral epidemic has driven investors to abandon riskier assets for the safety net of U.S. Treasuries, sending yields to the lowest level since last September.
- The Fed has acknowledged the downside risks associated with the coronavirus, but they have signaled that they continue to be comfortable with the current levels of policy rates.

Outlook

GROWTH: While many investors were expecting global growth to reflate during the first quarter on the basis of improved trade sentiment, that narrative has likely been put on hold with the recent developments regarding the coronavirus outbreak in China. The speed at which the virus spread led governments and corporations to take swift action to help contain the outbreak. Much of this involved reductions in traveling and transportation, which are likely going to take a toll on global growth in the first quarter. For U.S. growth, coronavirus disruptions will certainly be a headwind, but some of that weakness will be offset by stronger economic data we witnessed in January. Overall, we still expect growth for the U.S. to be within our expected range of 1.60% to 2.10%, but the uncertainty surrounding the disturbance from the viral outbreak could push U.S. GDP toward the lower end of that range.

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

INTEREST RATES: The coronavirus will certainly be a setback for the world economy in the first quarter, and the impact and uncertainty is reflected in current rate levels of U.S. Treasuries. The 10-year Treasury yield dropped nearly 40 basis points from its high of 1.89% to the low point of 1.50% in January. The swift repricing of U.S. rates stemmed from a classic flight-to-quality move by investors who were fleeing risk assets following the headlines around coronavirus. In turn, investors have priced in the higher probability of a rate cut from the Fed. Given the recent guidance from the Fed and the uncertainty surrounding the virus's impact, we think it's premature to assume a rate cut at this point. While short-term factors have driven rates to the lower end of our forecasted range, we expect the solid economic data we have witnessed in the U.S. to partially offset some of the macro driven headwinds. Therefore, we continue to maintain our expected range for the 10-year Treasury yield.

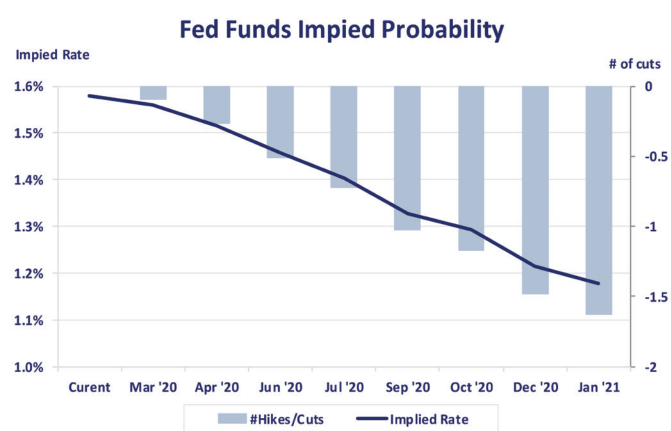
FORECAST PERIOD	10-YEAR TREASURY YIELD
End of 2020	1.50%-2.00%

January 2020 recap and macro themes

Risk assets experienced a strong start in early January as headwinds around trade continued to fade and reported corporate earnings came in better-than-expected. More importantly, the long-awaited phase one trade deal between the U.S. and China was signed this month. There were five fundamental topics the deal covered, which included intellectual property, China's purchases of U.S. goods, technology transfer, currency enforcement, and financial services. Nonetheless, the U.S. has said that existing tariffs will remain until China can show fulfillment of their end of the deal.

Just as trade-related headwinds began to fade, market participants were faced with a new problematic uncertainty involving China. This time it was in the form of a viral outbreak of the so-called coronavirus in mainland China. In turn, investors became more cautious toward risk assets throughout the month, putting pressure on bond yields as the coronavirus epidemic in China stoked fears that a broader pandemic may be underway. Many investors were quick to draw similarities to the SARS outbreak in 2003 and its impact on financial markets, however the mortality rates appears to be much lower for coronavirus. With the economic stakes relatively high, uncertainties surrounding the impact of the coronavirus outbreak has investors, companies, and governments all taking a cautious approach. Despite the virus being mostly concentrated in mainland China, the World Health Organization officially declared the situation a global health emergency. The cautious tone weighed on riskier assets such as equities and sent investors seeking safe haven in high-quality assets like U.S. Treasuries. In our view, an epidemic event of this nature in the second largest world economy is likely to only be a temporary setback for global economic growth at this point. Investor angst from the coronavirus outbreak continued to linger as markets were unable to shrug off the uncertainty associated to the virus. Stocks finished the month of January slightly in the red and Treasury yields moved lower with the 10-year Treasury yield near 1.50%. The Treasury curve remains very flat and bond investors are starting to price more rate cuts from the Fed later this year.

Regarding the Fed, many market participants expected the last Fed meeting to be a snoozer with not much actionable change to their main policy. The Fed delivered on that narrative as forward guidance continued to portray a Fed that is comfortable with the current stance of monetary policy. Idiosyncratic risks like the coronavirus aside, the committee's view on the fundamental outlook for the economy hasn't wavered. Hence, the debate among Fed officials was centered on the minutiae of its recent money market interventions. Recently, the Fed has been intervening in markets by conducting temporary repo operations and aggressively buying Treasury bills. Some investors believe the latter is partly responsible for the recent swell in asset prices, which could lead to a decision to slow the pace of purchases at some point in the near future. With forward guidance remaining the same and the debate focused on the trivial details of the Fed's open market operations, the latest Fed meeting offered little to influence broader market decisions for investors. However, should the coronavirus in China become a pandemic issue, we suspect there could be pressure on central banks to inject stimulus into the economy. While a rate cut seems unforeseen at this point, market participants have begun to price a lower Fed funds rate at the end of this year.



Source: Bloomberg, Allianz Investment Management LLC

Market indicators *(figure a)*

The equity markets rallied to record highs during the first half of January as positive sentiment regarding the trade deal with China helped buoy stocks. However, the exuberance was short-lived, as the risk from coronavirus wiped out most of the equity gains during the month. As with previous viral outbreaks, the risk-off scenario is expected to be brief, especially given the current strength of the U.S. economy.

The VIX index rose substantially at the end of January as coronavirus fears pushed volatility to the highest level since October of 2019. Haven-seeking investors quickly moved away from stocks and sent the VIX index to an intra-day high of 19.99. On a go-forward basis, we expect to see volatility to remain above long-term averages as late-cycle mentality remains and we move closer to the U.S. election.

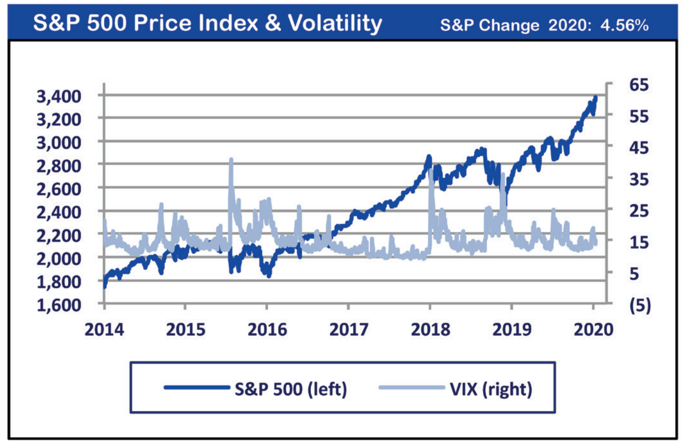
The risk-off trade has kept pressure on U.S. rates as the yield curve briefly inverted between the 3-month and 10-year points. Classic flight-to-quality events tend to drive investors toward longer-duration U.S. Treasuries and this recent episode was no different with the 30-year Treasury yield falling below 2% for the first time since last September. Overall, we expect yields will move back toward more normalized levels as coronavirus fears eventually fade.

After reaching a multi-month high in January, crude oil prices sold off drastically as investors feared the outbreak of coronavirus would have a much larger macro impact on global growth. The 15% decline in West Texas Intermediate crude oil prices will likely only have a marginal effect on consumers with lower gas prices at the pump. Lastly, it's likely prices will move higher as uncertainty surrounding the virus outbreak dissipates.

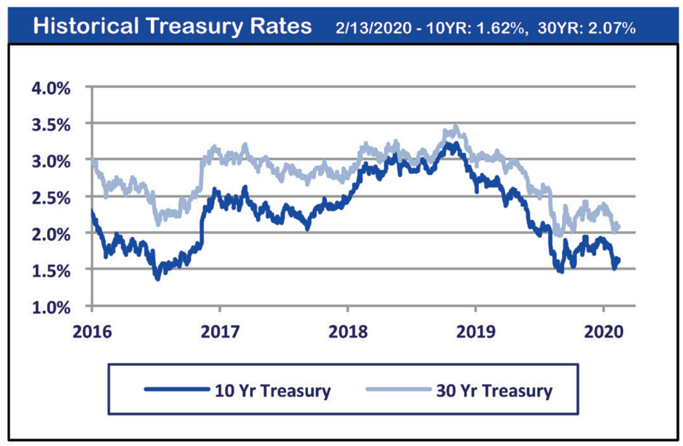
Economic indicators *(figure b)*

While recent GDP data highlighted weaker consumer spending, data from the Conference Board and the University of Michigan remains supportive toward consumption. The Conference Board's index on consumer confidence rose to 131.6 in January, while the final reading of the University of Michigan's consumer sentiment index was revised up to 99.8. Overall, consumer confidence remains high, but it's too early to tell whether virus concerns will have an impact on consumer attitudes.

figure a

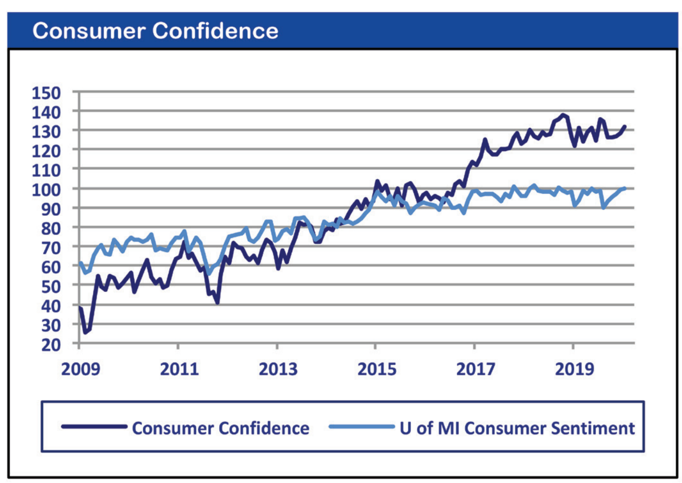


Sources: S&P, CBOE



Source: Bloomberg

figure b



Source: Bloomberg

Economic indicators *(continued)*

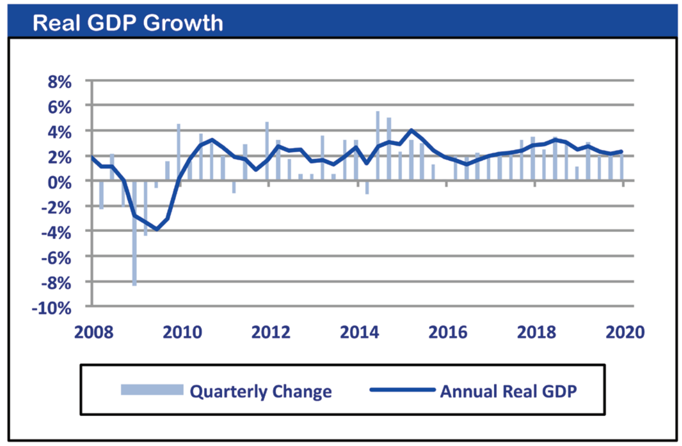
At face value, the results from the latest GDP data for the fourth quarter look decent with a 2.1% gain, but beneath the surface, signs of slowing consumption may be a potential concern. Indeed, consumer spending slowed to 1.8% from 3.2% in the previous quarter, but it's possible the shorter holiday season was a factor. Concurrent with the Fed's statement, business investment continued to be weak with a decline of 1.5%. Lastly, the net trade had a large impact on GDP which will likely be temporary as imports declined by 8.7%. Overall, the 2.3% annualized pace of GDP, while slower, is consistent with the U.S. economy's potential level of output.

Respondents to the latest ISM manufacturing survey were the most upbeat since July, which coincides with the recent signing of phase one of the trade deal with China. The reading of 50.9 and the new orders component rising by 5 points to 52.0 is a positive sign that activity is picking up. Furthermore, the non-manufacturing index jumped by half a percent to 55.5. Overall, both forward-looking indicators are indicative of increased activity in the U.S. economy.

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. Upward inflation pressures showing up in CPI data have yet to come through the Fed's preferred measure of inflation, core PCE. It's unlikely rising CPI will influence Fed decisions until that gap narrows between core CPI and core PCE.

The Bureau of Labor Statistics reported that 225k non-farm payrolls were added last month, which was well above the expectation of 165k and the 2019 monthly average of 175k. Wage increases were stronger than December's data with a 0.2% monthly gain, and we suspect this will be a continuing theme throughout the year as employers attempt to attract workers within tight labor market conditions. Overall, the January employment report provided a clear indication we haven't reached the end of the current economic cycle.

figure b (continued)



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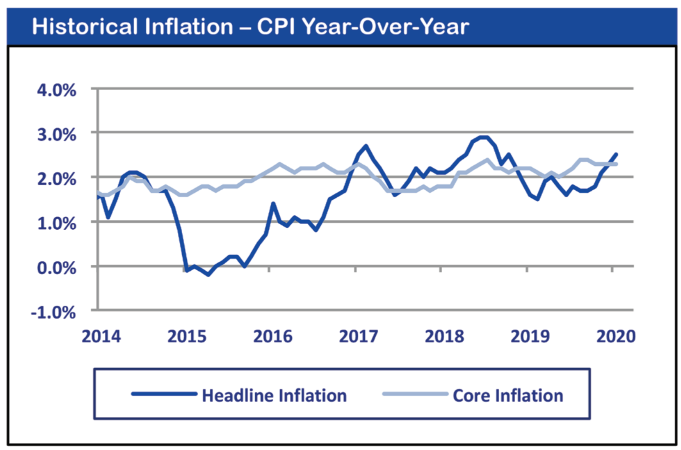

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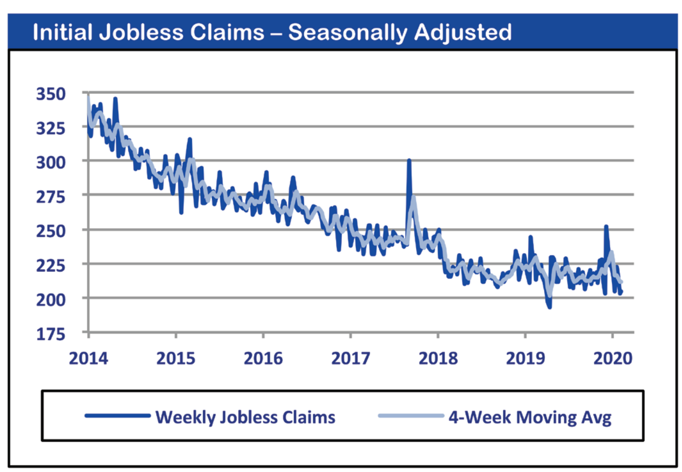

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	47.2	48.5	50.9	Monday, March 02, 2020
GDP Annualized	2.1%	2.0%	2.1%	Thursday, February 27, 2020
Unemployment Rate	3.5%	3.5%	3.6%	Friday, March 06, 2020
Retail Sales	0.3%	0.3%	0.3%	Friday, February 14, 2020
Consumer Price Index (YoY)	2.1%	2.4%	2.3%	Wednesday, March 11, 2020
U. Mich. Consumer Sentiment	99.1	99.1	99.8	Friday, February 14, 2020
Home Price Index (MoM)	0.46%	0.40%	0.48%	Tuesday, February 25, 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.