Market Update

(3/2020)

Allianz Investment Management LLC

March 2020 Market Update

Key points

- Price action in the market was downright ugly as coronavirus fears morphed from a risk-off event into a liquidity crunch.
- The 30-year and the 10-year Treasury yields dropped to the lowest levels ever as investors flocked to safe-haven assets.
- The message was clear from Jay Powell, in that the Fed is going to do whatever it takes to support the capital markets.
- Economic data releases continue to be an afterthought as investors focused their attention on the coronavirus and its implications to growth both domestically and abroad.

Outlook

GROWTH: Economic growth is looking more like a scarce commodity at this point as the coronavirus has literally led the global economy to a standstill. The pandemic virus has caused governments and businesses alike to take extreme precautionary measures in the form of self-quarantines and social distancing in order to keep the coronavirus from spreading more rapidly. As a result, it is widely known that specific industries will be hurt in this environment, such as travel and hospitality. Fortunately, we are confronting this problem on both the monetary and fiscal fronts with the Fed dropping rates by 150 basis points and the U.S. government providing over $1 trillion in fiscal stimulus. However, there continues to be a high degree of uncertainty around the economic fallout from coronavirus. While we know there will be a hit to growth in the current quarter and the potential for a recession remains high, we have yet to sharpen the pencils on where 2020 growth will end up, as it's too early to make that determination.

2020 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	TBD

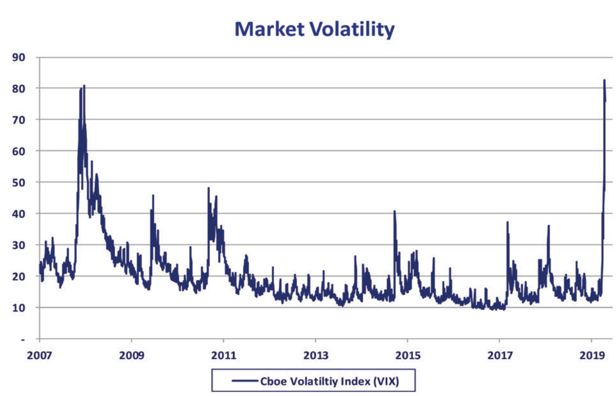
INTEREST RATES: This was undoubtedly a historic week in the financial markets as fears around coronavirus increased recession expectations and drove yields down to uncharted territory. The outright duration grab and move into safe-haven treasuries has flattened the yield curve and caused some dislocations in the market. In turn, we have witnessed extreme volatility across markets and even within the Treasury market. The 10-year Treasury yield traded all the way down to 31 basis points from levels above 1.00% in a matter of days. The Fed finally stepped up to provide liquidity to the markets as they increased the repo operations to over $1 trillion and altered their T-bill purchase program to extend to all maturities across the curve. The message was clear from Jay Powell, in that the Fed is going to support markets with whatever they need to keep functioning. Until the dust settles, it wouldn't be prudent to make an estimate on where 10-year Treasury yields will be, and therefore we will be making adjustments to our forecast in the coming months.

FORECAST PERIOD	10-YEAR TREASURY YIELD
End of 2020	TBD

February 2020 recap and macro themes

Continued uncertainty surrounding the coronavirus has spurred further risk-off mentality with both equities and bond yields declining. The 30-year and the 10-year Treasury yields dropped to the lowest levels ever recorded as the relentless buying from investors both domestically and abroad has continued to weigh on outright yields. Weaker PMI data released last month underscored investor jitters on the headwinds facing the global economy in the first quarter. Most of the concern is centered on the length of the disruption as its clear there will be an economic impact during the first and second quarters, but there is greater uncertainty around how large the impact will be. Overall, the coronavirus impact to equities and corporate spreads emphasizes recession risk being priced into the market as prolonged uncertainty persists around economic fallout from the outbreak.

Given the unprecedented moves in asset prices and extreme volatility, markets began to look dislocated, and liquidity across major asset classes started to dry up. Price action in the market was downright ugly as coronavirus fears morphed from a risk-off event into a liquidity crunch. Market participants struggled to find footing as most corporate bond trading effectively came to a halt. When spreads widened this much in 2016, it took almost 60 days, while the spread widening during the latest market rout has happened in only 12 days. The impressive volatility that has occurred in markets is something we haven't seen since the crisis era as the Cboe Volatility Index (VIX) closed at the highest level on record.



Source: Bloomberg, Cboe, Allianz Investment Management LLC

In the equity markets, the circuit breaker to the downside was tripped as stocks moved down by the 7% limit on a couple occasions and markets have been swinging wildly as investors continue to digest coronavirus headlines. Ultimately, the lack of liquidity and dislocations in the market were a signal for policy makers to act.

With capital markets functioning poorly, the Fed showed they were willing to act and they did so in a very big way. In an attempt to shock the markets, they implemented two emergency rate cuts totaling 150 basis points and brought policy rates effectively down to the zero-bound. After delivering the shock and not receiving the awe from markets, they pledged to do more. In addition to rate cuts, the Fed extended the daily repo operations to provide liquidity and offered over $1 trillion in repo through its program. If that wasn't enough, they also fired up the quantitative easing program again by pledging to buy $500 billion in Treasuries and $200 billion in agency mortgage-backed securities in the coming months. The message was clear from Jay Powell, in that the Fed is going to do whatever it takes to support the capital markets and keep them functioning.

Going into 2020, our base case called for moderate economic growth, inflation, and 10-year U.S. Treasury yields staying relatively range-bound, but that has been completely thrown out the window as the coronavirus has wreaked havoc on the global economy. At this point, we are unable to pinpoint forecasts with any good measure as the uncertainty surrounding coronavirus remains extremely high. In addition, the U.S. election could keep volatility elevated should a far-left presidential nominee gain momentum ahead of November and distort market confidence. Overall, we continue to be in a wait-and-see mode as we analyze the current economic landscape.

Market indicators *(figure a)*

- Beginning at the end of February, the coronavirus wreaked havoc on equity markets. Mass shutdowns and impacted supply chains have left investors concerned about the outlook for economic growth and as a result sent equities plummeting. Overall, we expect the equity volatility to continue while investors await additional answers on the virus's implications.

- Volatility, as measured by the VIX Index, increased during the last week of February before ending the month near 40. Unfortunately, it did not stop there as volatility spiked to an all-time high of 82.69 in March. A number of factors contributed to the surge in volatility, but two of the largest contributors were recession fears stemming from the coronavirus and policy reactions from central banks. With so much uncertainty surrounding the coronavirus, we expect elevated volatility to be present for the near future.

- Recession fears stemming from the coronavirus coupled with the Fed's emergency rate cuts weighed on Treasury yields as investors sought out safe-haven assets. The yield on the 10-year Treasury was slightly above 1.50% at the beginning of February, but by the end of the first week of March, yields had fallen all the way to 40 bps before popping back to over 1%. Other Treasury tenors behaved similarly with yields moving wildly throughout the month. Overall, we expect yield volatility to continue as investors continue to digest new information related to the coronavirus.

- Adding to an already volatile market was the oil price war that broke out between Saudi Arabia and Russia. After the two countries could not come to an agreement on production policy, they both began flooding the market with oil. As a result, WTI crude oil prices plummeted to levels not seen since 2001 and currently sit under $30 per barrel.

Economic indicators *(figure b)*

- Despite the market panic from coronavirus, consumer sentiment remained elevated in the U.S. as the University of Michigan Consumer Sentiment Index rose to 101.0 for the final reading in February. Despite sentiment surveys collected from participants through February 25, only a small amount of consumers actually mentioned the virus. Additionally, the Conference Board reported consumer confidence rose to 130.7 in February. Overall, the figures are robust with minimal influence from coronavirus, but we question whether the consumer index will be able to maintain its confidence given the current economic environment and uncertainty surrounding the coronavirus.

figure a

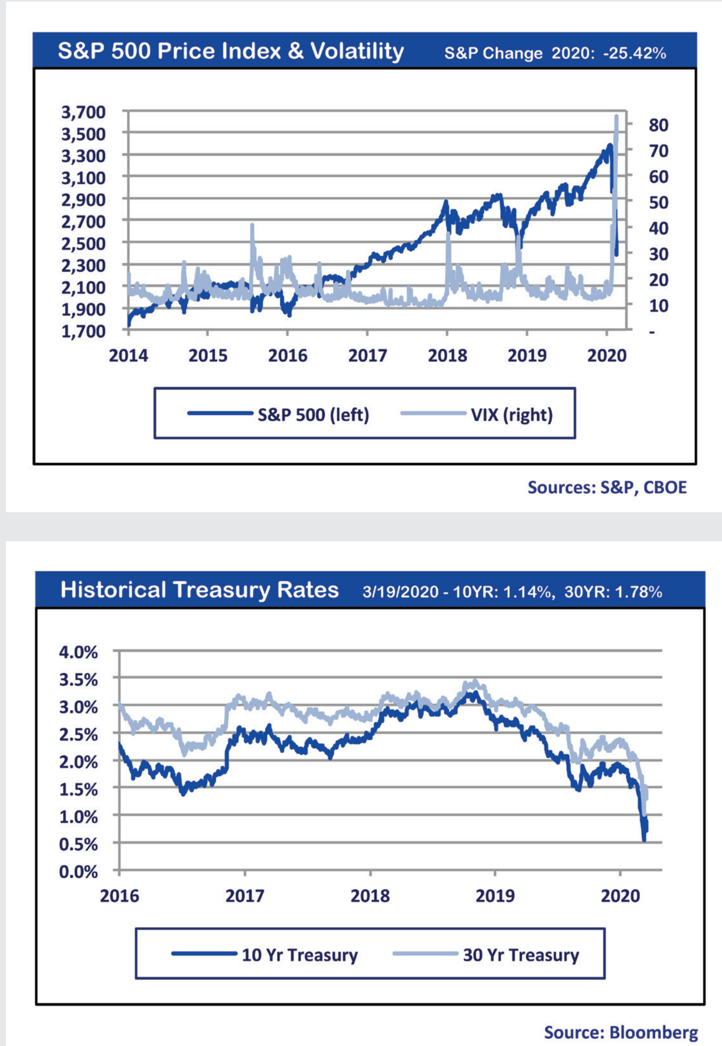
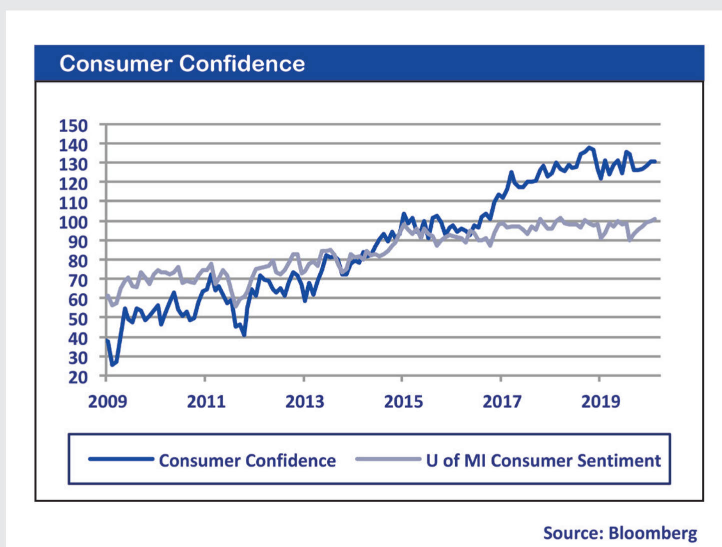


figure b



Economic indicators *(continued)*

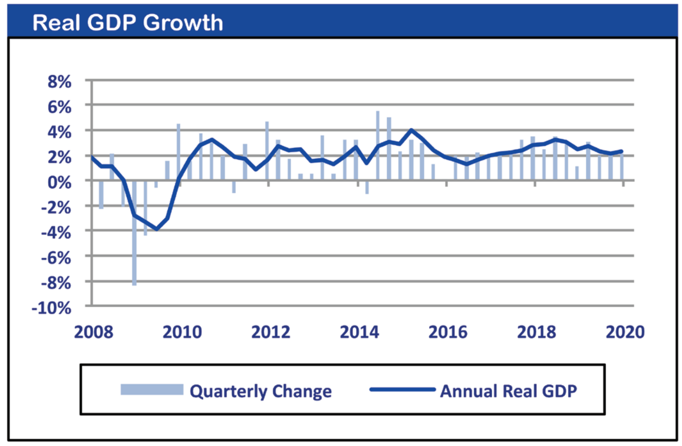
- The second estimate for GDP in the fourth quarter of 2019 was in line with estimates at 2.1%. Most notably, consumer spending was revised lower by 0.10% to 1.7%, but the decline in consumption was offset by positive revisions to trade and inventories. Regardless of how the economy performed in the last quarter of 2019, we certainly will see a slowdown in the economy during the first quarter. The slower pace is likely to drag out into the second as the coronavirus has wreaked havoc on the economy in the U.S. At this point, the likelihood of a recession is undoubtedly possible, but it's going to take some time to get a better understanding of all the economic impacts the virus will cause.

- Both the ISM Manufacturing and Non-Manufacturing indices remained in expansionary territory in February, coming in at 50.1% and 57.3% respectively. Both the indices, but specifically manufacturing, have been highly scrutinized recently as investors looked for further weakening and signs of a broader slowdown. Unfortunately, the trade reconciliation between the U.S. and China was quickly replaced by coronavirus fears, leaving investors to question the implications for the economy going forward.

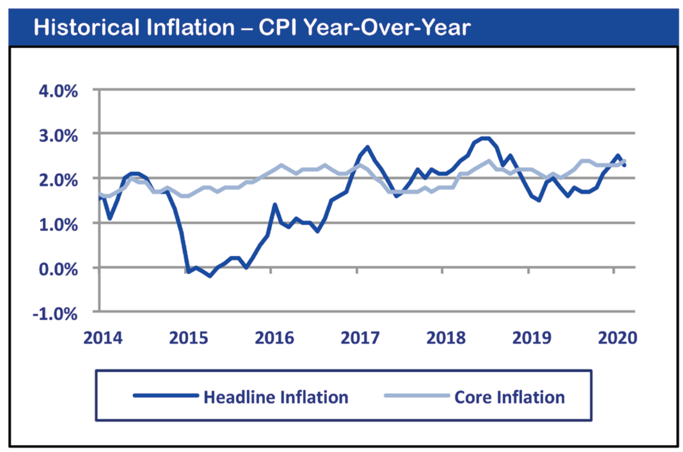
- Month-over-month CPI increased 0.1% in February, bringing the YoY figure to 2.3%. Within the data, price increases in food and shelter were more than enough to offset the declines from energy and ultimately led to the increase. Going forward, we expect energy to further weigh on the index, especially given the recent oil price war between Russia and Saudi Arabia that has dropped oil prices to levels not seen since 2001.

- Normally the employment report would be a highlighted event, but this economic data point was completely overshadowed by the risk-off sentiment in the market. Impressively, the economy added 273k in February, and January was revised higher to 273k from 225k. The unemployment rate dropped to 3.5% and wages rose by 0.3%. Overall, it's a solid labor market report, but many investors overlooked this as they focused their attention on the implications of the coronavirus.

figure b (continued)



Source: Bloomberg



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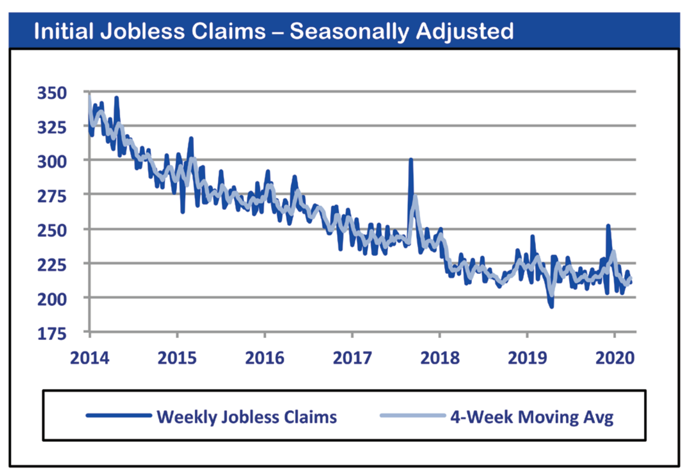

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	50.9	48.5	50.1	Wednesday, April 01, 2020
GDP Annualized	2.10%	2.00%	2.10%	Thursday, March 26, 2020
Unemployment Rate	3.60%	3.50%	3.50%	Friday, April 03, 2020
Retail Sales	0.30%	0.30%	0.30%	Tuesday, March 17, 2020
Consumer Price Index (YoY)	2.30%	2.40%	2.50%	Friday, April 10, 2020
U. Mich. Consumer Sentiment	99.8	99.1	100.9	Friday, April 10, 2020
Home Price Index (MoM)	0.48%	0.40%	0.43%	Tuesday, March 31, 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 2/3 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.