Market Update

(5/2020)

Allianz Investment Management LLC

May 2020 Market Update

Key points

- The month of April brought on some historically terrible economic statistics, but market sentiment is indicating the worst may be behind us
- Markets and the economy have been supported by trillions of dollars in fiscal aid from the U.S. government and additional monetary accommodation from the Fed
- The COVID-19 pandemic has taken quite a toll on the labor market in a short period of time, but investors remain focused on how quickly the recovery will take shape
- First quarter GDP was worse than expected at negative 4.8% and April GDP is likely going to look worse

Outlook

GROWTH: With GDP being a lagging economic indicator, the first look at how growth fared during the first quarter wasn't available until late April. With an initial reading of negative 4.8% GDP for the first quarter, we can see the destruction from the COVID-19 pandemic was worse than expected. Given the data points we have seen throughout the month of April, we already know that second quarter GDP readings are going to be even uglier, so what matters most going forward is the speed and velocity of the recovery. At this point, businesses are just beginning to make plans to open back up, and there is some uncertainty around how quickly demand will pick back up. Overall, we still subscribe to the U-shaped recovery, but consumer confidence and the willingness to spend will be key in the coming months as we analyze the speed of the recovery.

2020 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	TBD

INTEREST RATES: The recent decline in interest rates to current levels is likely to be with us for a while as the current economic backdrop isn't likely to bring rate hikes any time soon. In fact, the implied rates for Fed funds in the future have turned slightly negative, which implies the market is betting the Fed will adopt a negative interest rate policy later this year. That being said, Fed Chairman Powell was quick to squash the idea of negative rates in his latest commentary. Regarding the long end of the curve, we expect the Fed will hold interest rates down with continued purchases of U.S. Treasuries through the quantitative easing program. As we assess where we go from here, we think there is still quite a bit of uncertainty surrounding the economic environment and the pandemic. At this juncture, we don't think rates will move much from their current levels, but as the economy opens back up, we will get a better view of where rates are headed for our 2020 forecast.

FORECAST PERIOD	10-YEAR TREASURY YIELD
End of 2020	TBD

April 2020 recap and macro themes

While the month of April appeared to be horrible by any measure of economic statistics, financial markets actually behaved quite well as we witnessed a rebound in risk assets. Supported by trillions of dollars in fiscal aid from the U.S. government and additional monetary accommodation from the Fed, the S&P 500 recorded its largest monthly gain since 1987 of 12.88%. Additionally, the narrative around COVID-19 continued to improve as model statistics show that social distancing policies are indeed having a positive effect. With trends moving in a positive direction, government officials have been contemplating how and when to ease shutdown measures and social distancing policies, and we expect investors will be astutely focused on this topic throughout the month of May as they gauge economic demand going forward.

The Fed pretty much signaled they are going to support almost every corner of the market with their latest announcement and the addition of new facilities. The Fed added a couple new facilities to their arsenal and made changes to previously announced facilities to further support the economy. As a result, they have significantly expanded their balance sheet in a very short period of time.

Fed Balance Sheet:

Category ($B)	As of 4/29	As of 3/18	Change
Securities holdings	5,578	4,010	1,569
Repo outstanding	158	442	(284)
Discount window	32	28	4
Primary Dealer Credit Facility	26	-	26
Money Market Mutual Fund Liquidity Facility	46	-	46
Dollar swaps	439	0	439
Commercial Paper Fundinig Facility	0	-	-
Other	424	236	188
Total Reserves	6,703	4,716	1,987

Source: Bloomberg, Allianz Investment Management LLC

First, the Fed announced a new Main Street Lending facility in order to provide funding for banks that will make loans to businesses that employ less than 10k employees. In addition, a new municipal bond facility was announced where the Fed will buy up to $500 billion in new issue muni bonds with less than two years maturity to support state and local governments. Lastly, the Fed made changes to their corporate bond buying programs to increase the size of the program up to $750 billion. The increased size now includes high-yield through purchases of fallen angels and high-yield ETFs. All in all, the Fed facilities will add to an already swelling balance sheet, and spreads on corporate bonds have tightened significantly on the policy changes.

Outside of fiscal and monetary support, most market participants have been keenly focused on the labor market and the damage social distancing policies have inflicted upon it. For the weeks running up to the monthly non-farm payroll report for April, many investors got a glimpse of the destruction done to the labor market as job separations and unemployment claims continued to pile up on a weekly basis. Through the week of April 24, continuing jobless claims reached 22.6 million, which was almost 3.5 times more than the peak reached during the financial crisis. The non-farm payroll report summed it up with job losses of 20.5 million for the month of April. However, we see several signs within the underlying data that indicate the potential for a quicker recovery in the labor market is plausible. The number of unemployed that are on temporary layoff spiked above 18 million, meaning those jobs could come back quicker as the economy begins to open up. Additionally, the average hourly earnings figure jumped to 4.7% for the month, which indicates that most of the jobs lost were on the lower end of the pay scale. Lastly, the composition of job losses was higher in the industries that have been affected the most, including the hospitality and leisure sectors. Overall, the number of job losses is astounding, but we're looking through the headline figure to better understand the lasting effects on the economy, and the details in the April employment report signal that the labor market isn't as dire as the headlines might suggest.

Looking ahead, we are cautious on the overall state of the economy, as many uncertainties still exist, but it appears that much of the historically bad economic data is behind us. To put it in other words, it feels like we have reached the bottom of the trough, and we're looking for upward momentum from here.

Market indicators *(figure a)*

Despite the uncertainty surrounding corporate earnings and the fact that many companies chose to suspend earnings guidance, equities performed extremely well during the month of April. Major indexes, including the S&P 500, Dow Jones Industrial Average, and the Nasdaq 100, all had double-digit returns for the month. Looking ahead, the direction of the equity markets appears to be pinned to the outcome of the recovery as businesses begin to open back up. If consumer demand is tepid out of the gate, we could see a longer road to recovery, and this will have a negative effect on equity markets.

Market volatility measured by the CBOE VIX Index declined significantly during April as market sentiment improved for equities. While the current level of 35.0 is still elevated by historical measures, the VIX Index was down 36.2% in April. We expected elevated levels of volatility to persist in markets as a good amount of uncertainty continues to overhang the economy.

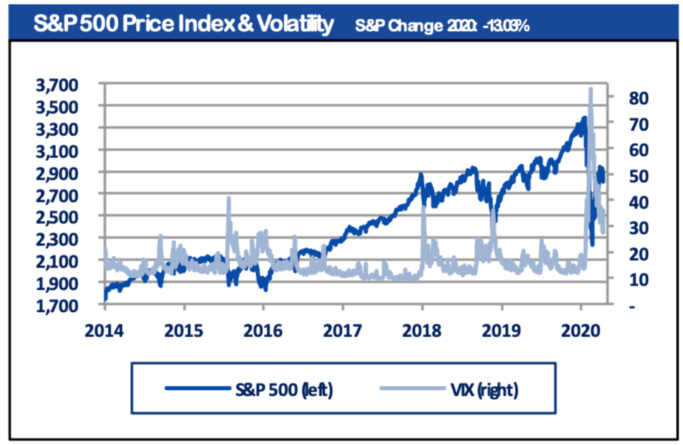
Treasury rates haven't changed much over the past month as Fed purchases of U.S. Treasuries have kept a lid on where yields can go. We have seen rates come up marginally in the front end of the curve as T-bill issuance has increased to fund the massive fiscal stimulus package. Additionally, longer-term rates moved up slightly on the news that a new 20-year issuance was going to be larger than expected. Overall, we don't see a strong conviction that Treasury yields are going to change much in the near term.

April was a historical month for oil prices as the price of West Texas Intermediate crude oil traded negative for the front-month delivery contract. Driving the price into negative territory was the absurd amount of supply flooding the market, which left producers with no place to store the oil. The price of oil has recovered somewhat as OPEC producers along with Russia have agreed to significant production cuts. For now, balance is slowly being restored to the market, but we don't expect this to happen quickly until lockdowns end and businesses open back up.

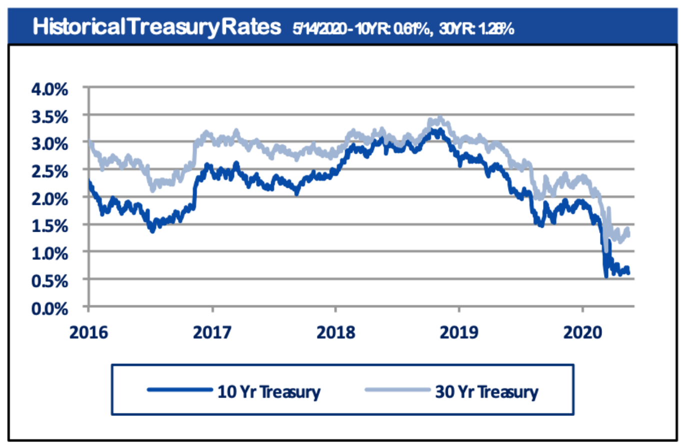
Economic indicators *(figure b)*

The final reading of consumer sentiment for April exceeded expectations of 68 and came in at 71.8, slightly higher than the preliminary reading of 71. However, the reading is still 17.3 points lower than March's and marked the lowest reading since 2011. Within the data, both the current conditions and expectations indexes declined month-over-month. The decline in sentiment is not surprising as stay-at-home orders coupled with mass unemployment as a result of the pandemic have weighed heavily on consumers.

figure a

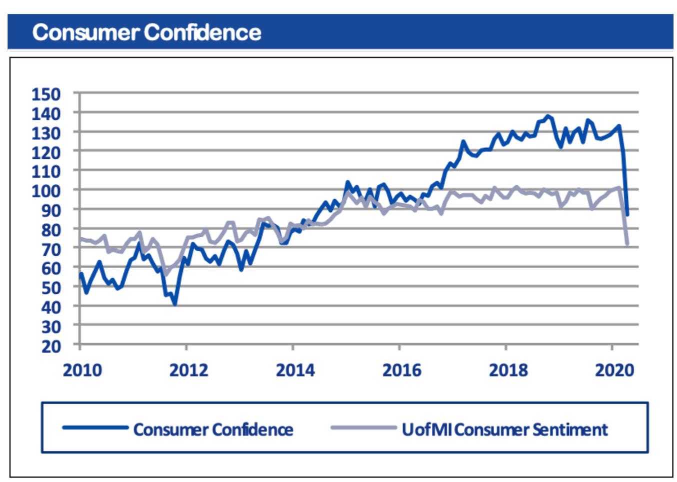


Sources: S&P, CBOE



Source: Bloomberg

figure b



Source: Bloomberg

Economic indicators *(continued)*

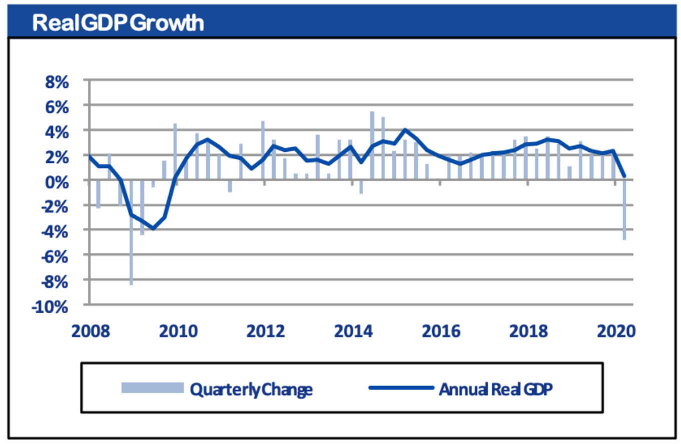
The U.S. economy contracted by 4.8% during the first quarter as precautionary measures to slow the spread of COVID-19 have essentially halted businesses. First quarter's reading was the first shift lower in GDP since 2014 and the worst quarterly reading since 2008. Within the data, every component, with the exception of government expenditures, declined significantly. Although expected, the decline in GDP further highlights the negative ramifications of COVID-19 on output. In the near term, we expect GDP to be grim as the virus continues to keep people in lockdown and out of work.

Both the ISM manufacturing and non-manufacturing surveys indicated a decline in activity but not as much as economists expected. The manufacturing index declined to 41.5 from 49.1 and the non-manufacturing index fell to 41.8 from 52.5. Both surveys are indicative of an economy in contraction, but the question that remains is, for how long that will be. As the economy begins to open up, we will be paying close attention to the survey data to get a better gauge on COVID-19's damage to the economy.

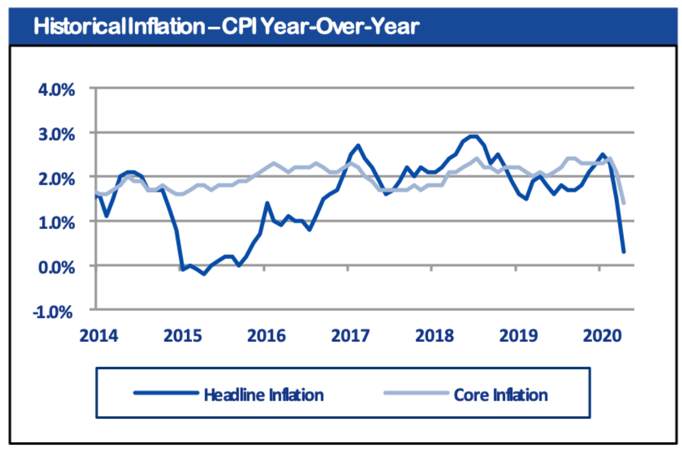
Consumer prices declined for the second straight month as the headline CPI figure dropped by 0.8%. Food prices were up while energy prices were down, but across the board the economic shutdown has brought deflationary pressures to the forefront. Additionally, core CPI was down 0.4% in April and was the biggest drop on record. Hotel, airfare, and apparel prices were the driving factors. Overall, we expect deflationary pressures to persist until the economy can open back up.

Initial jobless claims remain very high, but have fallen for the third straight week. Claims filed for the week ending April 25 declined to 3.1 million which represented a decline of around 700k. There are still some questions remaining on whether there is a backlog of unemployment claims yet to be filed, but the large number of continuing claims helps provide insight to how many jobs will be lost in the official labor market report from the Bureau of Labor Statistics. Continuing claims for the week ending April 25 came in at 22.6 million. For now, continuing claims are still on the rise, and we don't expect an economic rebound until that picture begins to change.

figure b (continued)



Source: Bloomberg



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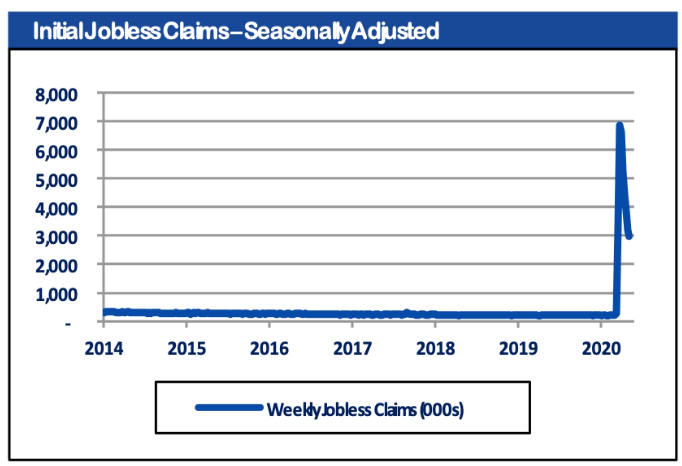

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	49.1	36.7	41.5	Monday, June 01, 2020
GDP Annualized	2.1%	-4.0%	-4.8%	Thursday, May 28, 2020
Unemployment Rate	4.4%	16.0%	14.7%	Friday, June 05, 2020
Retail Sales	-0.4%	-8.0%	-8.7%	Friday, May 15, 2020
Consumer Price Index (YoY)	1.5%	0.4%	0.3%	Wednesday, June 10, 2020
U. Mich. Consumer Sentiment	71.0	68.0	71.8	Friday, May 15, 2020
Home Price Index (MoM)	0.35%	0.35%	0.45%	Tuesday, May 26, 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.