Market Update

(6/2020)

Allianz Investment Management LLC

June 2020 Market Update

Key points

- After 128 months of expansion, the National Bureau of Economic Research officially determined the U.S. economy peaked in February 2020
- The jaw-dropping labor market report for May signaled the economy may be recovering faster than market participants expected
- Investors looked to high-frequency data points, such as initial jobless claims, to better gauge the current shape of the economy
- First quarter GDP was revised lower to negative 5%, but many investors were looking past the lagging economic data

Outlook

GROWTH: The latest information we have on GDP tells us that the decline in activity during the first quarter was worse than anticipated. The second estimate for first quarter GDP was revised lower, from negative 4.8% to negative 5.0%, and became the worst quarter of economic activity since December of 2008. Data during the second quarter was quite ugly; in fact, some of the economic data points were the worst ever recorded. At this point we know that second quarter GDP is going to be bad, but the question that remains is, how bad is it? With most economists presenting a wide range of outcomes for second quarter GDP, it doesn't make much sense to try and estimate where it will ultimately be. The lagging effect of the data doesn't provide much insight to where the economy is at today, but it does tell the story of where we came from. At this point, we know the economy has started to rebound, but at the end of the day most investors are trying to judge how strong the recovery will be.

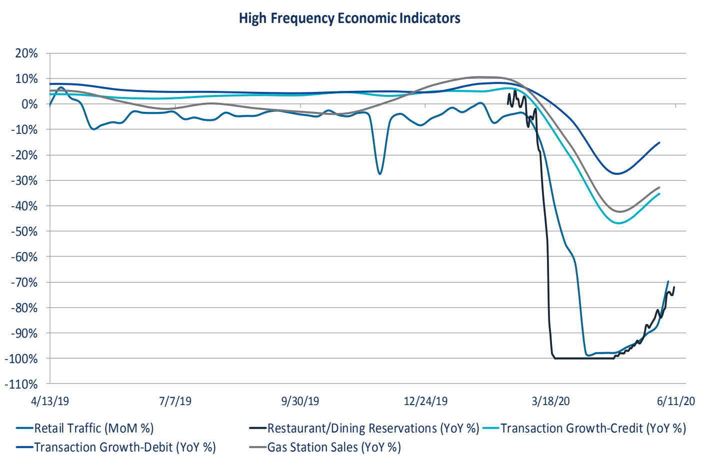
2020 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	TBD

INTEREST RATES: With the Fed pushing policy rates down to the zero bound and most lagging economic data throughout May coming in worse than expected, thoughts of negative interest rates in the U.S. started to swirl. Market participants had started to price some possibility of negative borrowing rates, but Chairman Powell was quick to squash that idea in recent commentary. In our view, the possibility of negative rates in the U.S. is quite an outlier. Regarding longer-term rates, the Fed has slowed asset purchases on the margin since March, and in conjunction with better labor market data, we saw the yield curve steepen significantly. The 10-year Treasury rose to 0.95% in early June, but has since retraced some of that yield increase as investor demand and purchases from the Fed continue to keep a lid on how high yields can rise. We think 10-year rates will likely remain range bound until further evidence of economic recovery presents itself and the Fed removes some monetary accommodation.

FORECAST PERIOD	10-YEAR TREASURY YIELD
End of 2020	TBD

May 2020 recap and macro themes

Risk sentiment continued to improve throughout the month of May as equity markets added to the impressive returns in April. Despite some of the economic data points signaling a weak economy, optimism surrounding the re-opening of businesses continued to push equities higher. For the month of May, the S&P 500® Index gained 4.5% while the Nasdaq-100® Index added 6.1%. Investors appeared to look past the negative lagging economic data in favor of higher-frequency data points in order to get a better assessment of current activity in the economy. When tracking high-frequency data points in early May, there was evidence of notable trends such as increased debit and credit card spending, declining jobless claims, rising gasoline consumption, increased restaurant dining in some states, and a steady rise in mortgage applications. Ultimately, the evidence of increased activity culminating with the strong employment report for May provided confirmation for risk asset investors who were betting on a faster road to recovery.



Source: Bloomberg, Allianz Investment Management LLC

Regarding the economy, the National Bureau of Economic Research officially determined the U.S. economy peaked in February 2020 with the recession brought on by the coronavirus pandemic. The 128-month expansion of the U.S. economy was the longest in history and was followed by a recession that will likely be classified as the shortest and deepest ever experienced. We can thank lawmakers and the Fed for acting so swiftly to support the economy and markets, but market participants will likely be grappling with the effects and consequences of the stimulus packages for years to come.

Turning to the labor market, the initial jobless claims data has been a closely followed data point over the past month as investors continue to assess the damage to the labor market from the shutdown. Throughout May, weekly jobless claims data steadily declined from above 3 million per week to less than 2 million for the last week in May. While there may be some noise within the claims releases given that some data could be from delayed filings, it is encouraging to see the numbers continue to decline. More notable though, was the continuing claims figure which started to decline from the peak of 25 million in early May to 21 million by the third week of May. This was a very positive sign and signaled that workers had been called back to work as states began the re-opening process. At any rate, the jobless claims and continuing claims data provided some evidence to investors that the economy was beginning to rebound.

Lastly, if the high-frequency economic data wasn't enough to persuade investors that the economy is on the mend, the employment report for May was a clear sign that the rebound was underway. The headline payrolls number in the employment report certainly caused investors to do a double take. The addition of 2.5 million jobs during the month of May was completely contradictory to what market participants were expecting as most economists were expecting a decline of 7.5 million jobs for May. The unemployment rate, which was expected to approach 20% after the May release, actually declined from 14.7% to 13.3%. Overall, the report suggests that the labor market could have reached a bottom and is recovering faster than originally anticipated.

Consequently, given the data that we have witnessed throughout May, on both the high-frequency side as well as from the Bureau of Labor Statistics' employment report, it appears that the recovery in the economy has begun sooner than expected. Looking forward, as the economic recovery begins to take shape, one area of focus will be consumers and their spending behavior. Looking at recent data on consumer attitudes, we can see that sentiment has begun to improve, but consumer spending will be key on the road to recovery ahead.

Market indicators *(figure a)*

Equities continued to make up some of their losses from the beginning of the year throughout May. All major indices, including the S&P, Dow Jones, and NASDAQ, gained over the month. Overall, market sentiment for equities continues to improve on the backing of states reopening and the potential for a faster recovery than originally anticipated.

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.

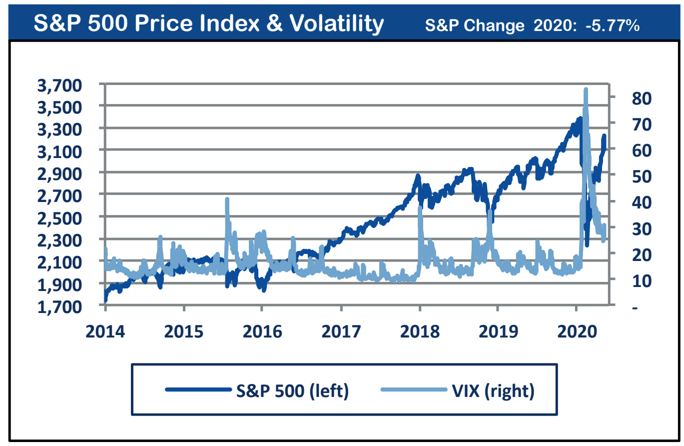
Despite the Fed continuing its Treasury purchases throughout May, yields at the long end of the curve actually rose over the month as investors added risk assets over safe-haven assets like Treasuries. Overall, we expect Treasury yields to remain anchored at lower yields as purchases from the Fed weigh on yields for the foreseeable future.

The price of oil continued to recover in May as OPEC producers agreed to significantly cut oil production. More specifically, oil prices increased from just under$20 per barrel at the beginning of May before ending the month at just over $35 per barrel. Overall, with OPEC producers agreement to reduce production, oil prices should start to drift higher as states start reopening and demand for oil ramps up.

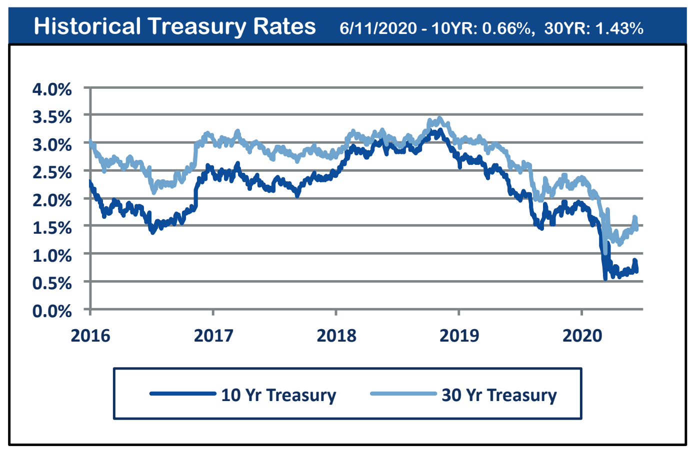
Economic indicators *(figure b)*

Recent consumer data has indicated that sentiment has started to improve from April's record low levels. The Conference Board's Index on consumer confidence rose to 86.6 in May from a prior reading of 85.7. Additionally, the University of Michigan's Consumer Sentiment Index came in at 72.3 for the final reading in May, which was up from the 71.8 reading for April. Overall, it appears that consumer sentiment may have bottomed, but and we will look for continued improvement over the coming months and its ability to ignite consumer spending.

figure a

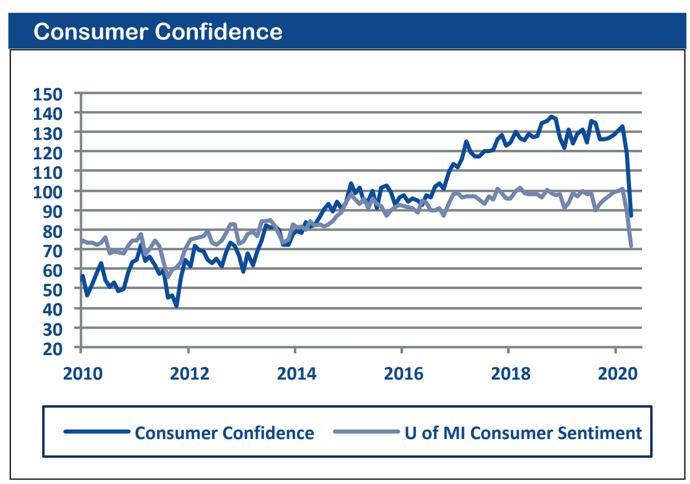


Sources: S&P, CBOE



Source: Bloomberg

figure b



Source: Bloomberg

Economic indicators *(continued)*

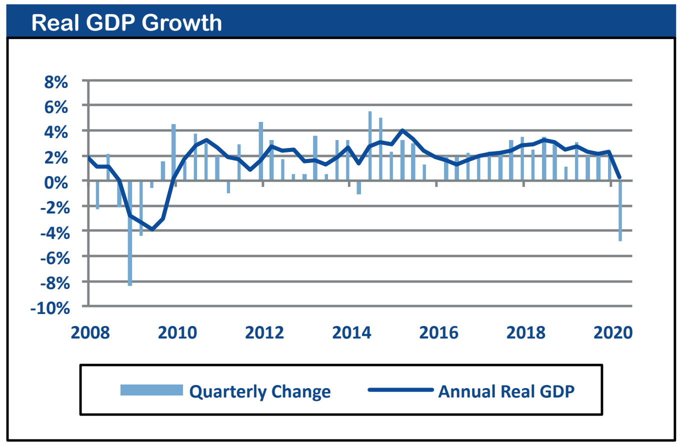
The second reading on first-quarter growth came in weaker than expected with a decline of 5.0%. The main driver behind the revision from -4.8% to -5.0%was within the inventories estimate. Overall, the figure doesn't provide much insight into the current environment because of it's lagging effect, but the decline in inventories should get some marginal payback in the second quarter.

While still signaling a contracting economy, the manufacturing ISM came in below consensus at 43.1, yet up 1.6 from April on a fairly broad-based recovery with new orders, employment and production all rising modestly. Among the six biggest industry sectors, Food, Beverage & Tobacco Products remains the only industry in expansion. Industry commentary was relatively cautious. The nonmanufacturing ISM came in better than expected at 45.4 in May, up 3.6 from April. The details were mixed, with big rises in business activity and new orders but only a small uptick in employment. In the nonmanufacturing sectors, respondents remain concerned about social distancing-related impacts but are also cautiously looking to resume business.

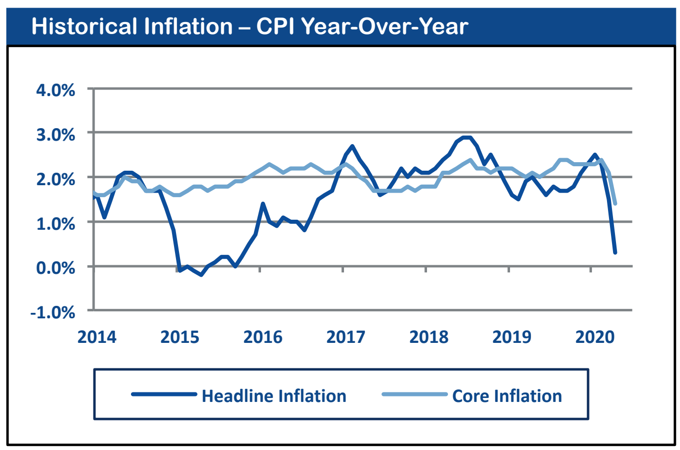
Consumer prices declined for the second straight month as the headline CPI figure dropped by 0.8%. Food prices were up while energy prices were down, but across the board the economic shutdown has brought deflationary pressures to the forefront. Additionally, core CPI was down 0.4% in April and was the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

There was a positive surprise in the latest employment report as the 2.5 million jobs added in May gave investors a strong signal that the economy is on the rebound. Most of the job gains were broad-based across sectors with the exception of hotels which had a decline of 148k. The sector with the largest comeback from previous job losses was the construction sector as they have recovered almost half of their previous job losses. While this is only the first positive labor report since the pandemic began, it's a welcome sign that workers are returning quicker than expected.

figure b (continued)



Source: Bloomberg



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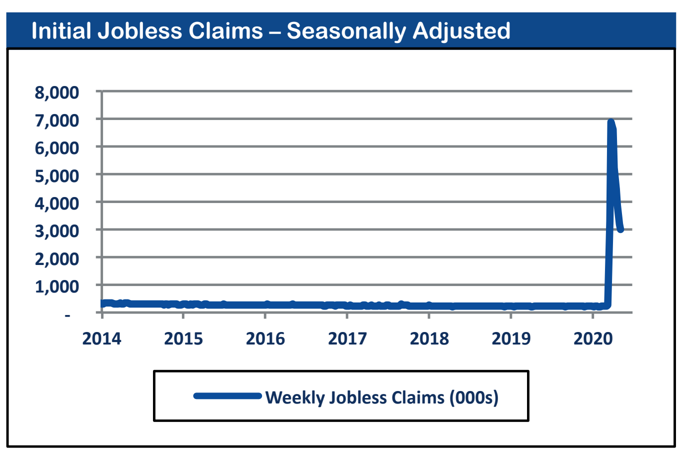

Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	41.5	43.8	43.1	Wednesday, July 01, 2020
GDP Annualized	-4.8%	-4.8%	-5.0%	Thursday, June 25, 2020
Unemployment Rate	14.7%	19.0%	13.3%	Thursday, July 02, 2020
Retail Sales	-8.7%	-12.0%	-16.4%	Tuesday, June 16, 2020
Consumer Price Index (YoY)	0.3%	0.3%	0.1%	Tuesday, July 14, 2020
U. Mich. Consumer Sentiment	73.7	74.0	72.3	Friday, June 12, 2020
Home Price Index (MoM)	0.45%	0.30%	0.47%	Tuesday, June 30, 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.