Market Update

(3/2019)

Allianz Investment Management LLC

March 2019 Market Update

Key Points

- Market uncertainties that were previously weighing on market sentiment continue to melt away.
- Economic growth for the fourth quarter surprised to the upside at 2.6%, and indicates the U.S. may be somewhat insulated from the economic woes of other developed countries.
- Positive traction on trade with China, the message of patience from the Fed, and rebounding economic data following the government shutdown has lifted equities for the second straight month.
- The weight from global interest rates has kept the U.S. 10-year Treasury yield from rising despite the relatively positive economic backdrop.

Outlook

GROWTH: Economic growth, or the lack thereof on the global front, has been particularly worrisome for investors as they continued to monitor economic data following the recent government shutdown. For the most part, data released on the U.S. economy has painted a better picture of the economy relative to the rest of the world. Much of the data has rebounded from the weaker prints in December and January with both consumer confidence and business surveys looking better. However, noisy economic data and global growth concerns kept expectations for fourth-quarter GDP quite low. Despite all the noise, the latest analysis on U.S. GDP from the Bureau of Economic Analysis showed fourth-quarter GDP at 2.6%, and was much better than expectations. Going forward, we will expect economic growth to slow, but the extent of the slowdown will depend on how much the global economy drags the U.S. down. For now it appears like the U.S. economy remains somewhat insulated, but this will be closely monitored through the first half of 2019. Overall, we are maintaining our growth forecast for 2.30% to 2.70% for 2019.

2019 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	2.30% - 2.70%

INTEREST RATES: The swift downdraft of global growth has weighed heavily on interest rates both globally and in the U.S. While the economic outlook for the U.S. remains positive, the European Central Bank just cut their forecast for growth in the Eurozone and added a fresh round of monetary stimulus for banks. This has put additional downward pressure on rates as the 10-year German Bund yield is at the lowest level since 2016 at 0.06%. The weight from global interest rates has kept the U.S. 10-year Treasury yield from rising despite the relatively positive economic backdrop. Additionally, the abrupt shift in monetary policy expectations from the Fed has kept the 10-year Treasury from surpassing the seven-year high of around 3.25%. That said, we still think there is potential for a modest rise in rates with the Fed possibly hiking rates one or two more times in the second half of the year and therefore, our forecast for the 10-year Treasury yield remains unchanged.

FORECAST PERIOD	10-YEAR TREASURY YIELD
12 months	2.80% -3.40%

M-5334

February 2019 Recap & Macro Themes

With global growth slowing significantly in the fourth quarter, many investors were eager to determine how insulated the U.S. economy really is from the rest of the world. A healthy labor market has typically been a strong signal for solid consumption and economic growth in the U.S., but weaker than expected retail sales data from December has cast doubts on how resilient the U.S. economy is from the weight of slowing global growth. There was likely some noise filtering though the release of fourth-quarter GDP, but the latest GDP report leads us to believe U.S. economy is still performing well relative to the rest of the world.

Quarterly % Change	2018			
	Q4	Q3	Q2	Q1
Real GDP	**2.6%**	**3.4%**	**4.2%**	**2.2%**
Personal Consumption	2.8%	3.5%	3.8%	0.5%
Investment	4.6%	15.2%	-0.5%	9.6%
Govt Expenditures	0.4%	2.6%	2.5%	1.5%
Exports	1.6%	-4.9%	9.3%	3.6%
Imports	2.7%	9.3%	-0.6%	3.0%

Source: Bloomberg, Allianz Investment Management LLC

Optimism over trade and the end to the government shutdown provided a decent tailwind for markets throughout the month of February. Most market participants had been worried about the automatic increase in tariffs on March 1 had a trade deal not been reached between the U.S. and China. However, encouraging headlines around the progress made between the U.S. and China has boosted sentiment and optimism in the markets. Ultimately, the Office of the United States Trade Representative (USTR) suspended planned China tariff increases "until further notice," lifting the 10-year U.S. Treasury yield to the highest level in a month for a brief moment. Overall, we have seen market uncertainties that were previously weighing on market sentiment continue to dissolve, and risk assets reflected that with their strong performance during February.

Throughout most of February investors were watching economic data trickle in, with some of the delayed reports from the government shutdown finally being released. December retail sales data was finally released and unfortunately, the results were not worth the wait as retail sales fell by the largest amount in nine years. Most market participants were perplexed by such a negative report that it was mostly shrugged off as an anomaly. Fortunately, the delayed release of fourth-quarter GDP wasn't reflecting the same picture as the retail sales data. The long-awaited fourth-quarter GDP data came in well above estimates at 2.6% versus economist expectations of 2.2%. Despite weaker than expected retail sales in December, the release of official GDP data indicates the consumer is alive and still has the wherewithal to spend. Translating the quarterly data to an annualized rate, growth in 2018 was 3.1%. Overall, the latest report on economic growth should provide comfort to the Fed and investors alike that the health of the U.S. economy remains intact.

In light of all the market uncertainties heading into the beginning of 2019, the Fed likely made the right decision to put rate hikes on hold for the time being. At the January Fed meeting, Chairman Powell softened rate hike expectations and embarked on a coordinated messaging campaign in favor of being more patient and flexible when adjusting monetary policy. In turn, market participants were eager to scan through the Fed's January meeting minutes, which were released in February, for additional insight. Within the minutes, the Fed reiterated its desire to be patient given that "inflation pressures were muted, and asset valuations were less stretched than they had been a few months earlier." Finally, the minutes also provided some commentary on balance sheet reduction, with the Fed likely to announce its plan to stop shrinking the balance sheet "before too long." The previous quotation has left some market participants believing this official announcement could come as early as the June Fed meeting. Overall, patience was the overarching theme of the minutes and as the Fed takes on a more patient approach, so too will investors.

Market Indicators *(figure a)*

- Equities logged another solid monthly gain last month with major indexes rising across the board. The Dow Jones Industrial Average had the strongest performance, rising by 3.67% when compared to the S&P 500® Index and the Nasdaq-100® Index. Overall, the rebound in equities since late December reflects the many market uncertainties that previously weighed on markets continues to melt away.

- Volatility measured by the CBOE VIX Index continued to recede in February as investor sentiment continued to improve throughout the month. The 10% decline in the index brought volatility back to a more normal average that we would expect at this point in the business cycle. Going forward, the current levels of volatility should persist, unless fears of an immediate recession bubble up again.

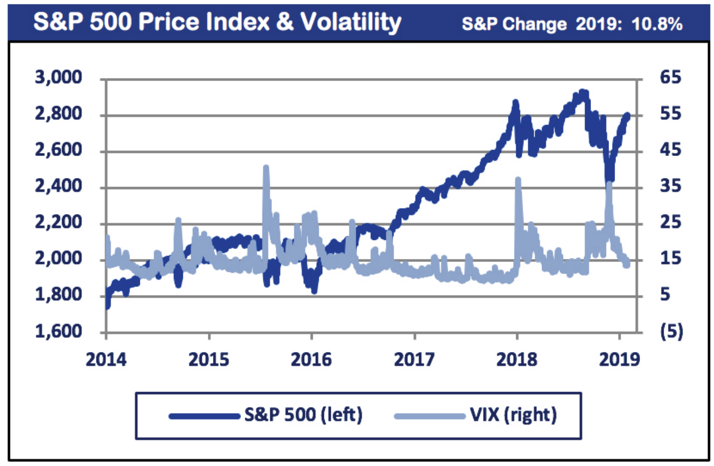
- Rates continue to be depressed by the weight of declining global interest rates. The combination of a dovish Fed and muted expectations for inflation indicate that interest rates have a high hurdle to materially move up from here. The 10-year Treasury traded in a narrow 10 basis point range during February, as there weren't any catalysts to push rates higher or significantly lower.

- Oil prices moved higher in February as positive traction on trade discussions with China and dovish Fed policy fueled the risk-on trade over the past month. As a result, crude oil prices were up over 6% during the month of February. As OPEC appears committed to further production cuts, we expect prices to continue to drift higher, but we remain cognizant that the upward direction is at odds with President Trump's public desire to keep prices low.

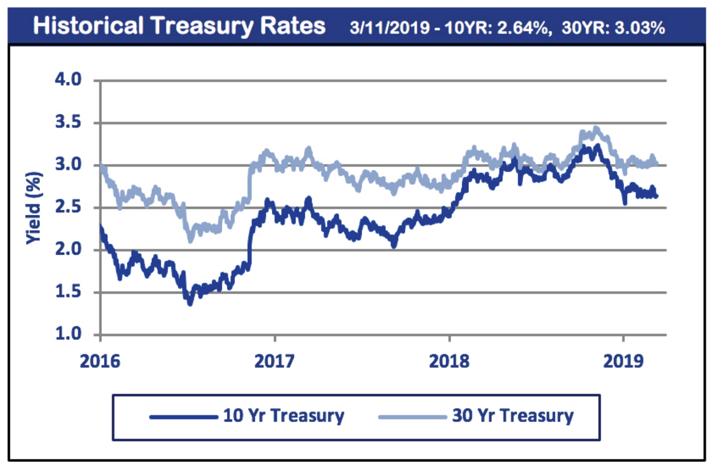
Economic Indicators *(figure b)*

- Both the Conference Board's and the University of Michigan's measures of consumer sentiment rebounded from the sharp declines in January. University of Michigan sentiment finished at 93.8, up 2.6 points from January. The Consumer Confidence Index rose to 131.4 from 121.7. With government shutdown concerns in the rear view mirror, consumers are clearly feeling more confident about the economy.

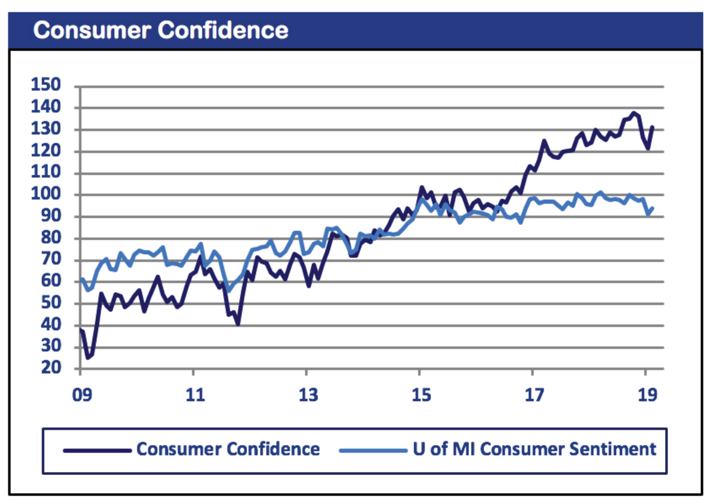
figure a



Sources: S&P, CBOE



Source: Bloomberg



Source: Bloomberg

Economic Indicators *(continued)*

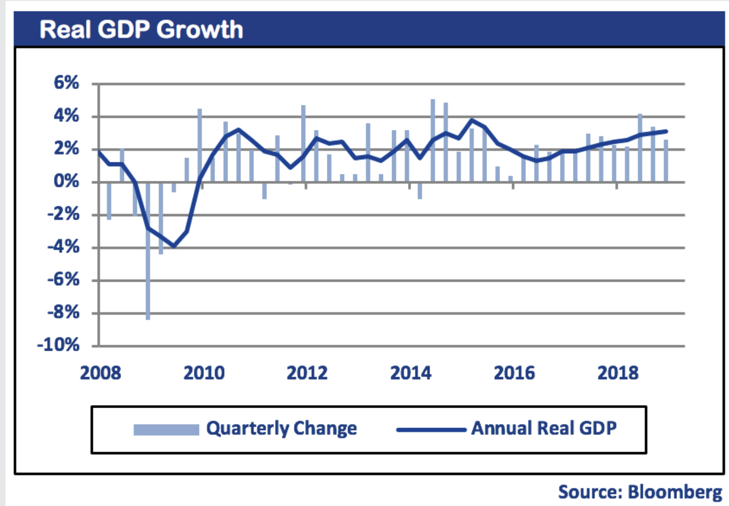
- The Bureau of Economic Analysis was finally able to release the estimate of fourth-quarter GDP at the end of February and the long wait appears to be worth it, as the report delivered a solid upside surprise. Business investment was a solid contributor to GDP in the fourth quarter as the economy grew by 2.6% and consumption data helped reassure investors that Americans continued to spend over the holidays. While growth abruptly slowed around the world, the latest GDP report indicates the U.S. may be somewhat insulated from the economic woes of other developed countries.

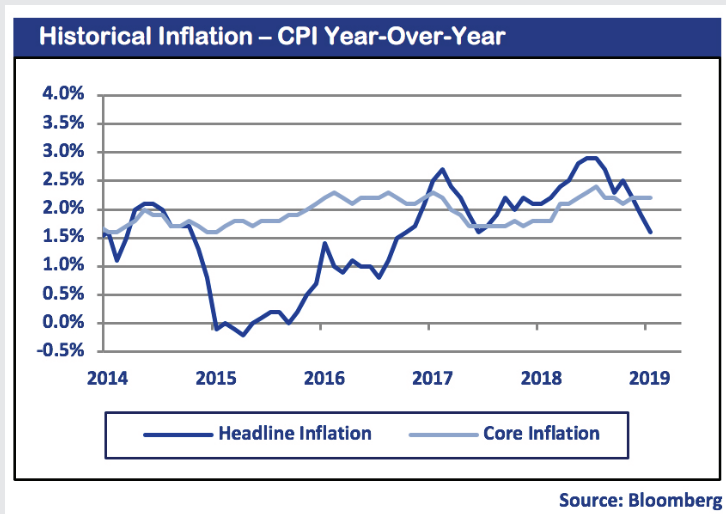
- The Consumer Price Index showed mixed signals with regard to the direction of consumer prices, as headline inflation declined to 1.6% while core inflation remain steady at 2.2% for the third consecutive month. Energy prices played an obvious role in the decline of headline CPI as gasoline fell by 5.5% in January. Nonetheless, the risk of rising inflation appears to be quite tame for the moment, which is in line with the Fed's reasoning for a pause in rate hikes.

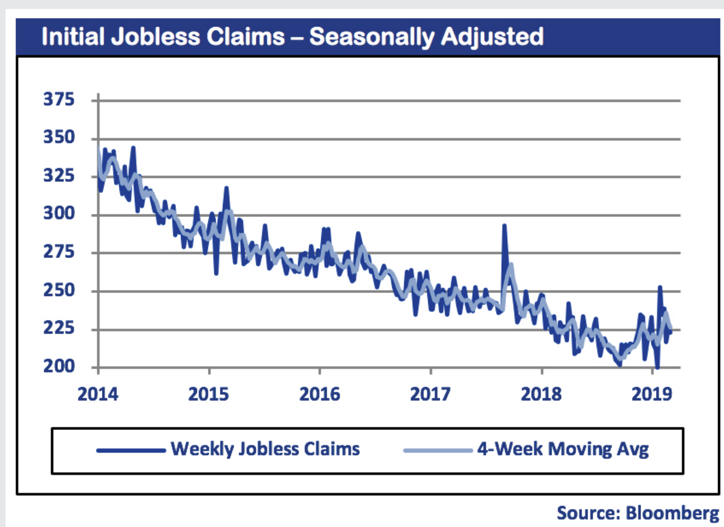
- The U.S. economy added a mere 20K jobs during February with most market participants attributing poor weather and the government shutdown to be the driving factors. On the other hand, average hourly earnings rose to the highest annual rate since 2009 at 3.4%. The bottom line is that slack in the labor market is becoming harder to see, especially considering the wage increases we witnessed over the past few months. Overall, this report shouldn't change the outlook from the Fed, as the 3-month average of payroll additions remains robust and the weak job number was likely a payback from last month's huge figure.

- The ISM Manufacturing Index dropped to 54.2. Results indicate that there were some concerns around the potential March 1 tariff hike. However, since additional tariffs have been put off indefinitely by the Trump administration, there is likely some upside potential in the coming months. On the other hand, the service sector of the economy rebounded significantly from January as the latest ISM survey from the nonmanufacturing sector rose three points to 59.7. All in all, regardless of the weakness in manufacturing, both surveys still indicate the overall health of the economy remains intact.

figure b







EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	56.6	55.8	54.2	April 1 (Monday)
GDP Annualized	3.4%	2.2%	2.6%	March 28 (Thursday)
Unemployment rate	4.0%	3.9%	3.8%	April 5 (Friday)
Retail sales	0.0%	0.1%	-1.6%	April 1 (Monday)
Consumer Price Index (YoY)	1.9%	1.5%	1.6%	March 12 (Tuesday)
U. Mich. Consumer Sentiment	95.5	95.9	93.8	March 15 (Friday)
Home Price Index (MoM)	0.3%	0.2%	0.4%	March 26 (Tuesday)

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.