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# Allianz Global Investors Insights

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*Global View*

## Is the Era of Central-Bank Independence Over?

With its new policy of yield-curve control, the Bank of Japan (BOJ) has begun supplanting financial repression with "fiscal dominance". Japanese monetary policy will now be subservient to government policy, which will use domestic fiscal measures such as wage controls to create the necessary levels of inflation that have up to now been hard to manufacture.

With this move, Japan has all but ended the pretence of central-bank independence. If the practice of financing fiscal policy with monetary policy is successful, it will create inflation that erodes capital savings in many bond markets, it will endanger the purchasing power of retirement savings, and it will threaten global trade by raising international tensions as currencies become more volatile again.

If Japan's new initiative is successful, it will create inflation that erodes capital savings, endangers the purchasing power of retirement savings and threatens global trade.

### Will the world follow Japan's lead?

The BOJ's recent changes are both a tacit admission that NIRP is not working and proof that Japan knows a new policy response is required to avoid a crushing classic recession. Japan's actions also move central-bank policy in a momentous new direction. The BOJ is promising to keep bond yields at their currently low levels while increasing the supply of yen into Japan's economy until inflation meets or beats the BOJ's 2 per cent target. This sounds like continued financial repression but in reality it is much, much more. It will allow the Japanese government to fight the labour constraints of its ageing and shrinking population by implementing a "wages policy" that will mandate income and pay increases until inflation rises sufficiently.

### The BOJ has raised the stakes in a dangerous game

With much debate at the Fed's latest Jackson Hole meeting about the policy responses needed to soften the inevitable US recession, the BOJ has substantially raised the stakes:

Neil Dwane
Global Strategist

It will be monetizing its government's financial needs at the expense of the yen. The Fed has admitted that it normally eases interest rates by approximately 5 per cent during a recession, which it cannot do now. As such, it may resort to another significant bout of quantitative easing (QE). For its part, the European Central Bank (ECB) has already begun to reach the limits of its own monetary programs, and it may be forced to taper regardless of its willingness to lessen its support for the economy. Indeed, central banks globally now recognize that the longer QE lasts, the more it distorts markets and economies, and the harder it is to cease.

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Allianz Global Investors

*Perspective on Europe*

# Europe's Big Banks: Well-Capitalized, But Not Profitable

The European banking sector is much stronger today than it was in 2008, at the beginning of the Great Financial Crisis. Indeed, since that time:

- capital levels have more than doubled;.
- asset quality has materially improved;
- new risk-averse management teams have restructured business activities; and
- politicians have given regulatory and supervisory authorities more power than ever

Still, something isn't right in the European banking sector. For instance, returns on tangible equity are already below 10 per cent on an aggregate basis. In addition, market consensus points to lower and lower returns that are now in the 5 per cent area for full-year 2016. These issues mainly stem from decreasing revenues due to insufficient volumes and accelerating margin compression.

**The sector's issues mainly stem from decreasing revenues due to insufficient volumes and accelerating margin compression**

Yet restoring profitability is easier said than done. Cost-cutting is the most obvious answer in the current low-growth, low-interest-rate environment, yet the downside of cost-cutting may be greater than its upside. Consider the many banks that suffer from the use of costly legacy IT systems: Upgrading this infrastructure would require heavy investment and involve elevated operational risk. Banks could also reduce the number of employees, but that might prove controversial for systemically important banks in countries with high unemployment.

We doubt that the ECB in its supervisory capacity will materially help large European banks to improve their profitability. Rather, the ECB's recent supervisory actions have focused on strengthening the banks' capital positions and asset quality. As a result, large European banks are better-capitalized and better-provisioned, but they are not more profitable.

**Simon Outin**
Senior Credit Analyst

**The ECB has made large European banks better-capitalized and better-provisioned, but not more profitable**

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*Grassroots℠ Research*

# UK Car Sales Not Yet Dented by Brexit

In the wake of the UK's historic Brexit referendum, Grassroots℠ Research conducted two studies to assess Brexit's impact on UK car sales – a big-ticket bellwether of consumer confidence.

During September 2016, we asked UK dealers selling a variety of different car brands, from standard to luxury, to share their views on several key topics:

- changes in year-over-year car sales for the July/August period;
- shifts in car pricing, measuring actual transaction prices rather than list prices;
- developing trends in the lease rates of cars to consumers; and
- any broader Brexit-related correlations or business impact.

Our findings indicated that for the standard and less-expensive segment of car dealers, average new car prices and car lease rates were essentially unchanged in the post-Brexit period – though slightly less than two-thirds of respondents reported that new car orders moved down by single digits on average. These same auto dealers were cautious of the post-Brexit environment, anticipating an eventual downturn on their businesses.

**Average prices and lease rates of standard cars were essentially unchanged in the post-Brexit period**

The premium-car segment had a different post-Brexit experience. The same indicators about prices and lease rates moved up slightly for most of the dealers we interviewed. Respondents said that during the months after Brexit, they enjoyed good sales of higher-end models, which pushed up average prices, and they saw strong demand for lease contracts for higher-end models. It is also worth noting that UK premium car dealers in general did not think that Brexit was having much direct impact on customer sentiment.

Although the outcome of the negotiations between the EU and the UK is still to be determined, most standard UK car dealers believe Brexit will be bad for the UK economy and the local automotive industry in particular,

**Johannes Jacobi**
Grassroots℠ Research Analyst

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*Viewpoint*

# Will the Falling Pound Cushion Brexit's Blow?

**Mike Riddell**
Senior Fixed Income Portfolio Manager

Global financial markets were fixated on the Brexit referendum in the run-up to the vote in June, and uncertainty has only increased since then. There is still no clarity as to what Brexit may actually look like, with some market-watchers speculating whether or not it will even happen (we believe it will).

Britain's economy was supposed to roll over in the aftermath of a "leave" vote. But based purely on the high-frequency UK economic data, one could make the case that Brexit looks to have been a good thing for Britain. That's a very dangerous outcome for European Union (EU) politicians desperate to avoid an EU exodus. They now have an incentive to make Brexit as painful as possible for the UK, even if it means the ultimately self-defeating prospect of wounding a country that buys the second-highest amount of euro-zone exports.

Things look far less rosy for the UK if you judge its health by the foreign-exchange market. Immediately after Brexit, the pound fell 7.6 per cent against the US dollar, the ninth-biggest daily move since 1862. This was actually a smaller drop than many had expected, which tells you a lot about the pound's positioning going into the vote.

**Initial economic data helped those who feel Brexit is good for Britain, but things look far less rosy in the FX markets**

Three months of pound stability followed, but the first two weeks of October saw another sharp move lower. UK Prime Minister Theresa May suggested that the UK is heading for a "hard" Brexit, with the UK giving up access to the single market in order to restrict the free movement of people. She also stated that the Brexit process is anticipated to officially start in March 2017, with the triggering of Article 50; ironically, this could mean that the UK might leave the EU two years later – on April Fool's Day, 2019.

Brexit uncertainty is not being helped by the fractious state of British political parties. The Labour Party is failing to provide sufficient opposition to the incumbent government due to an internal division between Labour's leader, Jeremy Corbyn, and its members of parliament in the House of Commons. For its part, the House of Lords is unlikely to step outside of its historic role of refining proposed laws in order to effectively provide scrutiny over the government's plans. This dysfunction means, as HSBC has noted, that the British pound sterling is now effectively functioning as the opposition to the government.

**The British pound is now effectively functioning as the opposition to the government**

Financial markets can signal their opposition to this state of affairs, but they cannot formulate policy. While the pound's further fall might lead May to be more attuned to the desires of the 48 per cent who voted to remain – or to the 52 per cent who in a recent poll revealed that they would prefer a "soft" Brexit – further political opposition will be needed to soften the government's hard Brexit goals.

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*Global View*

**Central banks now know that the longer QE lasts, the more it distorts markets and economies, and the harder it is to cease**

## Investment implications

Clearly, we are migrating from a world of financial repression – where interest rates are held below stubbornly low inflation rates – to fiscal dominance, where the monetary policy of central banks becomes subservient to the solvency and fiscal requirements of their governments. This is a significant shift for many reasons:

- As Japan heads down this path, the yen and Japanese government bonds will likely come under pressure. A weaker yen would likely help Japanese exporters, but the overall trend against globalization and free trade may ultimately work against them.
- Although fiscal dominance is so far limited to Japan, it could have profound implications for investors elsewhere if other governments follow Japan's lead and ensure that their bonds no longer protect the purchasing power of savers.

**Although fiscal dominance is so far limited to Japan, it could have profound implications for investors elsewhere if other governments follow Japan's lead**

- Whether economies stick with financial repression or tilt toward fiscal dominance, this negative environment may persist for decades. As such, global economic growth will remain slow and low, and investors' returns will be driven by their appetite for accepting volatility and risk.
- It continues to be important for investors to pursue alpha with active management, since beta returns are set to be low and volatile, which could undermine cheap index investments. And given the ongoing environment of volatility, investors should continue taking a close look at the risk-mitigation and diversification benefits that alternatives provide.

*For more on this topic, visit AllianzGI.com to read "The End of Independence: Japan's Shift to Fiscal Dominance".*

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## *Perspective on Europe*

Unfortunately, this situation is hard to solve quickly and may in fact be here to stay, which could lead to heightened market instability. In fact, the EURO STOXX Banks (Price) Index has already lost close to 30 per cent of its year-to-date market value, and the index's price-to-book ratio is now around 70 per cent. Similarly, banking debt has significantly underperformed when compared to other types of corporate debt.

As such, we expect market volatility to be the order of the day for the European banking sector for the coming months – and possibly for years – with no clear upward or downward direction overall. We also believe passive investment strategies are likely to miss opportunities linked to this volatile state. Active strategies, on the other hand – particularly those that rely on detailed fundamental analysis – may be better-suited to help investors navigate today's tough environment for European banks.

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## *Grassroots℠ Research*

and most predict a negative impact on car pricing and lease rates in 2017.

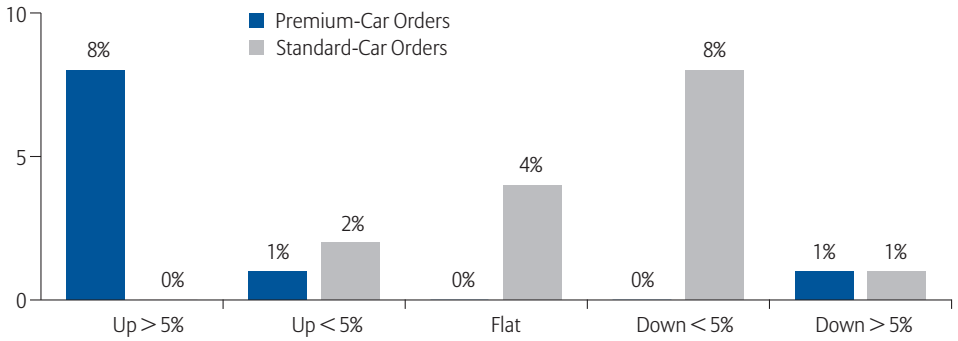
**Most standard UK car dealers predict Brexit will have a negative impact on car pricing and lease rates in 2017; the premium market has been less affected**

"This Grassroots study showed that two months after the June referendum, Brexit's impact on the car market appeared to be surprisingly low," said Ralf Stromeyer, AllianzGI's research sector team head for the European consumer segment. "Although there was a moderate decline in the standard segment, the premium segment reported strong growth. The caveat is that this growth was at least partly driven by a strong fleet business, which manufacturers may use to reduce inventories. We could also be witnessing 'pre-buying' ahead of anticipated price increases, given the drop of the pound sterling. For now at least, we can state that the Brexit vote has not caused the shock to the car market that some industry participants feared. This also may indicate a limited risk of a near-term UK recession, as consumers do not seem to be put off from purchasing big-ticket items."

**These results may indicate a limited risk of a near-term UK recession, as consumers don't seem to be avoiding big-ticket items**

**After the Brexit Vote, UK Consumers Bought More Premium Cars**

Orders of premium cars moved higher in the UK in July/August 2016 vs. one year earlier; standard-car orders moved slightly lower.




Source: Grassroots℠ Research as at August 2016.



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