9

Volume 8, Issue 9

Allianz Global Investors Insights

September 2016

Global View

'Risky' and 'Safe' Assets Can't Both Keep Winning

Stefan Hofrichter
Chief Economist

Just over one year ago, on 11 August 2015, the People's Bank of China shocked the global markets by announcing a sudden devaluation of the renminbi against the US dollar. What followed over the next six months was a perfect storm for emerging-market assets, with accompanying shock waves that also dragged down equities and bond yields in developed nations.

Yet in mid-February 2016, the tide suddenly appeared to turn and markets began to rebound across the board – in all likelihood because pessimism had gone too far and contrarian investors saw an opportunity to step in. This overall upward trend has continued for all asset classes, even factoring in a brief post-Brexit plunge:

- Worldwide, equities have recovered almost 20 per cent since earlier this year, with the US outperforming Europe and Japan (the latter by a wide margin); these regions are now standing at roughly the same market levels as one year ago.
- Emerging-market assets – equities, bonds and currencies – have done particularly well this year and have also recovered their losses from last August.
- Global bond prices, which move in the opposite direction to bond yields, have resumed their upward trend as well.

Worldwide, equities are standing at roughly the same levels as one year ago; global bond prices have resumed their upward trend as well

Yet to some market watchers, this rebound defies belief. How can risk assets (such as equities and spread products) and "safe" assets (such as sovereign bonds) all do well at the same time? We believe two forces are at work:

- First, economic data have started to stabilize in all major regions; this has lifted investors' risk appetites because it implies that economic growth is close to reaching its potential.
- Second, markets are discounting the ongoing and even increasing amounts of global monetary policy stimulus following UK's Brexit vote.

Yet although this sounds like a perfect environment for both risk assets and safe assets to continue their upward climbs, there are several reasons why this environment is unlikely to last much beyond the short term.

(Continued on page 4)

2 Perspective on Asia Pacific
Strong Leadership Revives Indonesia's Economy

2 Grassroots[SM] Research
New Study Measures the UK's Post-Brexit Mood

3 Viewpoint
In Shift Toward Alternatives, Illiquid Alts Gain Ground

Allianz Global Investors

Perspective on Asia Pacific

Strong Leadership Revives Indonesia's Economy

Raymond Chan
CIO Equity Asia Pacific

Indonesia limped into 2016 not only reeling from the volatility that hit most emerging-market economies last year, but coping with a range of other troublesome issues specific to Indonesia: a rupiah (IDR) that had been depreciating since 2011; a stubbornly high fiscal deficit worsened by inefficient tax collection methods; a trade account constantly at risk of a commodity price collapse; persistently high inflation; and eroding consumer and investor confidence related to the inability of its president to push through reforms.

Fast forward to August of this year, however, and the outlook for Indonesia's economy suddenly became brighter than it had been for some time. Several notable developments helped lead to such a drastic change of fortunes.

In August, the outlook for Indonesia's economy suddenly became brighter than it had been for some time

To begin, since the beginning of 2016, President Joko "Jokowi" Widodo's government has been gaining support from the opposition party. One of the government's biggest rivals switched its allegiance and joined the administration's coalition, enabling Jokowi to control the majority of Indonesia's parliament.

Since then, his government has been able to push through a number of large infrastructure projects and reforms, with one of the more notable programmes being the launch of tax amnesty. If this programme is successful, it will help ease the country's fiscal deficit and widen its tax base. Importantly, its passage is also a sign of Jokowi's increasing political clout.

Jokowi further demonstrated his political acumen in a subsequent re-shuffling of his cabinet. He was able to bring back Sri Mulyani Indrawati – a well-regarded and capable economist who was previously forced out due to political pressure – to be the new minister of finance. Jokowi also replaced several underperforming ministers with professionals from outside the government.

With a new economic team in place, Jokowi's government now looks to further stimulate Indonesia's economy with additional infrastructure projects and reforms. Growth is expected to be robust at around 5 per cent, and if everything proceeds smoothly, it should accelerate into 2017.

With a new team in place, Jokowi looks to stimulate Indonesia's economy with additional infrastructure projects and reforms

We are encouraged that Jokowi's leadership has finally kick-started the implementation of structural reforms, and as a result, we are bullish on Indonesia in general.

Contributing Author: Ho-Yin Pong

Grassroots℠ Research

New Study Measures the UK's Post-Brexit Mood

Kelly Reuba
Global Head of Grassroots℠ Research

In the weeks before and after the UK's historic Brexit referendum in June 2016, Grassroots℠ Research surveyed hundreds of UK consumers to assess their views on economic trends and gauge overall consumer sentiment.

The results of our polling – more than 800 registered voters were surveyed in June, and another 800-plus in July – indicated an increase in short-term pessimism, a mixed view on Brexit's long-term impact on the UK and greater confidence in personal household finances.

We saw several indications of a slightly gloomier overall mood in July:

- In July, 48 per cent of respondents expected the UK's economy to deteriorate in the next six months – up from 33 per cent in June.
- When asked to think back to how they felt six months before, 45 per cent felt less optimistic during July's survey; 27 per cent felt the same way in June.

At the same time, when asked specifically about Brexit's long-term effects on the UK, our survey participants were a bit more ambivalent:

- In July, 18 per cent expected Brexit would cause a significant long-term deterioration in the UK's economy – up from 4 per cent in June.
- Conversely, 42 per cent of July's respondents expected Brexit to improve the UK's economy either slightly or significantly over the long term – up from 35 per cent in June.

(Continued on page 4)

Viewpoint

In Shift Toward Alternatives, Illiquid Alts Gain Ground

Alternative investments are becoming an increasingly important part of institutional investors' portfolios, but many don't fully understand how alts work – nor are they fully happy with performance. Still, a growing number of investors are using alts for new purposes, like boosting portfolio returns, and many are beginning to tap illiquid alternatives like real estate, private debt and infrastructure debt.

These are some of the key findings published in the 2016 edition of *RiskMonitor* – our annual survey that reports on the top issues facing institutional investors around the world, from public pension plans to family offices and endowments.

How institutional investors view alternatives today

Most use alts for diversification, but performance is gaining traction: Our *RiskMonitor* research shows that 30 per cent of institutional investors use alternatives for the diversification benefits they provide, while about 25 per cent invest in alts because of their low correlation to other asset classes. However, a growing number of respondents (14 per cent) are now tapping this asset class for its performance benefits.

A growing number of respondents are tapping alternatives for their performance benefits

Income seekers are turning to alts: As the hunt for yield continues, illiquid alternatives appear to have found favor; 67 per cent of our respondents said illiquid alts can provide attractive risk-adjusted returns relative to traditional investment strategies.

Risk management is a growing focus: While 60 per cent of the institutional investors we surveyed strive to measure the risks posed by alternative assets, an equal number (62 per cent) want better risk-management tools (up from 49 per cent last year). More specifically, 38 per cent feel they do not have the necessary tools to properly assess cash flow patterns or liquidity risk.

60% of institutional investors strive to measure the risks posed by alternative assets, but 62% also want better risk-management tools

Kristina Hooper
US Investment Strategist

Illiquid alts are on the rise: More than half (56 per cent) of respondents feel that illiquid alternatives are key to building portfolios in the current market. In fact, 23 per cent would consider investing more in real estate, while only 10 per cent would consider investing less. Similarly, more respondents said they would increase their allocations to private equity and infrastructure equity/debt.

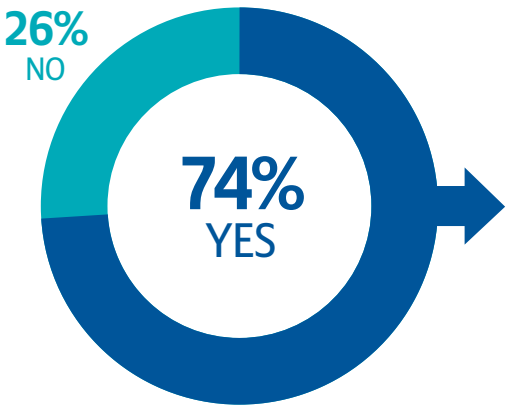
23% would invest more in real estate, while only 10% would invest less; we saw similar results with private equity and infrastructure equity/debt

(Continued on page 5)

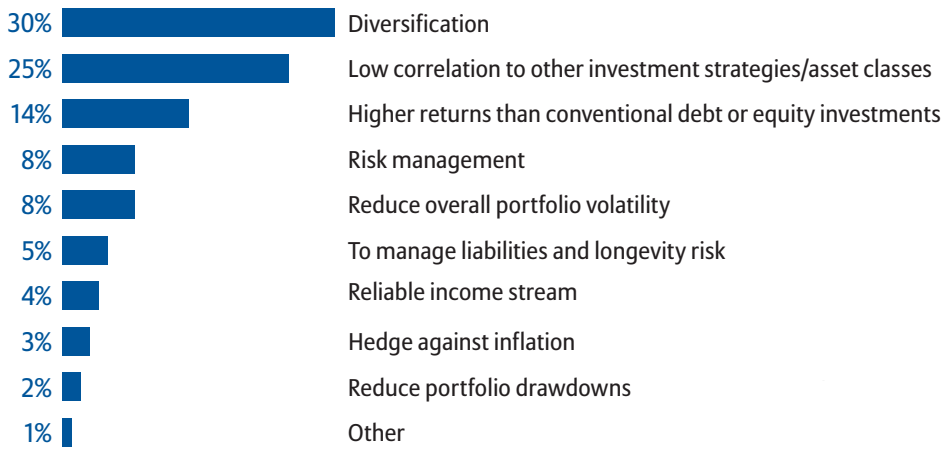
Alternatives Are Widely Used by Institutions, Primarily for Diversification

A big reason why alternatives are employed by so many investors is that there are so many ways to use them in portfolios.

Does your organization invest in alternative assets?



Reasons for investing



Source: AllianzGI RiskMonitor 2016.

(Continued from page 1)

Global View

Although this sounds like a perfect environment for both risk assets and safe assets, there are several reasons why it is unlikely to last

For starters, if economic data continue improving, investors will begin discounting a more hawkish US Federal Reserve – so far, the market is pricing in only one US rate hike before the end of 2016 – and anticipating less stimulus by other central banks. In such a scenario, risk assets may continue to do well, particularly if the earnings outlook also improves, but sovereign bond markets are likely to weaken in price, especially in the US.

If, on the other hand, economic or earnings data start to weaken again, or if political risks come back to the fore – just think of Italy's upcoming referendum or the US presidential election – prices for risk assets might retreat and investors could switch to safe sovereign bonds again.

Either way, something has to give: the high prices of risk assets or the high prices of sovereign bonds. Given our medium-term growth outlook, we tend to believe it's the latter: safe assets are more likely to lose out in the medium to long term.

We believe safe assets are more likely to lose out in the medium to long term

(Continued from page 2)

Grassroots℠ Research

18% expected Brexit to cause a significant long-term deterioration in the UK's economy, while 42% expected an improvement

We also asked survey participants to tell us more about their own household finances. Among our key findings:

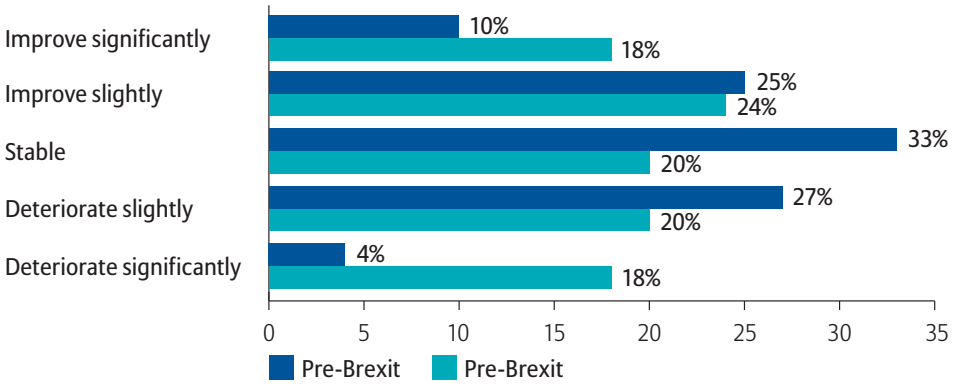
- 58 per cent of July respondents said their current household finances are stable – up from 49 per cent in our pre-Brexit survey.
- Our July survey also indicated stability in savings levels: 58 per cent said Brexit won't change their savings habits.
- However, slightly over one-quarter of July's respondents said Brexit will prompt them to reduce spending on bigger-ticket items, such as travel/holidays (29 per cent), household furniture (26 per cent) and autos (25 per cent).

58% said Brexit won't change their savings habits, but it will reduce their spending on bigger-ticket items

Finally, we asked participants in our studies to share their thoughts about changes in the financial markets. We found that 63 per cent of July's respondents were concerned that post-Brexit stockmarket volatility would have a negative impact on their financial situations in the next six months – a high number, but one that represented only a slight increase over the 56 per cent who felt the same way before Brexit.

Mixed Feelings About Brexit's Long-Term Legacy on the UK

Before and after the Brexit vote, we asked respondents to tell us how they believed the referendum would affect the UK's economy after 10 years.



Source: Grassroots℠ Research as at June 2016 and July 2016.

(Continued from page 3)

Viewpoint

Liquid alts still reign, but performance has disappointed: About three in five respondents (57 per cent) believe liquid alternatives have an important role to play in constructing portfolios. At the same time, when it comes to commodities – traditionally one of the most widely used types of liquid alternative investments – only 8 per cent are considering increasing their exposure, while 22 per cent are thinking about a decrease. This could be because 33 per cent of respondents are not satisfied with the performance of liquid strategies. Still, most investors (56 per cent) feel positive about the role liquid alternatives play in providing attractive risk-adjusted returns relative to traditional investments and asset classes.

Most investors feel positive about liquid alts' role in providing attractive risk-adjusted returns relative to traditional investments

Key takeaways

With alternatives being increasingly pressed into service by a wide range of investors for an even wider range of reasons, it's imperative that asset managers and financial intermediaries understand the benefits and challenges that alts bring to the table:

- While investing in alternatives is virtually commonplace now, investors still need help understanding how alts work – and how to use them.
- Increased market volatility could help more investors appreciate the low correlations of alternatives to other asset classes.
- With rates at record lows, finding adequate yield is a major concern. The search for income has pushed many investors towards equities, but alternatives are also benefiting.
- There is a growing appetite for illiquid alts – particularly real estate, but private equity and infrastructure equity and debt are also being put into action.
- Liquid alternatives remain an important asset class that can potentially generate uncorrelated returns and decrease volatility while providing greater liquidity.

There is a growing appetite for illiquid alts – particularly real estate, but also private equity and infrastructure equity/debt

Learn more about *RiskMonitor*

For more information about *RiskMonitor* 2016 – including access to the full study and an interactive tool for viewing key data points – visit www.allianzgi.com.

www.allianzgi.com | AGI-2016-08-22-16163 | 01902

Allianz Global Investors