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Capital Markets Monthly

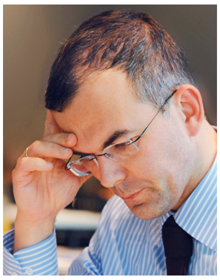
The three factors that will influence investments in 2017 most

Geopolitics, monetary policy and the global economy are the three factors that will exert the most influence on investments in 2017.

Geopolitics: Following the election of Donald Trump as the 45th President of the United States of America, deglobalization will probably pick up speed – as will deficit spending to further inflate the national debt. In Europe, the UK is going to try and present a roadmap for Brexit by the end of March 2017. The Netherlands will elect a new parliament in mid-March, followed by presidential and parliamentary elections in France (April/May and June, respectively). After the summer break, elections to Germany's lower chamber – the Bundestag – will take place by 22 October at the latest. So there are plenty of opportunities for (geo) political debate and associated volatility.

Monetary policy will probably remain one of the key constants. Irrespective of which course the much-debated US Federal Reserve Board (Fed) adopts, it will remain expansionary overall, as will global monetary policy. Although the European Central Bank (ECB) is not expected to embark on QE exit – cease its policy of quantitative easing – any time soon, it is slowly running out of arguments. The base effects of energy prices are already becoming noticeable and give rise to expectations of low consumer prices increasingly approaching the higher core rate, added to which public spending programmes are garnering wider support, while deglobalization and the associated higher tariffs will encourage price increases. In terms of domestic economies, this trend should be helped by **economic growth** – in major world regions, at least. The gaps in productivity are slowly closing, albeit at a stronger pace in the US than in the Eurozone. Global purchasing managers' indices support our expectations of another positive growth year ahead.

The guiding principle for investments in 2017 should be "reflation instead of deflation" in the context of inflation rates returning to normal. The reflationing trend advocates portfolios that include riskier assets again next year, e.g. equities and bonds with risk premiums. Bearing in mind the geopolitical tendencies, however, we should be prepared for greater volatility.



Hans-Jörg Naumer
Global Head of
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Thematic Research

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As of 25/11/16

Equity Indices	Status
FTSE 100	6,779
DAX	10,699
Euro Stoxx 50	3,017
S&P 500	2,213
Nasdaq	5,399
Nikkei 225	18,357
Hang Seng	22,831
KOSPI	1,974
Bovespa	61,559
FX	**Status**
USD/EUR	1.059

Interest Rates %		
USA	3 Months	0.94
	2 Years	1.14
	10 Years	2.36
Euroland	3 Months	-0.31
	2 Years	-0.76
	10 Years	0.18
Japan	3 Months	0.06
	2 Years	-0.15
	10 Years	0.03
Raw Materials		
Oil (Brent, USD/Barrel)		47.3

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As far as government bonds in the western hemisphere are concerned, reflationing is increasingly moving towards centre stage. The European bond market will probably prove best able to withstand this trend. Thanks to the European Central Bank's interest rate policy, yields – especially at the short end – are firmly in the grasp of monetary policy. Reflationing should gradually become noticeable at the long end although, here again, the ECB's government bond purchases will probably hinder any stronger rises. Inflation-indexed bonds and shorter durations, generally, are becoming interesting.

These three influencing factors should make 2017 an exciting year for investing on the capital markets. Fortunately, volatility management can be delegated – through the use of multi-asset products, for example.

Hans-Jörg Naumer

Allianz Global Investors

Understand. Act.

Markets in Detail

Tactical Allocation, Equities & Bonds.

- Global economic indicators have improved over recent months.
- As monetary policy remains loose around the world, equities should benefit from continued support although we must prepare for increased volatility.
- Following marked downward corrections in spring, corporate profits and earnings forecasts have stabilized considerably in Europe, the US and Japan. There is, however, no guarantee that the improved trends will persist. In our opinion, the earnings expectations for 2017 are still too ambitious.
- Generally speaking, investments should focus more on capital income (e.g. dividends) and less on price gains.

German equities ↗

- The economy remains in robust health with no signs (yet) of any worries on the part of exports (Brexit debate and deglobalization, which should gain more support following the election of Donald Trump).
- In terms of their long-term average, German equities are slightly undervalued according to the Shiller price/earnings ratio.

European equities ↗

- Europe remains under threat of increased political risk. Next year will see elections in the Netherlands, France and Germany.
- The UK economy is surprisingly positive at present, although the long-term risks have increased significantly in expectation of a hard Brexit, the consequences of which would probably be severely negative.
- Based on their Shiller price/earnings ratios, European equities rank among the more attractive markets.

US equities →

- US gross domestic product grew strongly in the 3rd quarter. Foreign trade, particularly, made a surprisingly good contribution to growth whereas investment momentum on the corporate front lost pace.
- In terms of valuations, US equities are not prepared for growing political and – over the medium term – economic risks.
- The sentiment for US equities has improved and the technical environment is encouraging a year-end rally.

Japanese equities →

- Despite the country's anaemic growth, the unemployment rate in Japan is trending lower, which will probably prompt demands for wage rises over the medium term.
- Japanese equities remain hostage to the Yen. Uncertainties surrounding the effectiveness of the Japanese central bank's new strategy are currently being over-compensated by the Yen's weakness caused by the Dollar. The tactical outlook for Japanese equities is therefore positive, although international investors should not neglect the exchange rate risks.

Emerging market equities →

- There are signs of cyclical improvement in China and the emerging markets in general.
- The economic imbalances in China are, however, increasing further.
- Concerns about protectionism are not yet noticeable. The firmer US Dollar could have an adverse impact not only on China but emerging market assets in general.

Sectors

- Commodities are exposed to various influences. Prices for industrial metals, for example, should benefit from Trump's triumph and the prospects for potential infrastructure investment. Recently, precious metal prices declined in expectation of interest rate hikes by the Fed.
- The improved cyclical environment and hopes of reflationing and stimulating policy measures should favour more cyclically oriented value sectors over the foreseeable months, and especially banks, which have been shunned for a long time (with focus on US banks).
- In structural terms, we still prefer the dividend style.

Investment theme: "Reflationing"

- Over the coming months, inflation rates in the OECD area should continue to rise in light of the recent stabilization of commodity prices and driven by base effects.
- Added to this, the trend towards deglobalization could result in higher tariffs and less competitive pressure on the price side.
- As far as government bonds in the western hemisphere are concerned, reflationing is slowly moving towards centre stage. With support from the ECB, the European bond market will probably prove best able to withstand this trend. Although the Bank of England (BoE) should also be able to support the Gilt markets, future inflation driven by import prices should not be ignored.
- Generally, inflation-indexed bonds and shorter durations are becoming interesting, especially in regard to US Treasuries.

Euro bonds

- Yields, especially at the short end, are still firmly in the grasp of low interest rate policy. Reflationing should gradually become noticeable at the long end although, here again, the ECB's government bond purchases will probably hinder any stronger rises.
- Slowly but surely, the debate surrounding the ECB's course beyond March 2017 will probably pick up speed. The European Central Bank has not yet said how it intends to continue with its purchases of government bonds beyond this date (see also our QE Monitor).
- Peripheral government bonds in the Eurozone remain supported by expansionary ECB monetary policy but are still prone to political risks.

International bonds

- More expansionary fiscal and more restrictive monetary policy measures should further encourage the cyclical increase of US Treasury yields.
- Over the medium term, the US yield curve should continue to flatten out. Prices on the US money market still do not seem to adequately reflect the Fed's current rate hike cycle.
- Yields on UK Gilts can be expected to rise, especially at the longer end, as a result of inflation.
- There are no signs of pressure on Japan's government bond yields, particularly as the central bank is anchoring yields on 10-year bonds at 0%.

Emerging market bonds

- Negative structural factors (e.g. high levels of debt and slower growth potential in numerous emerging markets, protectionist trends in the US) have clouded the secular outlook for EM government bonds.
- In contrast, the economic environment has recently stabilized, albeit not across all countries, but rather driven by India, China and Russia.
- Moreover, expectations of less expansionary monetary policy in the US over the medium term are weighing on this asset class.

Corporate bonds

- Investment grade and high yield bonds are being pulled in two directions – between accommodating monetary policy and a challenging macroeconomic environment (price trends) on the one side, and fading support for valuations on the other.
- Risk premiums on US corporate bonds (incl. high yield) can still be classed as moderately attractive, based on current fundamental and market data.
- The "pure" credit risk and liquidity premiums (estimated on the basis of market-based implicit vs. historic cumulative default rates) indicate a largely neutral valuation of investment grade Euro corporate bonds and a more ambitious valuation of Euro high yield bonds.

Currencies

- In light of the massive current account deficit and likelihood of dwindling capital inflows, Pound Sterling is in danger of further drastic weakening.
- Enthusiasm for long positions in the US Dollar has rekindled.
- Emerging market currencies have come under pressure, albeit to differing extents from one region to the next, in anticipation of a greater economic policy focus on national issues under Donald Trump and a tighter Fed policy.

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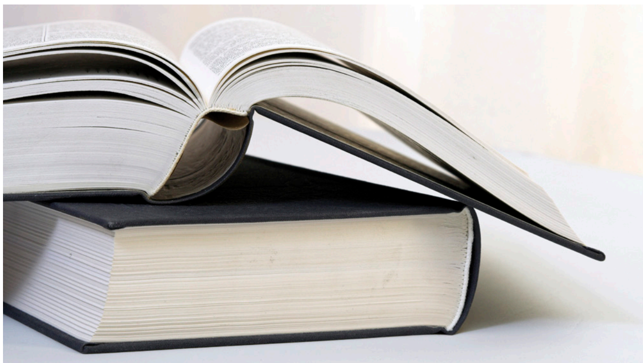

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