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Capital Markets Monthly

Three Reasons to Get Active

It is no secret active management has been challenged recently. Over the last 3 years, $1.3 trillion has moved into passive strategies, while $250 billion exited active funds. This shift—while notable—is misguided for three reasons.

First, the fair evaluation of an investment strategy should cover a full market cycle. A 2012 study from Robert Baird shows that, while 59% of managers add value over 1-year, 73% do when measured over a 5-year period. This concept is critical because of how abnormally long the current cycle has become: The S&P 500 Index hasn't experienced a bear market in the 7 ½ years since the financial crisis ended. To put that into context, the recovery from the Great Recession—the worst in 80 years—now equates to the fourth-longest US economic expansion and the second-longest S&P 500 bull-run in history.

What this means is that since the market troughed in March 2009, the rising tide that has lifted risky assets has simultaneously diminished the need for downside protection—an area where active managers have historically shown expertise. In fact, during the 2000-2 tech market bust and the 2008-9 financial crisis, active managers in the US large-cap space—one of the most competitive markets, globally—outperformed their passive peers by 471 basis points and 100 basis points, respectively.

We firmly believe that analysing corporate fundamentals makes active managers better equipped to see and navigate storms that darken the horizon. Active managers can benefit by underweighting underperforming assets or simply moving money into cash. When markets get rocky, passive vehicles not only own the entire downside of the index being tracked, they should underperform the index's losses after accounting for fees.

Second, the shift toward passive is troubling because of how the instruments are used. Frequently, passive investors buy index funds for tactical rather than strategic reasons, meaning they expect to move in and out of positions quickly. But when markets are volatile, there isn't always enough liquidity to trade efficiently. A good example is the "flash crash" on August 24, 2015 when the Dow Jones Industrial Average briefly fell nearly 1,000 points, its largest-ever intra-day loss. Circuit breakers (trading halts) were triggered almost 1,300 times, and the prices of some popular Exchange Traded Funds (ETFs) disconnected from their underlying assets. For instance, a $2.5 billion US consumer staples ETF lost 32% of its value while the companies in the fund were down 9%. Poorly-timed trades in vehicles investors mistakenly think are highly liquid can result in outsize losses.

Greg Meier
Vice President,
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"When markets get rocky, passive vehicles own the entire downside of the index being tracked."

As of 31/10/16

Equity Indices	Status
FTSE 100	6,990
DAX	10,665
Euro Stoxx 50	3,075
S&P 500	2,126
Nasdaq	5,189
Nikkei 225	17,442
Hang Seng	22,935
KOSPI	2,008
Bovespa	64,925
FX	**Status**
USD/EUR	1.095

Interest Rates %		
USA	3 Months	0.89
	2 Years	0.87
	10 Years	1.84
Euroland	3 Months	-0.31
	2 Years	-0.63
	10 Years	0.09
Japan	3 Months	0.06
	2 Years	-0.26
	10 Years	-0.04
Raw Materials		
Oil (Brent, USD/Barrel)		47.6

CapitalMarketIndicator

Bond Funds — Equity Funds

New Publication

Why Short-Duration Investing May Be a Smart Long-Term Move

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Third, passive managers have benefited from unprecedented monetary stimulus from the world's central banks. Since the financial crisis, all of the major central banks have cut interest rates into record low—in some cases negative—territory. They have also launched asset purchase programs (Quantitative Easing; QE), distorting the fundamental process of price discovery by private investors. The recent flood of central bank stimulus has buoyed capital markets generally, which has resulted in an increase in cross-asset correlations. This is important: When correlations are low, stocks should trade based more upon company-specific characteristics. When correlations are high, corporate fundamentals—and the work active managers do digging through balance sheets, income statements, pay-out ratios, etc—goes out the window.

From this standpoint, it is encouraging to see that some central banks are either in the process of normalizing policy or considering it. With US labour conditions strong and inflation accelerating, policymakers at the Federal Reserve are keen to continue the first US rate-hiking cycle in a decade. Across the Atlantic, European Central Bank officials seem to flirt with the idea of tapering QE. Even the Bank of Japan's new "yield curve control" policy may result in a slowing pace of asset purchases.

Reduced monetary accommodation is a natural part of the economic cycle—it should dampen cross-asset correlations and further support the argument for getting and staying active.

Greg Meier

Allianz Global Investors

Understand. Act.

Markets in Detail

Tactical Allocation, Equities & Bonds

- The power of the central banks globally appears to be diminishing and diverging. Continued monetary expansion in Europe and Asia should help support local assets, while the Federal Reserve rate hike cycle may generate volatility.
- Structurally, the reach for yield favours riskier asset classes (like equities), where dividends are an important factor. Growth is preferred over Value as long as the "lower for longer" rate environment persists despite high relative valuations.
- Despite existing negative factors (geopolitical uncertainty, low corporate earnings growth, uncertainty regarding US monetary policy, liquidity risks and valuations in some asset classes), riskier asset classes should continue to be preferred over government bonds in the medium to long term.

German equities ↗

- The economic situation remains solid, as demonstrated by the most recent IFO Business Climate Index, which in October 2016 reached the highest level since April 2014. The gain spanned both expectations and current conditions. There is no sign of concern about exports (Brexit debate).
- In terms of their long-term average, German equities are slightly undervalued according to the Shiller price/earnings ratio.
- A backlash against government's refugee policies could be a political risk during general elections in October 2017.

European equities ↗

- Unemployment in the Eurozone continues to decline, which is likely to support private consumption, although a moderate increase in inflation is expected in the next few months.
- While economic and political risks increased after the UK referendum, the UK economy has recently been surprising to the upside. However, long term risks have risen due to expectations of a "hard Brexit", with severe negative economic consequences particularly for the banking sector.
- Compared with the US, European equities appear to be attractively valued. With the prospect of bond yields stabilizing as we approach the limits of monetary stimulus, banks and Eurozone equities should also stabilise.

US equities ↗

- The US economy is in decent shape; current recession odds remain restrained.
- Continued low rates combined with the stable economic environment are having a positive impact on corporate earnings. The headwind from revised earnings forecasts is increasingly dissipating due to a) an improved energy sector following the stabilization of commodity prices and b) the improvement in investment sentiment.
- In terms of valuations, US equities are not prepared for rising medium-term growth risks, as they are already highly valued.
- In the event of uncertainties, the US equity market should benefit from its status as a "safe haven".

Japanese equities →

- Japanese fiscal and monetary stimulus has so far had very little positive impact.
- The most recent shift in the strategy of the Bank of Japan (BoJ) is fuelling fears that the central bank is running out of ammunition before having achieved its goals.
- BoJ "yield curve control" could mean Yen appreciation if the BoJ can control 10-year bond yields via slower injections of monetary stimulus. The strength of the Yen has recently weighed on the earnings of major export companies. We remain on the side-lines on Japanese equities.
- Improved growth throughout the Asian region is helping overall.

Emerging market equities →

- Capital outflows from emerging markets (EM) have lost momentum, which eases the pressure on investments in emerging markets and could motivate short-term investors to take a tactical overweight.
- The macroeconomic environment in China remains uncertain and is being propped up by state intervention. While China's official indicators are stabilizing, challenges remain. Our *AllianzGI China GDP Tracker* points to a cyclical slowdown later this year.
- The stabilization of commodity prices has provided emerging markets with respite. If EM currencies and commodity prices can hold up, we see some more scope for tactical EM outperformance. For the medium-term, we are less convinced of a sustainable upswing in the light of global growth risks. Structurally, the debt build-up in EM is a considerable risk.
- Within the segment, preference should be given to Asia (excluding Japan). Latin America seems to be labouring under both structural and political burdens.

Sectors

- Global cycle indicators move broadly sideways signalling no clear preference between classical cyclical or defensive sectors. Latest cyclical outperformance (including Financials and commodity sectors) was driven by a bottoming out of bond yields. We recommend a balanced sector allocation tactically, with a structural bias toward Defensives.
- Growth should be preferred over Value as long as the "lower for longer" rate environment persists, despite high relative valuations. Temporary corrective moves may occur when the valuation premium of Growth stocks gets too extreme. Oil should do best among Value sectors.
- Banks are currently benefiting from takeover speculation and rotation opportunities fuelled by valuation and positioning

considerations. The sentiment for European banks is still fundamentally subdued, due, not least, to negative earnings sentiment, narrower interest rate margins, debates about adequate equity ratios and little prospect of higher dividends.

Investment theme: Inflation-linked bonds

- Headline inflation moves in step with the oil price, prices for agricultural commodities and the exchange rate. Once the oil price starts rising – albeit within narrow bandwidths – inflation rates in the US and Europe should also start increasing again.
- Core inflation is explained by the difference between aggregate demand and potential supply, i.e. the output gap. In many developed countries, the output gap has significantly narrowed or is already closed. This points toward a further increase in the core inflation rate.
- Based on the expectations of professional forecasters, long-term inflation expectations for the US and the Eurozone have been largely unaffected by monetary policy. They remain anchored at around 2% for the next five years. Inflation-linked bonds could be attractive to investors who expect a higher inflation rate than the market, or at least that it will not slide further below market predictions.

Euro bonds

- The Eurozone is on a moderate growth path – base effects should continue to drive the rate of inflation higher in the months to come.
- We expect the European Central Bank (ECB) to continue its expansionary policy and further easing, despite the central bank's September 2016 decision to defer notice about further measures until later this year.
- Not least thanks to the ongoing support from the ECB's purchase programme, government bonds from the Eurozone periphery recently showed a rapid recovery from the temporary setback caused by the Brexit referendum. Peripheral sovereign markets are still pricing in a higher probability of default over coming years compared to pre-crisis levels. Despite pending political risks in the Eurozone, the market segment remains supported by the ongoing economic recovery and fiscal healing combined with an accommodative monetary policy stance by the ECB.

International Bonds

- In general, sovereign bonds look overvalued. Despite efforts to guide markets, central banks have become a source of volatility, notably in FX and bonds.
- Federal Reserve policymakers held rates steady at their September 2016 meeting, but kept open the possibility of a hike later this year. However, the US money market curve is still not fully priced for a Fed rate hike cycle. We think rate hike expectations will build over time, based on the extremely flat policy path that is currently priced in. This should lead to additional flattening of the US Treasury curve over the medium-term.
- At the beginning of August 2016, the Bank of England put a comprehensive series of measures in place (lower interest rates, quantitative measures that included the purchase of corporate bonds, a new financing facility) in response to expectations of slower economic growth in the wake of the Brexit vote, and announced possible further steps.
- Overall, a rapid reversal of the negative interest rate environment (the yield on more than 30% of government bonds from developed countries is currently negative) is unlikely.

Emerging market bonds

- Since mid-February of this year, the risk premiums on emerging market bonds in hard currency have dropped considerably. Prospects for the future will probably be burdened by the continuation of the Fed rate hike cycle and the longer-term structural problems (including higher debts and weak productivity growth trends).
- From a valuation perspective, emerging market bonds in local currency would seem to be more attractive than their hard currency peers over the medium term, given the – in many cases – fundamentally undervalued currencies.
- In contrast to several developed bond markets, local emerging sovereign real yields are (on average) significantly positive. Within the segment, preference should be given to Asian bonds.

Corporate bonds

- Following the ECB's announcement of its intention to start buying non-bank corporate bonds from June 2016 onwards, the risk premiums on Euro-denominated corporate bonds have fallen.
- Implied US corporate default probabilities are markedly above average historical cumulative rates. However, for both investment grade and high yield, proxies for credit risk and liquidity premiums are currently slightly below their long-term averages. Based on this, US corporates are moderately expensive.
- After the previous massive expansion of spreads, the US high-yield market (bonds with poor credit ratings) has posted a significant recovery since February 2016, helped both by a more stable oil price and the overall attractive valuation of this market segment.
- Although Euro high yields continue to benefit from the indirect support of the ECB's accommodating policy, they are trading at unattractive levels from a valuation perspective. We are standing by our neutral assessment.

Currencies

- Over the medium term, the development in relative monetary policies will continue to exert dominant influence over the EUR/USD exchange rate. The expected tightening of the Fed is providing some support for USD.
- The structural factors supporting the US Dollar are intact (not least due to the greater, albeit declining, growth potential). After overshooting its fundamentally justified longer-term value, the greenback is, however, still in a phase of cyclical exaggeration vis-à-vis numerous currencies (including the Euro), despite some corrections since the beginning of the year.
- There are some signs that the decline of emerging market currencies has come to an end as commodity prices bottom out.
- With the risk of a „hard Brexit", the Pound Sterling has fallen dramatically in recent weeks. However, like the Euro, the Pound is typically an interest rate sensitive currency. Compared to expected interest rate differences the Pounds decline looks exaggerated.

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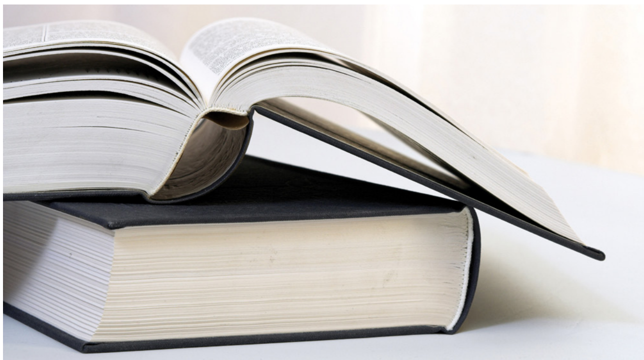

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Imprint

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