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Allianz Global Investors Insights

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Global View

The Importance of Being ACTive: Agile, Confident, Thorough

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Global Strategist

At our most recent semi-annual Investment Forum, held in Hong Kong in January 2016, we reviewed the key strategic issues present in the global economy and reaffirmed the investment advice we have been offering to our clients, leaving many of our previous strategic conclusions unchanged:

- slow and low economic growth will continue;
- low inflation will persist, but labour markets are tightening;
- monetary policy is not always effective, yet financial repression is still in effect; and
- politics and geopolitics will continue affecting economies and markets.

Understanding these macroeconomic and political issues then allows Allianz Global Investors to calibrate how we, and our clients, should invest. Crucially, we have consistently argued that clients need to take risk in a low-yield environment and that beta returns only will not suffice; the time for alpha has come.

Read more in the following summary of our Investment Forum discussions.

Where will growth come from in a world of financial repression?

Sovereign leverage is already high – much higher in developed than emerging markets (EM), though emerging-market debt is rising rapidly. Although this lowers gross domestic product (GDP) growth, additional fiscal stimulus can boost economic activity. Yet with quantitative easing running its course, fiscal stimulus is clearly not a panacea; structural reforms or further currency depreciation may be needed to boost competitiveness.

The growing list of concerns about China overshadowed some brighter news in 2015, centred around the economy's shift toward consumption, successful supply-side reforms, a growing private sector no longer starved of credit by the big banks and the low valuations of many listed companies. China's rebalancing will provide global boosts to tourism, entertainment and e-commerce.

With clarity of execution expected soon on the next Five-Year Plan, China's policy seems to be headed in the right direction: the private sector is being released and resourced, and the state-owned sector is being restructured and reformed by the state-owned banks.

A review of emerging-market debt and currencies

In 2013, we favoured emerging-market debt (EMD) and related currencies based not only on attractive break-even spreads, but also on expected higher GDP growth and lower levels of sovereign debt. Since then,

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EM economies have weakened from collapsing commodities and the re-emergence of over-investment and borrowing in US dollars. Commodity- and non-commodity-based EM economies have clearly diverged, which has benefitted commodity importers considerably. Globally, almost all EM currencies still look attractive, although risks remain elevated.

We expect EMD and oil prices to remain highly correlated – even higher than EMD and US Treasuries were during the "taper tantrum". Within EMD, we are now experiencing very high levels of spread volatility, and the asset class is suffering from a divergence between sovereign debt itself and that issued by corporates or other entities. On a positive note, EMD trades are now less crowded, with some outflows and less supply expected in 2016. We may see attractive returns if economies stabilize in the second half of 2016 and if the US Federal Reserve (Fed) does not behave unexpectedly.

ESG and climate change

The recent 21st Conference of the Parties (COP21) in Paris sought to reduce greenhouse gases by aiming for net zero emissions soon after 2050, and all COP21 signatories will now adopt and report transparent emission results and targets. With investors around the world responding purposefully to this growing consensus, we expect to see further client action on related issues. Moreover, companies already focused on environment, sustainability and governance (ESG) issues have lower cost of capital, generate higher shareholder value and offer lower volatility. It is clear that in the longer term, ESG will become the industry standard.

Income investing

In the hunt for income globally, the US offers some of the highest yields outside of EM. Importantly, the market structure has been changing because of tougher financial regulation: Investment banks and primary dealers now hold reduced inventories of both investment-grade and high-yield bonds. High-yield bonds in particular have seen a backup in yields as fears have grown over rising US interest rates and rising US energy defaults. Importantly, however, the US has never fallen into a recession without the presence of an inverted yield curve, which suggests that a recession is at least a year away.

It is also important to note that fixed-income investments are not the only source of income potential. Over the very long term, dividend payers in the US have offered both less risk and better returns than non-dividend payers, outperforming 85% of the time. Recently, however, non-dividend payers have substantially outperformed, which seems attributable to both central bank policy and concerns around tax treatment. Yet in a world of financial repression, equity-dividend investing offers stable annual returns with some inflation protection and the prospect of capital appreciation. Moreover, taking a contrarian approach to the momentum-fuelled markets can generate good return of capital and income, and offer a defensive way to invest with lower levels of volatility.

Half of all sovereign bonds globally yield less than 1 per cent on a five-year basis, as central banks globally reduce interest rates to the minimum and occasionally below. We hope not to see the US yield curve invert in 2016, as this is a harbinger of recession. Fixed-income investors do not agree with the Fed's pace of interest-rate increases in 2016 and beyond, which will continue to cause volatility as sentiment and data shift around. European credit in 2016 will be driven by interest-rate risk and increasingly substantial credit risk. Accordingly, to fund any acceptable return, investors must sail between solid corporates, which offer good yields and volatility levels, balanced with some contingent convertible bonds, with higher yields but much higher volatility.

Inflation, currencies and central banks

While headline inflation is low and has been falling globally, core inflation is actually quite resilient. As oil, commodity and agricultural prices stabilize, we may see a rebound in consumer price index levels during 2016. Inflation expectations remain anchored around 2 per cent, and index-linked bonds look attractive relative to conventional bonds.

With the Fed's five preconditions for raising rates now met, history suggests the US economy should remain solid for the next year or so. Monetary policy divergence will become more visible in 2016, with the US and UK normalizing while Japan and the euro zone continue to fight disinflation. All other countries will be forced to follow either one policy or the other.

Oil remains a prominent theme as both a harbinger of world economic activity and the epicentre of a serious geopolitical situation. The fall in oil and other commodities has been very deflationary for the world so far, and forced many emerging economies to impose austerity as their finances collapse. Evidence is building of both a drop in future supply and investment, but markets are focused on today's headlines, which are deteriorating.

Key conclusions

Global growth will remain slow, low and fragile, and inflation will be dominated by oil in the shorter term. Politics will play a key role, as the need for structural reform will only grow, and in the next few years developed economies will continue to outperform emerging ones. Within equities, structural-growth companies will most likely remain attractive in generating capital appreciation, and ESG is now an important driver for many clients. Sovereign bond markets remain unattractive and politics and currencies will affect returns, with yet more volatility added from the difference between the Fed "dots" and the market futures forecasts. We continue to face investment challenges that are similar to those of the last few years, but with markets elevated, we expect volatility to be high and beta returns to be low. Investors would be well-served to choose ACTive strategies – those that are agile, confident and thorough – at the asset allocation and selection levels.

Perspective on Europe

A Tug-of-War in Euro-Zone Bond Markets

Ann-Katrin Petersen
Investment Strategist

A significant buyer of government bonds entered the euro-zone stage in March 2015, in the shape of the European Central Bank (ECB). In volume terms, the ECB has now completed 46 per cent (EUR 694 billion) of its extended EUR 1.5 trillion quantitative easing programme and 42 per cent (EUR 530 billion) of the planned bond purchases under the public sector purchase programme[1] – amounting to roughly 7.4 per cent of the market volume of outstanding public debt.

From an investor's perspective, this has contributed to an ongoing "tug-of-war":

- On the one hand, the steady and price-insensitive buying by the Eurosystem, in combination with still-subdued market-based inflation expectations, will likely continue to exert downward pressure on yields. As our January 2016 *QE Monitor* indicates, more than one-third of total euro-zone government bonds have negative yields, with Germany and France standing out from the crowd.[2]
- On the other hand, investors must consider fundamental factors driving yields higher, such as an expected, gradual rise of euro-zone inflation data over the course of 2016 and the Fed rate-hike cycle.

While euro-zone sovereign bond markets look vulnerable and prone to higher volatility, lingering financial repression may continue to prevent bond yields from returning closer to nominal growth rates. The search for yield goes on.

Soundbites from Research

Using Model Portfolio Performance to Assess Our Analysts

Gunnar Miller
Global Head of Equity Research

At the beginning of 2016, Allianz Global Investors implemented a new quantitative-measurement element for our research analysts: the performance of Global Research Sector Model Portfolios (GRSMs). AllianzGI has six GRSMs divided by industry; these are highly concentrated 10-stock model portfolios that rebalance to equal positions with each trade.

In implementing this change, we are looking to accomplish five key goals:

- First, to encourage members of each Global Sector Team (GST) to identify what we believe to be the best stock in the world within each industry, for the benefit of AllianzGI's portfolio managers.
- Second, to promote vigorous debate between members of the GST within Chatter, our in-house information-sharing network. Although this debate will occur in private GRSM discussion groups, a brief summary will be posted to the relevant specific stock pages at the time of the trade.
- Third, to expose our research analysts to the experience of participating in the management of concentrated, active, global portfolios.
- Fourth, to make our analysts' work even sharper, as each stock candidate for inclusion must have updated drivers and targets, plus a clear narrative explaining advocacy.
- Fifth, to draw out "read-throughs" across geographies and narrow sectors. For instance, an internet analyst with a strong secular argument against a particular media business can now be heard because we require tech/media/telecom analysts to come together to debate the best stocks.

With the implementation of GRSMs as a measurement for our research analysts, our clients will benefit from portfolios that reflect well-thought-out stock ideas – ideas shaped by discussion and debate that have been taken to a new level among our research colleagues globally.

[1] Sources: ECB, AllianzGI Global Capital Markets & Thematic Research. Data as at 22 January 2016.

[2] Sources: Bloomberg, AllianzGI Global Capital Markets & Thematic Research. Data as at 12 January 2016.

Perspective on the US

How Walmart's Higher Wages Affect Other Retailers

Kelly Reuba
Global Head of Grassroots℠ Research

More than 1.2 million Walmart and Sam's Club associates will receive a pay increase on 20 February under the second phase of the company's two-year plan, according to the company. Walmart's pay hikes include upping the entry-level starting wage from USD 9 per hour to at least USD 10 per hour, on average.

To find out how Walmart's move may affect other retailers who rely on minimum-wage workers, Grassroots℠ Research gathered wage data from a variety of companies in select cities throughout the US, with the aim of determining if and when wage inflation may occur.

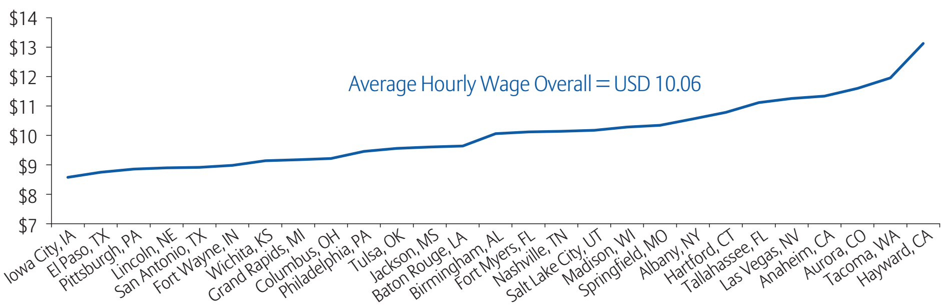
To obtain this wage data, Grassroots℠ reporters interviewed 201 sources working at a range of companies in both urban and suburban areas. Among the findings:

- The average starting hourly wage by city was USD 8.67 for a new employee with minimal or no experience, and USD 9.15 for one with three to five years of experience.
- The average hourly wage overall was USD 10.06.
- City by city, the gap between the highest and lowest hourly wage was USD 4.55.
- When examining average hourly wages by the type of company, grocery stores and health care services paid the highest, followed by mass-merchandise stores. All three paid more than USD 10 per hour.
- Fast-food restaurants, hobby stores and drugstores all fell below the USD 10 mark, while dollar stores paid the lowest at below USD 9 per hour.

This research revealed that the primary factors affecting wages are position type and level of experience, although new, non-supervisory employees typically start at the state minimum wage level. In markets where wages are above the local minimum wage, such rates are deemed necessary to cover cost of living increases, attract and maintain good people, and to be competitive with nearby employers. The overall implication is that retailers paying below the new USD 9 to at least USD 10 per hour starting wage for Walmart and Sam's Club associates will need to increase their hourly wages to successfully compete for workers.

How Much Do Wages Vary by City?

The gap between cities' highest and lowest average hourly wages was USD 4.55.



Source: Grassroots℠ Research as at December 2015.

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