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Allianz Global Investors Insights

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Global View

5 Good and 5 Bad Scenarios for 2017

Every New Year, we envision a range of market-moving events that could take place but are far from inevitable. Here are ten possibilities for 2017.

The Good

1. Europe progresses
After Europe's torrid political environment in 2016, fears about its "dis-integration" may end up misplaced. If political tensions fall as elections are completed, confidence could grow about a "soft Brexit" that could help investment and employment rise – which would be another important step toward a fully united Europe. Low valuations and reduced political risks might then combine to generate good equity returns.

2. Green funding takes off
Despite President Trump shifting US energy policy back toward coal and oil, global efforts to improve the quality of future economic growth could accelerate quickly thanks to "green bonds" promoting lower pollution and cleaner water and energy systems. Despite US climate-change scepticism, corporations and investors could join forces to minimize ecological damage.

3. Fiscal stimulus boosts global growth
The realization that negative interest rates were a policy error could lead to a more fiscally stimulative set of economic policies globally, which could relax the investment tension created by this distorted interest-rate environment. European and US populism could create new spending that boosts economic activity, which would increase investment, reduce unemployment and lift confidence.

Populism and new fiscal spending could boost economic activity after a period of draining austerity

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4. "Ch-India" consumption takes off
With China rebalancing toward a consumption-based economy, and with reform movements converging in India and Indonesia, the world is witnessing the creation of a new consumer market with 4 billion people. Incomes here are expected to grow rapidly in coming years, with the "American dream" alive and well in the south-eastern part of the region.

Neil Dwane
Global Strategist

5. Active managers add alpha
After a generally woeful year adding alpha in 2016, active managers could improve pricing and performance transparency and align costs to meet client objectives. At the same time, the so-called "free costs" of passive investing could become unstuck as volatility widens spreads, lifts interest expenses, and reveals greater illiquidity and positioning concentration – all of which would further detract from indexed returns.

The Bad

1. Trump inspires trade protectionism
True to his campaign promises, Trump could

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Allianz Global Investors

Perspective on the US

Policy, Politics and Technologies Scuffle in a New Era

Steven Malin, Ph.D.
Investment Strategist

Central bank policies now impede economic growth

Throughout most of the post-crisis period, the US Federal Reserve argued that the United States' weak economic growth, productivity and capital spending were caused mainly by insufficient aggregate demand. In response, the Fed implemented aggressive monetary accommodation to stimulate spending – and, for a while, it succeeded. However, GDP growth soon decelerated and business investment stayed subdued, which indicated that the economic theory the Fed relied upon had proved to be faulty.

Consequently, several Fed officials in 2016 wrote extensively about how structural changes in the US economy had been interacting with ultra-low interest rates and tougher regulations on banks to make interest rate targeting difficult, reduce the target level of policy rates and restrain real economic growth. Among their key findings:

- Precautionary savings rose, causing real consumption to not keep pace with real disposable income, and persistently low interest rates encouraged households to postpone consumption and build up precautionary savings.
- Regulations raised hurdle rates on prospective business investments.
- The mix of regulatory and economic policies encouraged capital spending outside the United States rather than within it.
- Low interest rates encouraged corporate leverage – not to finance productive investment, but to finance share buybacks and dividend distributions.
- Fed ownership of Treasury securities removed collateral from the repo market used to finance day-to-day operations of businesses.
- Low interest rates strained pension funding.
- Mortgage financing became more difficult, and banks chose to restrict some forms of lending in order to protect their equity from potential loan losses.

New fiscal priorities must heed the modern industrial revolution

The Fed's policies and unforeseen structural changes have not been the only factors causing sluggish US economic growth. Growing populist movements are set to at least partially shape a new wave of fiscal intervention into economies – and monetary policy must account for these new influences in the years ahead. These movements reflect a combination of globalization, technological changes, political stalemates and geopolitical crises that have resulted in lower inflation-adjusted incomes and widening of income and wealth disparities.

Growing populist movements are shaping a new wave of fiscal intervention, which monetary policy must account for

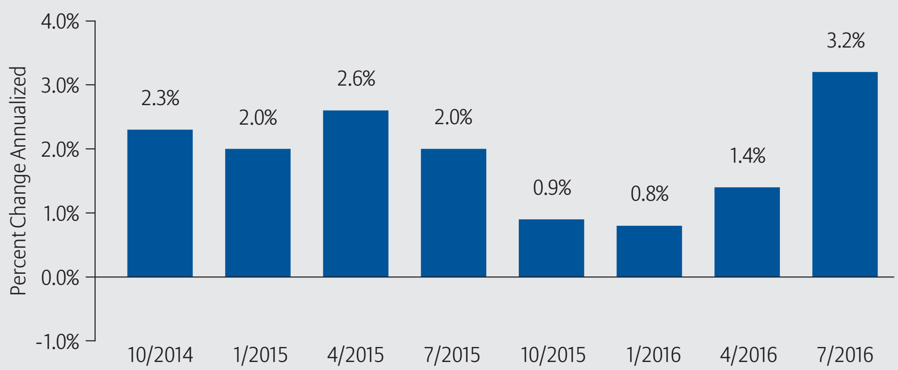
Moreover, the inexorable development, marketing and implementation of a range of new technologies has already reshaped how businesses are organized – and arguably altered every aspect of economic activity. This chain reaction of technological progression will continue to generate enormous upheaval and opportunity. Not only have modern technologies become disruptive, but they have reduced the need for material inputs, enabled production at a zero marginal cost, made the entirety of human knowledge accessible via the cloud, and made knowledge available to anyone in the world at virtually no cost. These are new technologies that now "crowd-in" knowledge and understanding instead of crowding it out.

Clearly, the pace of adoption of new technologies has never before been so pervasive and rapid. As a result, all households, businesses and government must adapt to and change with this new, modern industrial revolution or else risk their economic and financial well-being, now and in the future. This has significant implications for the Fed and other central banks: Failing to master the implications of this industrial revolution will not only cause them to miss their policy targets, but push them toward setting the wrong targets.

For more on this topic, visit allianzgi.com for the new "Under the Macroscope" white paper by Steven Malin.

Economic Growth Stays Range-Bound

Real GDP growth has been modest, but sustainable.



Source: Federal Reserve Bank of St. Louis; Allianz Global Investors as at 29/11/2016.

Viewpoint

Three Key Drivers of Growth-Value Rotations

Stefan Rondorf, CFA
Senior Investment Strategist

Equity markets were shaken more thoroughly in 2016 than any of James Bond's martinis. At first glance, index returns for major markets stayed in normal ranges, but just under the surface was one of the most forceful sector rotations since the 1980s. This resulted in previously unloved sectors like mining, energy and – in the US – banks outperforming by a wide margin, while former investor darlings like consumer staples found themselves left behind.

Three top-down drivers of growth-value rotations

So how can investors get a grip on movements like these? Setting aside for a moment certain bottom-up (ie, company-specific) drivers and valuation factors, we have identified three key top-down (ie, macroeconomic) drivers that can move stocks along the spectrum from defensive growth to cyclical value.

1. GDP growth

The level and direction of gross domestic product growth plays a major role in sector rotation. Periods of low or decelerating economic activity help companies exhibiting superior growth rates precisely because growth is scarce in such an environment. This has been the case since 2011, when low absolute and less dynamic GDP growth began pushing investors toward growth stocks. We believe global growth dynamics will turn around and move slightly upward in the near future – partly driven by easing fiscal strains in Japan, the UK and the US – which should help value stocks slightly. However, this situation should not last past 2018 or 2019, because the ongoing recovery still lacks the resilience and self-sustaining qualities it needs to achieve "escape velocity".

Global GDP dynamics should help value stocks slightly in the near future, but the overall trend favours defensive growth

2. Inflation expectations

Projections of increasing prices generally support recovery rallies in cyclical value names, while persistent disinflation typically helps defensive growth stocks. This explains why rising inflation expectations – which are often seen in conjunction with rising commodity prices and some pick-up in economic growth – tend to drive up earnings estimates in traditional cyclical value sectors like mining, energy and banks. Since the spring of 2016, many developments have contributed to rising inflation expectations, and we believe some of these will be sustained in 2017: Overly depressed market expectations have begun to correct themselves, commodity prices have recovered and we have seen some initial adjustment to overcapacity in China. Moreover, output gaps have begun gradually closing around the globe – particularly in the US labour market. This should lead to increasing wage inflation, especially if the Trump administration starts to fiscally stimulate the US economy, which has a labour market that is already close to full employment.

Since spring 2016, rising inflation expectations have favoured a shift toward value stocks; this should be sustained in 2017

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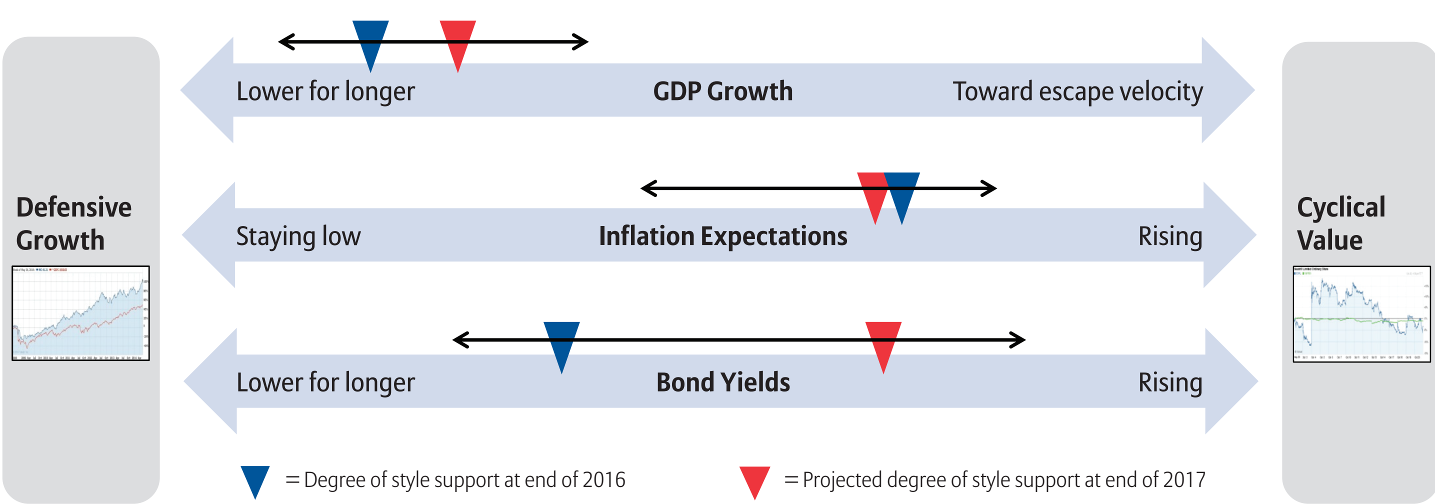
Macroeconomic Indicators Slightly Favor Value Investing

Rising inflation expectations and bond yields support a shift to the cyclical value style, but still-low GDP levels favor defensive growth.



Source: AllianzgGI Economics & Strategy. View expressed as of December 2016.

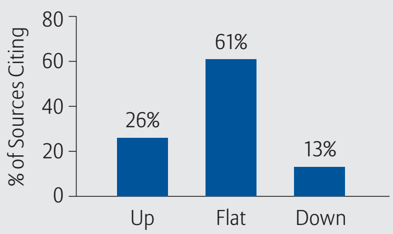
Grassroots℠ Research

Hospital Capex Stable Despite Unclear Outlook for Obamacare

Phil Simon
Grassroots℠ Research Associate

One of the most contentious issues in the recent US presidential election was the future of the Affordable Care Act (ACA) – frequently referred to as "Obamacare". Since becoming law in 2010, the ACA significantly expanded health-care insurance coverage in the US, which subsequently brought more revenue to hospitals. These higher revenues, in turn, led to additional capital expenditures (capex) on items such as information technology, beds and operating-room equipment.

Few Hospitals Plan to Cut Capex
Most survey respondents said their capex plans are flat year-over-year, while more than a quarter plan to increase 2017 spending.



Source: Grassroots℠ Research as at December 2016. Chart shows expected 2017 year-over-year capital spending levels.

After the Republican party's sweep in the 2016 US elections, which increased uncertainty about the outlook for the ACA, Grassroots℠ Research interviewed 25 hospital representatives to find out if the upcoming change in political leadership was driving any shifts in their near-term capital-spending plans.

For almost all of the hospitals represented in the study, the election's outcome has not affected strategic planning or delayed big-ticket capex purchases, since most hospitals either were already committed to their current budgets or would not start making new plans until the summer of 2017. As one source explained, "We're already moving forward with our 2017 plan, and there are no delays. No one is moving their dials quite yet. The political situation is way too fluid still."

Overall, most sources expect hospital capital spending to move higher in 2017, or to stay flat on a year-over-year basis. Commenting on the study, Michael Dauchot, a senior health-care research analyst at Allianz Global Investors, said, "Compared with overall fears about sudden change, the results of the study were positive and supportive of a stable capex environment for hospitals."

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Global View

introduce trade policies that indeed "make America great" – but at everyone else's expense. NAFTA might be realigned, which would hurt Mexico, cause dramatic consequences for an already-collapsing Venezuela and reverberate through a recession-weary Brazil. A stronger US dollar would, ironically, make life harder for Trump.

2. Middle East stays troubled
This region could easily become even more troubled than it is today. While the Islamic State may be targeted more effectively by its enemies, the recent coup in Turkey, the regional effectiveness of the Kurds, the disarray in Egypt and Libya, and the deteriorating detente between the US and Iran all suggest there may be worse to come – including a new kind of Thirty Years War between the Sunni and Shia people. Any of these developments may well underpin a stronger oil price.

3. "Solar minimum" causes polar winter
Our sun is a key driver of global weather and temperatures, and its radiation and sun-spot activity may fall to record lows this winter. The latest El Niño already parched many major farm regions globally, leaving them vulnerable to a truly polar winter – which could reduce upcoming harvests. La Niña seems slow to arrive this time, raising fears about rising food prices and adding another leg to the reflationary inflation cycle.

> The latest El Niño left many regions vulnerable to a polar winter that could reduce upcoming harvests

4. Central-bank credibility falls
In Japan and Europe, negative interest rates did more harm than good – including to central-bank credibility. With Japan now adopting "fiscal dominance", monetary policy could begin accommodating any and all fiscal desires of governments. And with insolvent euro-zone banks still at risk, the European Central Bank will do everything it takes to keep economic growth moving forward – that is, until its efforts no longer work.

5. France chooses Le Pen
After enduring recent political shocks in the UK and Italy, Europe could be convulsed by the election of Marine Le Pen to the French presidency. Her policies would be hostile to the EU and Europe could remain directionless, beset by populism across the continent, confused by the complexities of Brexit and unnerved by the apathetic attentions of President Trump – all of which could further undermine NATO.

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Viewpoint

3. The direction of bond yields

Bond yields reflect both growth and inflation expectations, but they also tell us about investor positioning and monetary-policy expectations. Lower bond yields are better for the defensive growth end of the spectrum, and we have seen this situation manifest itself in recent years. During this time, bond markets priced in a secular stagnation scenario, which allowed for the discounting of distant future cash flows at ever-lower discount rates, driving up earnings multiples for growth stocks considerably. With risk/return perspectives deteriorating in sovereign fixed-income securities, this shift also made defensive equities a serious investment alternative for multi-asset allocation funds. Today, however, the leading global bond market (the US) is slowly waking up to a tough rate-hike path, unusual late-cycle fiscal stimulus, stronger inflation and too-ambitious valuations – which mean US bond yields are expected to move higher during 2017. This should favour value names – particularly banks, especially when higher bond yields come with steeper yield curves.

> US bond yields are expected to move higher this year, which should aid value names – particularly banks

A closer look at valuations

Beyond these macro drivers, valuation of course plays a role in sector rotation, and there is still some room to move in today's market. For example, banks are still at above-average discounts relative to markets, and consumer staples look pricey despite a recent correction. However, the huge valuation gap between pricey growth and cheap value has already closed quickly, especially with value areas like materials and energy appreciating markedly.

Tilting toward value

We believe bond yields will be the strongest of our three top-down drivers in the next year; GDP growth expectations are only slightly upward-turning, and inflation already moved dynamically during 2016. As the accompanying graphic shows, the outlook for inflation expectations and bond yields favours cyclical value names in the coming months; however, the GDP growth picture is improving only moderately, which is an argument in favour of defensive growth stocks.

As a result, while the value rotation trade is too strong to ignore and should continue for some time, we believe that in the end, this is still only a trade – not a complete change in climate. The big picture for GDP growth has not been altered, and there are still constraints to supply such as low productivity, deteriorating demographics and reform fatigue in many parts of the Western world. Once the markets realize this, rising inflation expectations and bond yields should slow – which would once again argue for an above-average valuation premium for defensive growth stocks.

> While the value rotation trade is too strong to ignore, we believe this is still only a trade – not a complete change in climate

In between, equity markets will probably continue to be shaken between the two styles – and investors may find themselves in need of a drink from their favourite bar keeper.

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