April 2017

Capital Markets Monthly

As of 31/03/17

Equity Indices	**Status**
FTSE 100	7,325
DAX	12,313
Euro Stoxx 50	3,503
S&P 500	2,363
Nasdaq	5,912
Nikkei 225	18,983
Hang Seng	24,112
KOSPI	2,160
Bovespa	64,984
FX	**Status**
USD/EUR	1.069

Interest Rates %		
USA	3 Months	1.15
	2 Years	1.27
	10 Years	2.42
Euroland	3 Months	-0.33
	2 Years	-0.76
	10 Years	0.33
Japan	3 Months	0.06
	2 Years	-0.23
	10 Years	0.06
Raw Materials		
Oil (Brent, USD/Barrel)		52.6

CapitalMarketIndicator

Bond Funds | Equity Funds

New Publication

Capital Income: Dividends:

www.allianzglobalinvestors.de

When the Rubber Hits the Road

The geopolitical scene is about to get smoky and hot. Within the next few weeks, investors will have fresh information on a variety of risks that have dominated news headlines. The outcome will drive markets and set the course for the remainder of 2017.

In Europe, an election super-cycle kicks into high gear, as French voters go to the polls to select a new president. While the anti-euro, far-right candidate, Marine Le Pen, is positioned to win first-stage voting on April 23, she probably won't take an outright majority. This would mean a final, second-stage vote on May 7, with one of the more establishment, market-friendly candidates—perhaps Emmanuel Macron—winning. But as any Trump supporter or Brexiteer will happily tell you, the polls can be wrong. And while France should take the main stage in Europe, nitty-gritty details on the UK-EU divorce should come to light, and Italian elections—where euro-sceptic parties are polling above 50%—could be called at any time.

On the other side of the pond, the clock is ticking on President Trump's first 100 days in office, which rumbles to a close on April 29. Optimism about Trump's pro-growth agenda has been a key factor supporting US corporate earnings, inflation expectations, share prices and the spike in 'soft', survey-based economic data like consumer and business confidence. But, despite running the presidency and both houses of Congress, things haven't gone smoothly. Trump has struggled with both self-inflicted injuries—like wiretapping tweets and Russia connections—and external obstacles, like high federal debt levels and fiscal hawks within his own party.

The March 24 failure of the Republican initiative to dismantle Obamacare may be an indication of future challenges to buoyant animal spirits. Governing is complicated. Gaining consensus around debt-financed initiatives like major tax cuts and $1 trillion in infrastructure spending might not be a slam dunk. Congress is scheduled to go on a 2-week recess starting April 10. On April 28, the US government is scheduled to run out of the cash. Aside from side-lining the risk of a government shut-down, an agreement to extend financing—at least until the fall when the debt ceiling again becomes an issue—would be an easy way to demonstrate that Trumponomics is alive and kicking.

Against this uncertain geopolitical backdrop, central banks around the world are struggling to balance massive monetary accommodation against a spurt in inflation pressures. Headline prices in the US, UK and Europe are already at or above 2%. At the same time, seven central banks globally are still running negative interest rate policy (NIRP), while aggregate global quantitative easing continues to expand at breakneck speed. Looking ahead, we think central bank liquidity—one of the factors that helped support risky assets during the post-crisis era—might peak by early 2018.

Today's risk-takers should benefit if uncertainties fade amid favourable European election results and forward progress in the Republican economic growth agenda. But if risks veer into reality, earnings expectations—and thereby share prices—might start to look a little bit extended. As usual, we'll know for sure when the rubber hits the road.

Best Wishes from San Diego,

Greg Meier

Greg Meier
Vice President,
US Capital Markets Research
& Strategy

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Allianz Global Investors

Understand. Act.

Markets in Detail

Tactical Allocation, Equities & Bonds

- Supported by both industrialized and emerging countries, global macro data improved again in January and February, after posting the strongest quarterly momentum in almost seven years at the end of 2016.
- Due to the continued cyclical improvements, we remain long equities, despite concerns about politics and valuations.
- With US interest rates rising, we are defensive on bond duration globally.

German equities

- Export-oriented companies should enjoy a further boost from the global economy. There are no signs yet of any early impacts from de-globalization.
- In contrast, consumer confidence is expected to ease a bit due to rising inflation. But the labour market remains strong: Within the Eurozone, Germany continues to have the lowest unemployment rate.
- Measured against the long-term average of the Shiller price/earnings (P/E) ratio, German equities appear slightly overvalued.

European equities

- Supportive cyclical data has helped shield equities from political uncertainty and bond market volatility. While economic data in the US and Europe has been coming in ahead of consensus, a peak in positive surprises is probably approaching.
- Overall, the most recent macroeconomic data for the UK have been better-than-expected. The impact of a "hard" Brexit, however, could be severely negative.
- European equity market valuations are average. Some countries are inexpensive.
- Some of the political risk in the Eurozone has already been discounted. One indicator of this trend is the banking sector, whose performance has bottomed out.

US equities

- Historically low interest rates combined with expansionary Fed policy has helped lift US equity valuations to high levels. This creates a drag on return potential in the long-run. Recent volatility may be a first symptom of limits to monetary easing.
- Solid macro data—particularly in the labor market—supports the all-time highs in US equities—at least for now. But the US business cycle is maturing, which suggests approaching headwinds: e.g. lower margins due to higher wages.
- US large caps are more exposed than domestic oriented small caps to shifts in the value of the US Dollar.

Japanese equities

- Japanese equities remain hostage to the Yen. Yen weakness at the end of 2016 helped support shares, but the currency has strengthened again recently. Globally, the cyclical picture is improving – tactical investors might therefore overweight Japanese equities.
- The Bank of Japan balance sheet of ETFs as a percent of the TOPIX index market cap is on track to reach 5.3% by end-2017, and 6.2% by June 2018. We are sceptical "Abenomics" will work long-term.

Emerging market equities

- Emerging markets are benefiting from stimulus in China, a cyclical surge in world trade, and increasing commodity prices (which have shown diminished correlation with the US Dollar for the time being).
- Whether these supporting factors persist remains to be seen. The US Dollar is still facing upward pressure and the stimulus in China seems to be coming to an end. Tactical overweighting might be advisable although investors with a longer-term horizon should tend towards neutral.

Sectors

- Given that inflation expectations have already moved, bond yields are the key for the recovery in value stocks to continue. We like US banks as a play on steeper yield curves, at the expense of sectors like consumer staples or utilities.
- In the past, rising bond yields have been associated with the outperformance of cyclical vs. defensive sectors. Rising inflation expectations are a threat to the elevated P/E ratios of defensive sectors like consumer staples.
- Financials currently offer the most attractive entry point valuation-wise. Other cyclical sectors, notably industrials, appear expensive.

Investment theme: Capital income

- The environment of low/negative interest rates will probably persist, especially in the Eurozone and Japan. And after subtracting inflation, US Treasury yields are hardly adequate. This means capital income is all the more important.
- Asymmetric monetary policy should continue favouring risky assets against a heightened volatility backdrop. Investors should keep an eye on corporate bond yields and, above all, on dividends that allow investors to hold shares in real assets – equities.
- Dividends historically have dampened portfolio return volatility. They look promising this year: we estimate that MSCI Europe companies, alone, will distribute EUR 315 billion—a record! Back in 2016, they paid out EUR 302 billion.

Euro bonds

- Even if it only seems to be an argument about semantics, the European Central Bank (ECB) has, in fact, started "tapering" – reducing its government bond purchases "Real" tapering – the gradual reduction of the monthly purchase programmes – is slated for 2018.
- While accommodative monetary policy and persistent political uncertainty have provided support for German bunds, fundamental overvaluation and fears of a gradual reduction in ECB bond purchases could weigh from the start of 2018 onwards.
- In the Eurozone, we expect continued directional yield curve movement for the time being (steepening when yields rise, flattening when yields fall).
- Euro peripheral sovereign markets are currently 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

- The year-over-year increase in oil prices is helping push inflation higher in many countries. Core inflation should also gradually increase as output gaps narrow. De-globalization could have an inflationary impact over the medium-term.
- From a global perspective, monetary policy should remain loose, although the US Federal Reserve will probably raise interest rates faster than what is currently priced into markets.
- In fundamental terms, US Treasuries are still overvalued although the extent of overvaluation has decreased.
- Lack of compensation for duration risk (=beta) highlights the vulnerability of US Treasuries. Negative long-end term premia have regularly been a harbinger of rising interest rates. Our advice for the bond segment would therefore be to shorten duration.

Emerging market bonds

- Negative structural factors (e.g. high debt levels, slowing growth potential, protectionism) have clouded the outlook for EM government bonds.
- Moreover, the removal of Federal Reserve policy accommodation is a headwind. Still, the economic environment has improved in recent months.
- In contrast to many developed markets, local emerging sovereign real yields are on average significantly positive.

Corporate bonds

- Credit risk and liquidity premia indicate broadly fair valuations of Euro investment grade corporate spreads, while Euro high yield is trading at expensive levels.
- In the US, re-leveraging in the private sector reflects share buy-backs financed by cheap debt, a prospective risk in a rising rate environment.
- In terms of historical default rates, US corporate bonds may be somewhat overvalued.

Currencies

- Currency speculators have massively reduced their long US dollar positioning amid a loss of faith in Fed interest rate hikes. But a resumption of the "Trumponomics" trade could extend the cyclical overshooting of the US dollar.
- Reflecting renewed risk aversion, speculative long positions have been reestablished in the yen.
- Measured relative to interest rate differentials, the GBP looks "fairly" valued.
- Our long-term equilibrium model for valuing exchange rates shows that the fundamental undervaluation of many (particularly emerging market) currencies versus the US Dollar remains significant.

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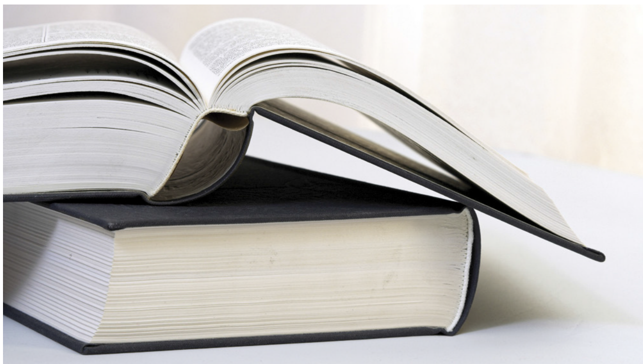

Data origin – if not otherwise noted: Thomson Reuters.

Imprint

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