February 2017

Capital Markets Monthly

Disruption

The main topics at our recent Investment Forum in Hong Kong included not just **technological disruption** (introducing something new to replace the old), but also geopolitics. Both will probably continue to occupy the capital markets for quite some time to come, a fact of which we were reminded, not least, by the first political steps taken by the new POTUS (President of the United States). He raised doubts, not just about the entire Western alliance policy, but about globalization in general – and with it, the mechanism providing competition and comparative locational advantages that constitutes a win-win situation for all stakeholders. And not just for China, by the way, which also featured on our agenda of in-depth discussions. Our forum discussion on how China is increasingly opening up on the capital markets was fascinating.

Following a phase of almost exuberant optimism while waiting for Trump's fiscal policy measures, reality is now reasserting itself. Meanwhile, **geopolitics** remain on the agenda as we wait for further details on Brexit, the parliamentary elections in the Netherlands (in March) and the presidential elections in France (in April).

The only constant among all these variables seems to be **global monetary policy**, although just how immutable it ultimately proves to be remains to be seen. Donald Trump's criticism of Yellen's policy makes one wonder whether the interest rate curve might not turn out to be steeper than expected. There is, however, no denying that anyone wanting a weaker US Dollar is not going to want a more restrictive monetary policy. By contrast, ECB President Draghi is facing rising inflation rates in the Eurozone, which makes another extension beyond December 2017 of his bond purchase programme in its current form increasingly unlikely. Nevertheless: The major central banks are persisting with their expansionary monetary policy, and the phase of low/negative interest rates cannot be expected to end any time soon.

On the upside, the **economic indicators** in virtually all the key economic regions have been painting an increasingly friendly picture over recent weeks.

As of 30/01/17

Equity Indices	Status
FTSE 100	7,129
DAX	11,682
Euro Stoxx 50	3,262
S&P 500	2,281
Nasdaq	5,614
Nikkei 225	19,041
Hang Seng	23,361
KOSPI	2,084
Bovespa	64,302
FX	**Status**
USD/EUR	1.063

Interest Rates %		
USA	3 Months	1.04
	2 Years	1.20
	10 Years	2.48
Euroland	3 Months	-0.33
	2 Years	-0.68
	10 Years	0.46
Japan	3 Months	0.06
	2 Years	-0.21
	10 Years	0.08
Raw Materials		
Oil (Brent, USD/Barrel)		55.4

CapitalMarketIndicator

Bond Funds | Equity Funds

New Publication

Capital Income: Dividends

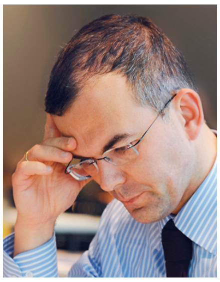
www.allianzglobalinvestors.de

Active management is the order of the day if disruption is to evolve into (Schumpeter's) creative power of destruction: Active stock-picking to filter out the winners of (technological) change, and active selection of investment segments to take advantage of volatility.

Above and beyond any disruption, monetary policy, economic development and corporate earnings should favour riskier asset classes.

Remain creative. Yours

Hans-Jörg Naumer.



Hans-Jörg Naumer
Global Head of
Capital Markets &
Thematic Research

Active management is the order of the day if disruption is to evolve into the creative power of destruction.

Allianz Global Investors

Understand. Act.

Markets in Detail

Tactical Allocation, Equities & Bonds

- Expansionary central bank policies should give equities a structural boost, albeit with fading momentum.
- Valuations on the regional equity markets are very mixed. They are high on the US market, neutral or low in Europe, and seemingly also offer good value for money in several emerging markets.
- Global capital markets continue to be dominated by "reflation trades". Improving economic data, the anticipated fiscal stimulus in the US and interest rate hikes by the Federal Reserve Board (Fed) currently point towards rising equity markets and weaker bond markets. In the long run, we expect many asset classes to generate earnings below their long-term averages.
- In light of the expected volatility, active investing is a must! And that applies both within asset classes and across all asset classes.

German equities ↗

- Export-oriented companies should enjoy a further boost from the global economy. There are no signs yet of the initial impacts of much-discussed deglobalization.
- In contrast, consumer confidence is expected to suffer somewhat due to increasing inflation and the recovery in the oil price. Nevertheless, given the robust state of the labour market, there are no grounds for scepticism here. Within the Eurozone, Germany continues to have the lowest unemployment rate.
- In terms of their long-term average, German equities appear to be slightly undervalued according to the Shiller price/earnings (P/E) ratio.

European equities ↗

- The growth path in the **Eurozone** is flat, with low inflation, although the latter should increasingly pick up pace over the coming months.
- 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. Price pressure at the wholesale level has increased considerably due to the weak Pound and should have a noticeably dampening effect on purchasing power as inflation rates rise.
- Political uncertainty remains rife on the old continent.
- Corporate earnings are expected to improve in the wake of a weaker Euro exchange rate and the recovery in the energy sector – and possibly also in banking – coupled with a slightly positive effect as US stimulus extends to this region.

US equities ↗

- The latest economic indicators support the strong condition of the US economy. Following marked downward corrections in spring, corporate profits and earnings forecasts have stabilized considerably, and not just for US equities, but for European and Japanese stocks as well.
- The majority of factors (recovery in the energy sector, fiscal stimulus, possible tax reductions) point to a positive turnaround for corporate earnings. A rising wage cost ratio may well hinder improvements in profitability, however.

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 and thus push up inflation, albeit not necessarily to anywhere near the Bank of Japan's target of 2%.
- The impact of the fiscal package on Japan's GDP is expected to be limited. With an estimated fiscal multiplier of ~1.0 and a net infrastructure spend of just 2 billion Yen, our calculations suggest that the contribution to Japan's economic growth will be around ~0.4% of GDP and approx. 0.02% to global economic growth.
- Japanese equities remain hostage to the Yen. Uncertainties surrounding the impacts of the Japanese central bank's change in strategy are currently being over-compensated by the Yen's weakness caused by the Dollar.

Emerging market equities →

- Monetary and fiscal policy stimuli have given the Chinese economy a new cyclical boost, while deflation has ceased at producer level.
- Export-oriented countries such as Japan, China and Malaysia will probably bear the main burden of growing protectionism under the Trump administration.
- Korea, which currently benefits from its free trade agreement with the US, could be hit hardest if renegotiations are initiated.
- Valuations of emerging market equities seem to be favourable on average.

Sectors

- Commodities are exposed to various influences. Prices for industrial metals, for example, should benefit from Trump's political agenda and the prospects for potential infrastructure investment. Recently, precious metal prices declined in expectation of interest rate hikes by the Fed.
- Over the next few months, beneficiaries of the improved cyclical environment and hopes of reflationing and stimulating policy measures should include banks, which have been shunned for a long time (with focus on US banks).

Investment theme: Capital income

- The environment of low/negative interest rates will probably persist, especially in the Eurozone and Japan. After deducting inflation, however, the yield on US Treasuries is hardly adequate, either. Which is why capital income is all the more important.
- Since asymmetric monetary policy should favour riskier asset classes in a generally volatile market environment, investors should keep an eye on the coupons on corporate bonds and, above all, on the dividends that allow investors to hold shares in real assets – equities – through equity funds.
- Dividends not only reduce fluctuation in a portfolio in historical terms; they also look promising again this year: we estimate that the companies listed in the MSCI Europe alone will distribute EUR 315 billion this year. A record. Back in 2016, they paid out EUR 302 billion.

Euro bonds

- At its December Council meeting, the European Central Bank (ECB) announced that it is extending its asset purchase programme ("QE") until the end of 2017, reducing the volume of monthly purchases to EUR 60 billion from April (see also our in-house QE Monitor). Despite initiating this "QE exit", the ECB's monetary policy remains extraordinarily loose.
- Our models show a continuing fundamental overvaluation of long-term German government bonds.
- Peripheral government bonds in the Eurozone remain supported by expansionary ECB monetary policy, but are still prone to political risks. Compared with pre-crisis levels, Eurozone peripheral bonds continue to price in higher default probabilities over the next five years.

International bonds

- The increase in oil prices is causing inflation to rise as well. Core inflation will probably also increase gradually as production gaps narrow.
- The main (ideal) scenario remains a gradual return of US Fed policy to normal. From a global perspective, monetary policy continues to be loose, however. The global monetary base could peak (relative to gross domestic product) in 2018.
- The bond markets remain overpriced despite support from monetary policy.

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.
- Moreover, expectations of a less expansionary monetary policy in the US over the medium term are weighing on this asset class.
- In contrast, the economic environment has recently stabilized, albeit not across all countries.
- Following Trump's election, capital outflows have picked up speed again.

Corporate bonds

- The implied default probabilities for US corporate bonds are significantly above the average cumulative default rates of the past, albeit still below their long-term average.
- This analysis shows that both investment grade and high-yield bonds are moderately overvalued. Based on their fundamentals, however, our calculations show that the valuations are still moderate.
- Our fundamental models justify the current spreads for Euro investment grade and high-yield bonds.

Currencies

- Currency speculators have massively reduced their long holdings in US Dollars, which partially reflects a loss of faith in Fed interest rate hikes. Growing risk aversion is likely to have supported the Yen.
- In anticipation of tighter US interest rate policy, the Japanese Yen had weakened again considerably, and can be expected to stabilize moving forwards.
- The correlation between emerging market currencies and commodities peaked in May 2016. Since then, correlations have been much lower up to the present, although the long-term ratio seems to still be valid.
- Currencies that are typically prone to interest rate sensitivity are the Euro and the Pound Sterling. The latter has depreciated drastically in light of a hard Brexit, but the loss seems exaggerated relative to the expected differences in interest rates.

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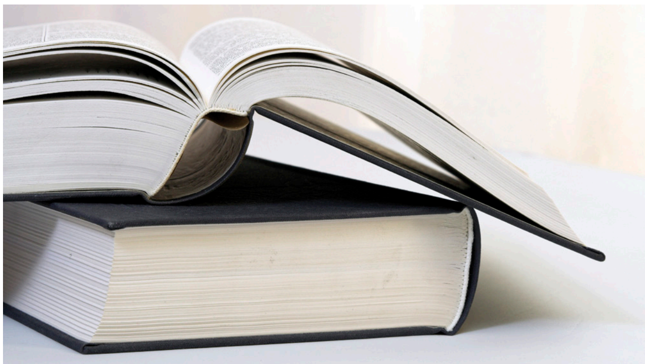

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Imprint

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