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October 2017

Allianz Global Investors Insights

Global View

Key Findings from Our New York Investment Forum

Twice a year, our top strategists, economists and portfolio managers from around the globe gather for our Investment Forum. At our September 2017 meeting in New York City, we reassessed our house view and examined the key themes that will affect investors over the months and years ahead. Here are some of our top takeaways.

Investors *still* must take some risk to earn some return

For some time, we have been advising our clients to take measured risk in their portfolios – and that advice has not changed. With interest rates set to remain lower for longer, investors simply have no choice – even with the markets near record highs. Yet investors certainly have risk on their minds. Our new *RiskMonitor* 2017 survey shows that geopolitics are the top concern for institutional investors, and two-thirds say active management is essential in this market environment.

Philanthropic giving could be the next ESG frontier

ESG (environmental, social and governance) investing is now mainstream and takes many forms – from screening to advocacy to impact investing. The majority of investors use ESG for return potential, and leading pension funds choose companies that exhibit good governance. But new ESG areas are emerging – such as philanthropic giving – that put more emphasis on societal impact. The days of seeing philanthropy and investing as separate things may be over.

The days of seeing philanthropy and investing as separate things may be over

Investors should look for value in the US market

Long-term US fundamentals look troubling: Productivity growth is down and the labour force is declining, indicating softer growth ahead. So why are stock valuations so stretched? Because equities are the best option for many investors, and because companies are using low-interest loans to buy back shares. As the US Federal Reserve raises rates, stocks may pull back. But if reflationary policies work, value stocks – particularly energy and banking names – may begin to outperform.

Neil Dwane
Global Strategist

US energy independence is getting closer

The US shale gas industry has changed the world order for oil: Post-shale, oil prices halved, US consumer energy

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Allianz Global Investors

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Global View

spending hit multi-decade lows and OPEC lost much of its power. The US is marching toward energy independence, but is the market under the false assumption that shale will grow forever? Traditional energy stocks have come under intense pressure despite strong fundamentals, which may be a good contrarian buying opportunity.

Traditional energy stocks have come under intense pressure, which may present a contrarian buying opportunity

There is no easy fix for the productivity challenge

Productivity is arguably the most significant driver of economic growth, but productivity growth is slowing and shows no sign of turning around. One reason is the demographic "time bomb" of our aging society. To be sure, some new technologies could help, but they have yet to deliver their full transformational value. The key to tackling the productivity challenge is corporate and government leadership that emphasizes innovation, research and development, and long-term thinking.

We expect a tough slog for President Trump

Although Mr. Trump's presidency so far has been a rocky one, his administration still has goals to meet – tax reform, in particular. His recent announcement of a "framework" for tax reform represents a potential step forward on a key plank of "Trumponomics". There is clearly a renewed spirit among Republicans to pass new legislation before mid-term Congressional elections in November 2018, which will be a critical moment for the president's party and a litmus test on his own popularity. Yet there are several hurdles that must be crossed before making it to the finish line.

US health care needs a cure

Health-care costs represent 16 per cent of US GDP versus around 6 per cent for most other developed countries, and the US is on track to spend 27 per cent by 2028. The quality of care is high for those who can afford it, but costs are rising unsustainably – and the added spend doesn't always equal improved outcomes. Addressing pharmaceutical spending is one possible solution. Investors in pharma stocks should avoid firms with overlapping products and look for innovative products with proven outcomes.

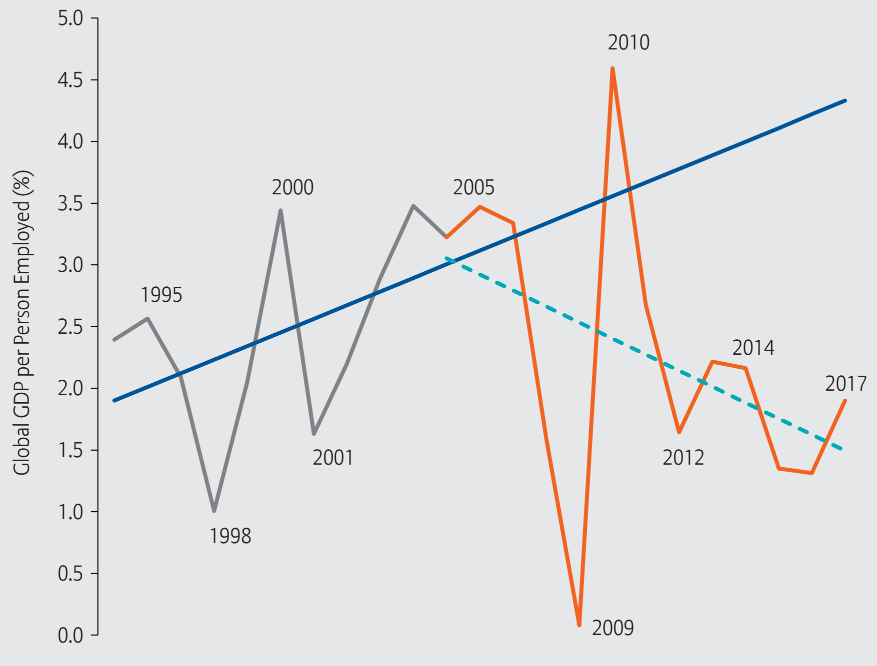
Economists might be mis-measuring inflation

The Phillips curve – the model that central banks use to measure how increased levels of employment result in higher inflation – may no longer be valid, but the bigger question may be whether inflation is being mis-measured. Do standard measures of consumer price inflation match everyday perceptions of how prices are rising? Are increased rental and commuting costs accurately reflected? Do lower tech prices offset escalating costs elsewhere? Policymakers should be aware of the real-world impacts of inflation amid increasing social divisions and the rise of populism. And investors must remain vigilant about protecting the real purchasing power of their savings from all and any threats of inflation.

Investors must stay vigilant about protecting purchasing power against any threat of inflation

Today's Low Labour Productivity Is Well Below the Long-Term Trend

Global GDP per person employed, annual and trend, from 1995-2017.



Source: The Conference Board as at September 2017. ©2017 The Conference Board, Inc. Content reproduced with permission.

Perspective on the US

To Capitalize on Disruption, Try the '3 Vs'

Mona Mahajan
US Investment Strategist

The "Amazon effect" on the US retail sector might be one of the best-known examples of the disruption phenomenon, but disruptive forces are emerging in all parts of the US economy – from the energy sector to the US government. To prepare your portfolio, consider a long-term strategy centred on the "3 Vs": shifting to value stocks, focusing on victors and preparing for volatility to rise.

The FANG effect

Facebook, Amazon, Netflix and Google – the so-called FANGs – have been among the biggest drivers and beneficiaries of disruptive technology – and for good reason. They have proven business models that keep strengthening as they widen their user bases and shake up competing sectors. Just witness Amazon's recent push into the world of grocery stores and home delivery.

Interestingly, however, FANG stocks' robust earnings have translated into valuations that have kept steady or even declined over the past five years. At the same time, "value traps" have emerged in companies that have become less relevant due to significant industry change. For example, retail department-store chains have been disrupted as people increasingly shop online, and we could see their multiples move lower to reflect this secular shift.

"Value traps" have emerged in companies that are less relevant due to disruption

Booming US energy

Disruption is creating opportunities elsewhere too. The emergence of the US energy sector on the global stage has significantly disrupted the global energy market. Today's low energy valuations reflect a seemingly boundless supply of US energy – shale in particular, even though US shale makes up only 8 per cent of global energy supply. Even though oil prices have declined dramatically and may remain range-bound in the near term, we believe US energy stocks are generally oversold. Investors would be wise to look for emerging catalysts that could reverse this extreme negative sentiment.

Disruption from D.C.

While governments are seldom considered fast-movers, Washington D.C.'s efforts to disrupt certain segments of the economy could have widespread implications.

Reforming US health care

Little progress has been made by the Trump administration to "repeal and replace" Obamacare, yet this sector remains ripe for disruption. US health-care outcomes are lower than most of the developed world while costs continue to rise – the US health-care system could make up 28 per cent of US GDP by 2028. We believe investors should continue to seek out health-care innovators with proven outcomes – as they could be tomorrow's winners – and avoiding avoid firms with overlapping products.

Investors should continue seeking out health-care innovators with proven outcomes

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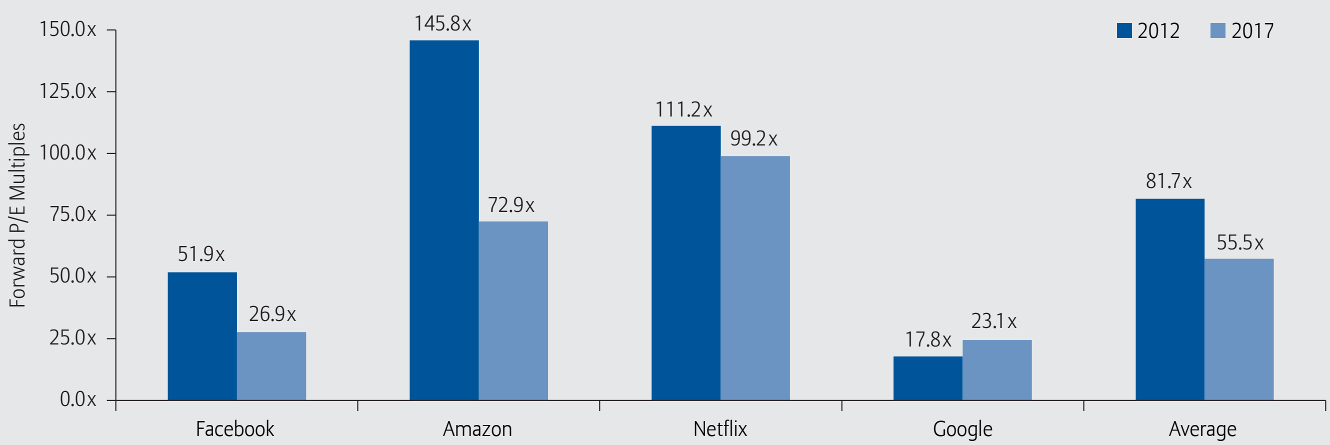
FANGs Not Fuelled Solely by Multiple Expansion

Average forward P/Es have dropped for the FANGs. Earnings growth remains fairly robust, and valuations aren't as stretched as they were in the '90s tech boom.



Source: Bloomberg based on forward price-to-earnings (P/E) multiples. Data from 31 December 2012 to 30 September 2017.

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Perspective on the US

Janet Yellen, the financial disruptor

The US Federal Reserve under Chair Yellen has just begun unwinding 10 years of balance-sheet growth, potentially cutting its USD 4.5 trillion balance in half over the next 3-5 years. This will remove liquidity from the financial system, which could cause financial conditions to tighten in the US economy.

Investment implications: Watch the "3 Vs"

As disruptive forces transform entire industries, US equity markets continue to approach all-time highs – benefiting also from a low interest-rate, high-liquidity regime that has lasted nearly 10 years. However, a new regime is likely beginning, marked by rising rates and potentially lower liquidity, which could make the "3 Vs" worth watching:

1. Value stocks

As the Fed normalizes its balance sheet and interest rates, we will keep an eye on value stocks, which have lagged since the financial crisis. Within the value universe, we recommend remaining selective – avoiding "value traps" in particular. We would consider sectors such as energy, where we see a long-term fundamentals story, and US banks, which stand to benefit from a steepening yield curve and decreasing regulation.

2. Victors of disruption

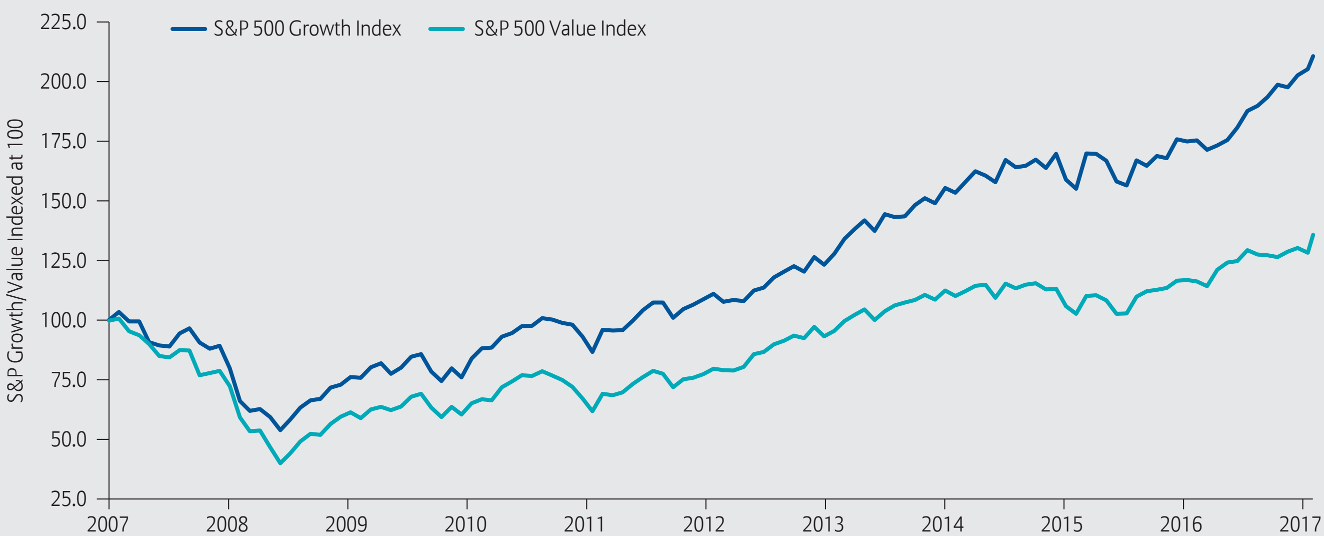
The ubiquity of disruptive technology means there will be winners and losers that emerge in all sectors – and the FANGs have clearly shown how investing in disruptive winners can generate alpha. A "winner-take-all" trend is emerging, underscored by the shrinking number of US publicly listed companies – from more than 8,000 in 1996 to around 4,400 in 2016. We believe it is imperative for investors to align themselves with the future victors of disruption. For our part, we will continue to rely on our global in-house research teams – including our proprietary Grassroots® investigative research division – to help us seek a fundamental information advantage.

3. Volatility

The US equity market has not seen a 10 per cent correction in almost two years, and the VIX – the well-known "fear index" gauge of market volatility – remains near all-time lows. With peak central-bank liquidity likely behind us, we expect more volatility ahead – and an increased chance of a market correction. We may also see upside shocks in the US market if tax reform passes or if hurricane relief efforts translate into increased infrastructure spending. While these events would clearly fuel the markets, the associated volatility would require investors to reposition portfolios – another reason for investors to consider active management to navigate the final phase of the US economic cycle.

Will Growth and Value Flip As the Fed Shifts Direction?

In the last 10 years, US growth stocks grew 108 per cent while value names increased only 31 per cent. Will the Fed's "great unwinding" alter this dynamic?



Source: Bloomberg. Chart shows indexed monthly data. Data from 31 August 2007 to 30 September 2017.

Some or all the securities identified and described may represent securities purchased in client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. The securities or companies identified do not represent all of the securities purchased, sold, or recommended for advisory clients. Actual holdings will vary for each client. FANG is an acronym widely used on Wall Street and among many investors; it stands for four high-performing large-cap technology companies – Facebook, Amazon, Netflix and Google (now Alphabet) – that are also household names.

Viewpoint

Expect More Rules and Less Discretion from the 'New' Fed

Steven Malin, PhD
Senior Investment Strategist

The recent announcement of Vice-Chair Stanley Fischer's impending retirement from the US Federal Reserve's Board of Governors opens up another opportunity for President Donald Trump to recast the leadership of the central bank.

A key reason to make changes at the Fed would be to limit its discretionary powers, which now encompass monetary, fiscal, regulatory and supervisory policies. These powers grew dramatically over the past three decades, making the Fed the financial system's most powerful discretionary authority.

The Trump administration wants to reduce the Fed's regulatory authority

President Trump has the opportunity to appoint at least five new governors before his term is even half-completed. Mr. Trump will likely look for candidates whose priorities align with his own:

- Rolling back the Fed's regulatory authority and enforcement.
- Restoring the central bank's independence within government.
- Separating monetary policy – narrowly defined – from fiscal policy.
- Advocating for a rule-based approach to the formulation and implementation of monetary policy, with a renewed emphasis on money-supply growth as well as interest-rate targeting.
- Demonstrating sensitivity to the needs and challenges of regional and community banks.
- Taking a pro-business approach consistent with the views of his administration.

> President Trump could name five new Fed governors before his term is half-completed

The president may also prefer candidates who possess strong leadership skills and have senior-level experience at the Fed. All told, it is unlikely – though not impossible – that Janet Yellen will be reappointed as Fed Chair. Either way, there is already an appointee awaiting US Senate confirmation who has long favoured less regulation: Randal Quarles, who is in line to be Vice-Chair for Regulation.

Among advisors with the ear of the Trump Administration, the reduction of the Fed's regulatory authority is a top priority. These advisors believe that the Fed suffers from regulatory over-reach that has extended the operations of the central bank well beyond its legislated missions – putting the US economy and financial system at greater risk. What's more, analyses by administration staff and its trusted advisors conclude that the Fed may now be more politicized and less independent than it has been at any time in its history, with the exception of 1936-1951, when it lacked effective monetary-policy authority.

The problem with informal guidance and politicization

What makes the Fed such a political force is its ability not only to institute formal rules, but also to issue informal "guidance". The problem with issuing guidance without firm and explicit rules is that it maximizes the Fed's discretion while minimizing regulatory accountability.

> The Fed's ability to institute formal rules and informal "guidance" makes it a potent political force

Regulation via guidance also presents opportunities for misbehaviour. Without clear rules limiting political pressures, it is possible for regulators to cede ground to special-interest groups and their representatives.

A strong example of this kind of politicization can be seen in the Fed's earlier involvement in "Operation Chokepoint". Led by President Barack Obama's Attorney General, Eric Holder, this effort enlisted the help of Fed regulators to extend their regulatory powers (ie, by imposing higher capital requirements or withholding permission for transactions) to pressure banks into eschewing dealings with enterprises that the Obama Administration found undesirable.

In a similar way, the discretionary powers given to the Fed to approve bank mergers on the basis of Community Reinvestment Act compliance produced trillions of dollars of risky mortgage originations by banks in the 1990s and 2000s. Knowingly or not, the Fed understated the risks and commensurate capital requirements associated with these mortgages.

What to expect from the new Fed

In response to regulatory over-reach, the partial loss of Fed independence and its politicization, expect the recast Board of Governors to push in 2018 and 2019 for the following changes:

- The Fed will focus financial regulation increasingly on explicit objectives that relate directly to financial-sector performance.
- The Fed's regulatory authority will follow rules established by Congress and become increasingly subject to Congressional budgetary discipline. Clear rules will lead to greater discipline in the formulation and implementation of monetary and regulatory policies to insulate policy-makers from special-interest pressures and foster emphasis on long-run public policies.

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Viewpoint

- More transparent regulatory standards will be formed and enforced, making regulators and supervisors more accountable to the public. Supervisors will remain vigilant to look for violations of the letter or the spirit of black-letter regulations despite the more relaxed regulatory stance.
- The micro- and macro-prudential supervision of banks will continue, with special emphasis on avoiding micro-management of each bank's business practices.
- The elimination of the Fed's holdings of agency mortgage-backed securities likely will occur at a faster pace than was outlined in the 2017 principles of balance-sheet normalization; this should extricate the Fed from direct incursion into fiscal-like policies.

Expect more transparent regulatory standards – and more accountability for regulators and supervisors

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Grassroots[SM] Research

Survey of US Consumers Sheds Light on 'Generation Z'

Consumers have long been the driving force behind the US economy, powering an estimated 70 per cent of US gross domestic product with their spending. To learn more about what fuels the lifestyle and consumption preferences of US consumers, Grassroots[SM] Research – Allianz Global Investor's proprietary investigative-research team – commissioned interviews with 841 respondents throughout the country.

What we found sheds light on several key differences between generations – including baby-boomers, who are well-understood, and "generation Z", which is just now beginning to make its preferences known.

Our survey reached people born between 1942 and 1997. For the purposes of this study, we defined baby-boomers as those born between 1942 and 1964, and generation Z as those born between 1991 and 1997.

Notable lifestyle differences between boomers and generation Z

As expected, we found several notable differences between the oldest and youngest survey respondents:

- **Marriage** – 54 per cent of all respondents, 58 per cent of baby-boomers and 22 per cent of generation Z are married
- **Parenthood** – 64 per cent of all respondents, 65 per cent of boomers and 27 per cent of generation Z are parents
- **Property ownership** – 62 per cent of all respondents, 74 per cent of boomers and 39 per cent of generation Z own a house or apartment

Saving for retirement is not yet a priority for generation Z

When we asked our survey respondents about their top financial priorities today, we learned that retirement was the most frequently cited concern by only 36 per cent of baby-boomers. About one-quarter of boomer respondents said their biggest priority today had to do with the costs associated with owning a home – such as mortgage costs, association fees, maintenance/upkeep and purchasing furniture.

The biggest priority for one-quarter of boomers today is home-ownership costs

Meanwhile, 27 per cent of generation Z respondents put the most emphasis on life experiences – such as dining/entertainment, travel and social activities. At the same time, about one-fifth of those in generation Z said paying down student debt was their most important priority. Saving for retirement topped the financial to-do list for only 4 per cent of generation Z members.

Kelly Reuba
Global Director of Grassroots[SM] Research

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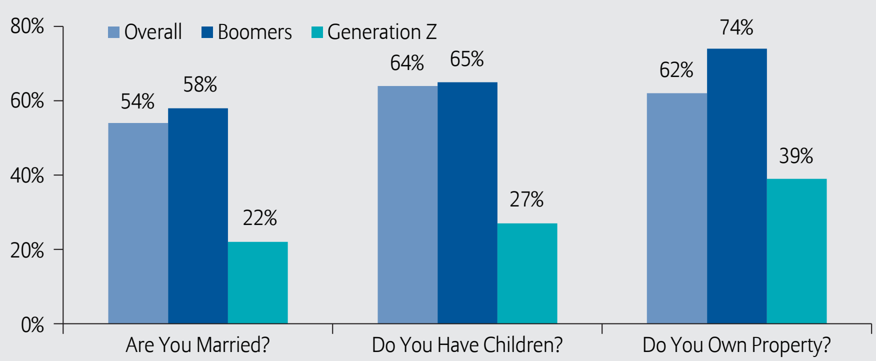
How Different Is Generation Z from the Rest?

Survey respondents born between 1991 and 1997 are just starting out their adult lives, as reflected in their lifestyle choices.



Source: Grassroots[SM] Research. Data as at August 2017.

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Grassroots℠ Research

To see how their focus shifted over time, we also asked the respondents to tell us about their financial priorities over the next five and ten years.

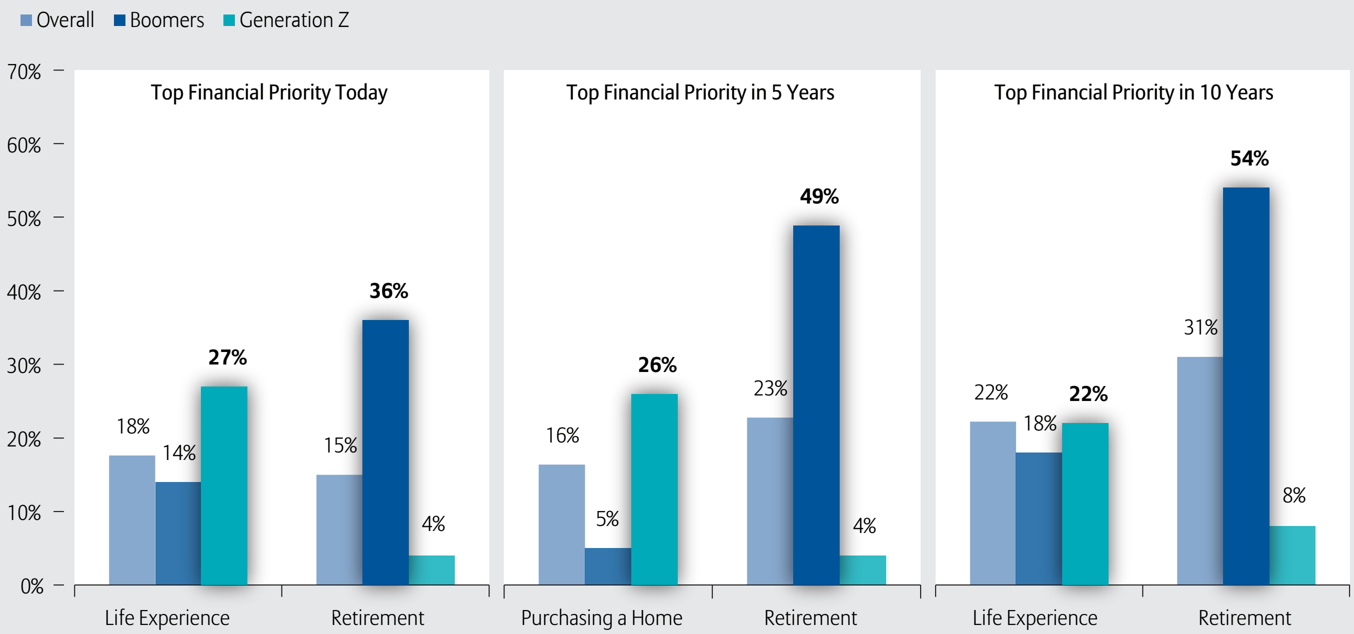
- Retirement steadily climbed up the priority ladder for baby-boomers, 49 and 54 per cent of whom cited it as their most important financial concern for the next five and 10-year periods, respectively.
- Many of our generation Z respondents, on the other hand, changed their priorities when thinking about the next five years: purchasing a home was the most-cited priority for people we spoke to, topping the list for about one-quarter of respondents.
- When we asked other generational cohorts the same questions, retirement topped the list of financial priorities in 10 years for those born between 1965 and 1973 (46 per cent) and those born between 1973 and 1980 (32 per cent).

Life-stage progression should lead to a shifting financial focus

To Financial Services Research Analyst Katherine He, this Grassroots℠ Research study shows clear evidence of how consumers' life stages can shift their financial priorities: "Student debt is a particularly high burden to generation Z, even more so than to the millennial cohort immediately ahead of them. Over the next five years, we can infer that we'll see increasing home-purchasing activity by millennials as they begin to have children. Meanwhile, generation Z is likely to focus on reducing their debt now before shifting their focus to buying a home – and, even later, to saving for retirement."

Generation Z Not Yet Focused on Retirement

Our survey of 841 respondents asked about their top financial priorities today, in 5 years and in 10 years. The most-cited choices for each time period are marked in bold.



Source: Grassroots℠ Research. Data as at August 2017.

Volume 9, Issue 10 | 273990 | INSIGHTS_OCT | 02572

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