March 2017

Capital Markets Monthly

Pro-factual

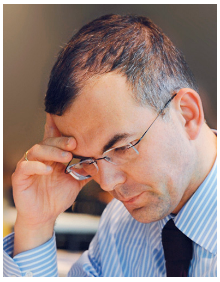
It's almost an irony of history: Now that the cost of preparing, storing and disseminating knowledge is virtually zero – thanks to digitalization – and "information" could be reaping the benefits of infinite scalability, possibly for the first time in history, the term "post-factual" is gaining in importance. Emotions, irrational behaviours, fake news ... that's what it's all about. If something doesn't fit, it's made to fit. Rational investors are particularly well advised to be guided by pro-factual rather than post-factual when investing. March again provides more than enough reasons why.

- Pro-factual (1): Geopolitics continues to be an issue. The UK government plans to file its application for a "hard Brexit" by 31 March, the Dutch go to the polls (15 March), and the race for the Elysée Palace in Paris moves into the home straight. The first round of presidential elections is slated for 23 April.
- Pro-factual (2): The period during which the debt ceiling in the US was carved in stone under constitutional law runs out in mid-March, yet the climb down the debt mountain has made virtually no progress, despite financial repression. In this respect it will be interesting to see what happens with the fiscal packages planned by the new US president, which already seem to be reflected in the prices on the markets.
- Pro-factual (3): Their advent coincides with a period in which both monetary and fiscal policy are expansionary, which is not a healthy recipe for price stability. Nor is that any reason to expect the US Federal Reserve Board (Fed) to adopt any all too relaxed approach to monetary policy.
- Pro-factual (4): Worth noting is the fact that the expectations of interest rate hikes reflected in implied money market rates are not as high as the expectations of the members of the Federal Open Market Committee (FOMC). So there is room for unpleasant surprises in the shape of a third rate hike in the course of this year. All the more so as the US economy is proving to be greater than assumed – post-factual.
- Pro-factual (5): At the same time, global monetary policy – regardless of any US interest rate hikes – remains expansionary and thus a key driver of investments in riskier asset classes, such as equities. The March meetings of the Fed, European Central Bank (ECB) and Bank of Japan (BoJ) are not likely to change anything, either.
- Pro-factual (6): Valuations in some parts of the equity market are already extremely ambitious (in the US, for example). They are moderate to inexpensive in Europe, and fairly low on average in the emerging markets, as well.

On balance, equities should still form part of a portfolio, but expect volatility.

My advice is to remain pro-factual and invest accordingly.

Yours, Hans-Jörg Naumer.



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Although the pace of information processing and dissemination is increasing and the boundaries fading, people are talking about post-truth rather than pro-truth. The contradiction could scarcely be greater.

As of 27/02/17

Equity Indices	Status
FTSE 100	7,254
DAX	11,823
Euro Stoxx 50	3,311
S&P 500	2,370
Nasdaq	5,862
Nikkei 225	19,119
Hang Seng	23,741
KOSPI	2,092
Bovespa	66,662
FX	**Status**
USD/EUR	1.059

Interest Rates %		
USA	3 Months	1.05
	2 Years	1.14
	10 Years	2.32
Euroland	3 Months	-0.33
	2 Years	-0.96
	10 Years	0.19
Japan	3 Months	0.06
	2 Years	-0.28
	10 Years	0.06
Raw Materials		
Oil (Brent, USD/Barrel)		56.1

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Markets in Detail

Tactical Allocation, Equities & Bonds

- Global macroeconomic data continue to improve.
- Valuations differ considerably on the capital markets. They are high in key asset classes, such as US equities and German and US government bonds, but low in the emerging markets.
- Political risks have increased further.
- Equity markets are deriving most of their support from monetary policy.

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. 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 ↗

- Overall, the most recent macroeconomic data for the UK were better than expected. The impacts of a hard Brexit on the economy would, however, be severely negative. Price pressure at input level (the key term is "import price inflation") is already increasing and will probably cause purchasing power to decline when it filters through to consumer prices in the next round.
- Valuations on the European equity markets 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 ↗

- Valuations on the US equity market must still be judged as high.
- The expansion of the Fed's balance sheet up to and including 2014 encouraged this development, although the trend is now coming to an end.
- Solid macroeconomic data are shielding equities from attack overall. The positive surprises do, however, seem to be close to peaking.
- Most factors point to promising earnings trends in 2017, which should have a positive impact on equities albeit possibly not quite to the degree that is generally being assumed.

Japanese equities →

- Despite subdued growth, the trend-based unemployment rate in Japan is declining, which will probably provoke higher wage demands and, in consequence, cause inflation to rise over the medium term, although the interim strength of the Yen will contain inflationary pressure.
- Japanese equities remain hostage to the Yen. Its weakness at the end of 2016 helped; a renewed upwards trend took some of the pace out. Globally, the cyclical picture is improving – tactically oriented investors might therefore overweight Japanese equities.

Emerging market equities →

- The cyclical recovery of world trade and commodity prices is providing support.
- Emerging markets are benefiting from occasional stimulus in China, a cyclical surge in world trade, and increasing commodity prices that are demonstrating weaker correlation with the US Dollar for the time being.
- Whether or not these supporting factors persist remains to be seen, however, the US Dollar is still facing upward pressure. The stimulus in China seems to be coming to an end. Tactical overweighting might be advisable. Investors with a longer-term horizon should tend towards neutral.

Sectors

- Now that mining and oil equities have rallied, they are no longer cheap, but are still being driven by very positive earnings revisions. The pace of recovery is likely to fade, however. In the case of mining equities, it is probably too late to jump on the bandwagon now.
- 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 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

- Even if it only seems to be an argument about semantics, the European Central Bank has, in fact, started "tapering" – reducing its government bond purchases – although extremely expansionary is still a suitable description of its package of measures. "Real" tapering – the gradual reduction of the monthly purchase programmes – is slated for 2018.
- While accommodating monetary policy and persisting political uncertainty are supporting German government bonds, the existing fundamental overvaluation and fears of a gradual reduction in ECB bond purchases could weigh increasingly heavily from the start of 2018 onwards.
- The widening of the spreads between Eurozone government bonds and German Bunds and the expansion of the Target2 balances reflect the political risks in the Eurozone.

International bonds

- As oil prices start to rise again, they are pushing up inflation rates around the world. Core inflation will probably also increase gradually as ouput gaps narrow. In addition, deglobalization efforts will have an inflationary impact over the medium term.
- From a global perspective, monetary policy should remain loose, although the US central bank will probably raise interest rates in more steps than expected by the markets to date.
- In fundamental terms, US Treasuries are still overvalued although the extent of overvaluation has decreased, not least due to higher yields.
- Our advice for the bond segment would therefore be to shorten duration.

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 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.
- The capital outflows from the emerging markets are not yet returning. Any overweighting of this segment should therefore preferably be in US Dollars.

Corporate bonds

- In terms of their historical default rates, US corporate bonds seem to be moderately overvalued.
- Our fundamental and market-based valuation models justify the currently low spreads for Euro high yield and investment grade corporate 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.
- 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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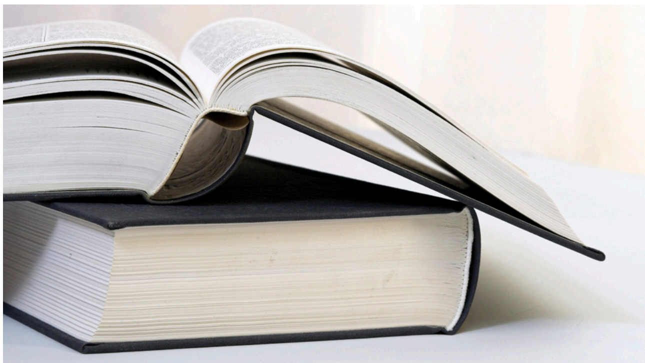

Data origin – if not otherwise noted: Thomson Reuters.

Imprint

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