Allianz Global Investors

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A Shift in Market Psychology: 6 Ways to Stay Ahead

Mona Mahajan
US Investment Strategist

2018 has already marked a clear shift for investors: after nearly two years of eerily complacent markets, robust economics and earnings momentum, and relatively subdued yields, risk markets have now begun to demonstrate a return to elevated, and perhaps more normal, levels of volatility. In the past, a buy-the-dip strategy – used by many investors – worked fairly well. But as we move further along in this cycle, we may continue to see a shift away from buy-the-dip, toward more selective, tactical and active management.

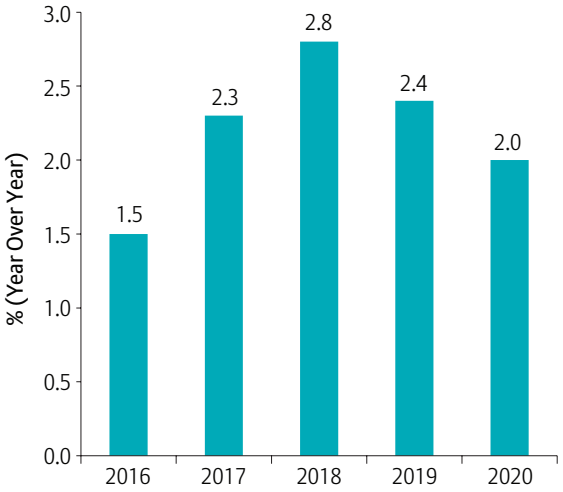
Peaking economic momentum and potentially rising rates, combined with recent uncertainties around global trade, tariffs, and turnover in Washington, D.C., are likely to keep volatility elevated this year. Below we discuss some of the potential economic drivers of this shift in market psychology, as well as ideas for investors to remain well-positioned through the cycle.

Has momentum peaked?

Over the past several quarters, US GDP and earnings revisions have demonstrated consistent upward momentum, helping drive positive sentiment in equity markets (see chart below). More recently, we have started to see the upward revisions stagnate and even roll over, and it is increasingly difficult to see further upside surprise from current elevated levels.

Is US real GDP all grown up?

Consensus forecasts for US real GDP show growth peaking in 2018 at 2.8%.

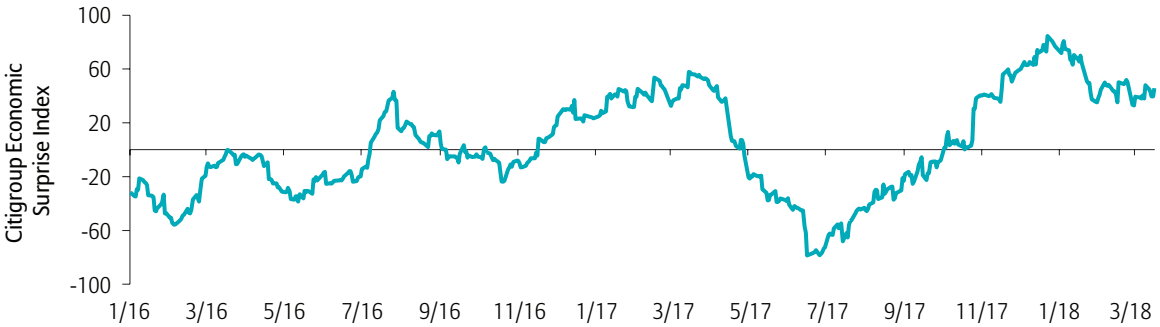


Source: Bloomberg. As of March 2018.

However, we do not foresee a downturn or recession in the US economy in the next six to 12 months. On the contrary, the US economy remains robust and will to some degree be supported by the new tax reform bill, as well as largely synchronized global growth, perhaps making 2018 a peak year for this cycle.

A surprising surprise index?

US Economic Surprise Index, upwardly robust since June 2017, may be signaling a plateau.



Source: Bloomberg. As of 3/16/2018.

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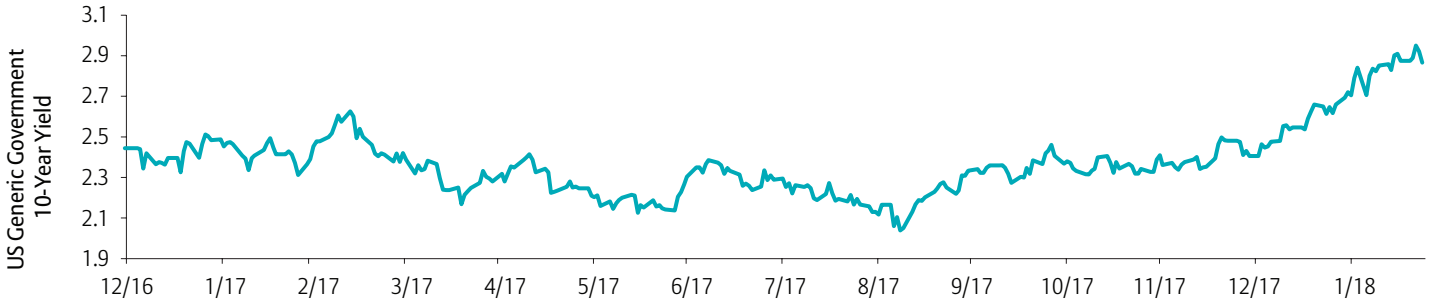
Rates may not be done rising

While gradually rising rates can be healthy for an economy, a sign of growth and a benefit to savers, if rates move too rapidly we could see a negative impact to the real economy.



Source: Bloomberg. As of March 2018.

Rising rates have sparked volatility

Investors are increasingly faced with the reality that the Federal Reserve is raising rates, and we may see a 10-year Treasury yield approach 3.0% by year-end. The market is slowly starting to price in the likelihood of the Fed raising rates at least three times in 2018. This also remains our base case, with a bias to the upside.

In addition to rate hikes, we are seeing a reduction in the Fed's balance sheet, and thus US Treasury auctions that are above-average size and need to be absorbed into the marketplace. These forces, combined with gradually rising inflationary expectations, have created upward pressure on rates.

The Fed will affect market liquidity

The Fed has already indicated that it will be removing liquidity from the financial system, both through rate hikes and tapering of its balance sheet. Importantly, the March 20-21 FOMC meeting will be the first one chaired by Jerome Powell, and investors will get valuable insight on how he may shape the Fed going forward. Among other data points, we will be looking for 1) any change in language around inflation expectations, and 2) the updated median glide path on the "dot plot," or the projected rate-hiking path of the FOMC members. Keep in mind, the Fed recently reiterated that it expects the long-run federal funds rate to be 3.0%.

Faithful to a fundamental outlook

As we review our base-case forecast outlined at the beginning of the year, our fundamental outlook remains solid: *we continue to see mid-single digit returns for 2018, well below the 20% returns we saw in 2017, but in-line for where we are in the cycle*. We also believe that the Federal Reserve may likely raise rates three times this year, with an upside bias to this expectation.

And as we approach a turn in the cycle, rates and equities will likely remain volatile. However, there are ways to shore up a portfolio.

6 ways to keep ahead of the pack

1 Equities are a bright spot

We continue to favor equities, which can do well in a Fed cycle generally, despite volatility. The average annual S&P 500 return over the last four Fed cycles has been 9.2%.

2 Stick with big winners

Within equities, growth and large-cap stocks continue to outperform. And in a potentially inflationary environment, both can continue to do well. Our conviction lies in the long-term story of "winners from disruption," particularly in technology and health care.

3 Valuing value

Over this cycle, value holdings will likely show signs of market leadership, remaining attractively valued versus historical levels. These companies may also benefit from tax reform and potential infrastructure spending. In particular, financials and certain industrial companies can do well in this environment.

4 Keeping up with high yield

Within fixed income, we continue to favor shorter-duration strategies, and as we do not see a rise in defaults over the near term, higher-yielding fixed-income securities remain attractive.

5 A view abroad

We favor exposure to international holdings, both equity and fixed income, as many countries are behind the US in their economic cycles and have more favorable valuations. We prefer Europe for value and dividend equities, Asia for growth and disruptors, and emerging markets broadly for fixed income and yield.

6 Given the alternative

As we get further along this cycle, we also believe investors should gradually increase allocation to alternative strategies, such as absolute return and private credit and equity, which are generally uncorrelated to equity markets over time.

As volatility persists in the markets, the case for active management has also re-emerged. We have seen many notable active strategies outperform during the correction period, which reinforces the value proposition of the active investor: in down markets, investors do not want to perform in-line with an index, they want to outperform. Positioning with active over this next phase of the economic cycle can provide investors with a good source of alpha in their portfolios.

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