

# A Shift in Market Psychology: 6 Ways to Stay Ahead

March 2018



**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.

## A surprising surprise index?

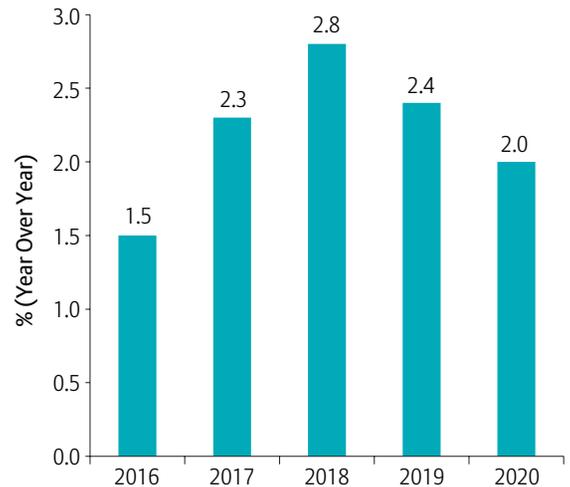
US Economic Surprise Index, upwardly robust since June 2017, may be signaling a plateau.



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

## 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.

## 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.

Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security.

The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted.

This material has not been reviewed by any regulatory authorities. In mainland China, it is used only as supporting material to the offshore investment products offered by commercial banks under the Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations.

This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors U.S. LLC, an investment adviser registered with the U.S. Securities and Exchange Commission; Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 199907169Z]; Allianz Global Investors Japan Co., Ltd., registered in Japan as a Financial Instruments Business

Operator [Registered No. The Director of Kanto Local Finance Bureau (Financial Instruments Business Operator), No. 424, Member of Japan Investment Advisers Association and Investment Trust Association, Japan]; and Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan.

© 2018 Allianz Global Investors U.S., LLC.  
COMM-220-0318 | 450944 | 02927

