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Fixed Income newsletter

The quarterly fixed income newsletter of Allianz Global Investors

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Editorial

What more can be expected from the fixed-income markets?

It would be stating the obvious to acknowledge that current interest rate levels do not accurately reflect prevailing fundamentals in terms of growth and inflation. Although yields in the Eurozone are certainly being driven lower by a growing structural imbalance between savings and investment, the securities purchase programme implemented by the European Central Bank is the real cause behind the historic fall in bond rates.

Investors have not been hard done by however, as their portfolios have largely benefitted, delivering surprisingly positive performances. And there certainly have been some surprises. A few years ago, would any reasonable investor have anticipated that in 2016 over 10 trillion of global bond assets would be yielding negative rates? Or would any reasonable investor have imagined that one day it would be necessary to pay in order to grant credit to a corporate issuer? In this somewhat irrational world, it is now time to accept that this windfall effect is soon going to come to an end. Past returns have, to a certain extent, already been "pre-empted", as payback time is drawing near. But when will this be?

Once again, the central banks hold the answer.

The Fed, after having struggled so hard to remain inactive, is running increasingly short of valid arguments to defend its unjustifiable position. The full employment situation in the US, combined with a steadily accelerating rate of wage inflation, is clearly indicating an imminent increase in interest rates in 2016 and 2017. However, given the highly unusual character of the forthcoming monetary normalisation phase, we are anticipating a series of measured rate-hikes which will be much more restrained than during previous cycles.

The ECB on the other hand has only one option. Despite its tentative comments at the beginning of October regarding potentially tapering quantitative easing, which was mooted in order to test the market reaction to the idea of progressively scaling-back monthly securities purchases, it can realistically only press ahead with its planned programme, or even consider stepping it up, given the low level of inflation in the Eurozone.

What are the implications for interest rates? The markets have so far remained relatively immune to the idea of an increase in the Fed Funds rates. Before too long however, investor anticipations are likely to be reflected in a flattening of the treasuries yield curve, and higher long term rates compared to the current levels. As core interest rates are unlikely to remain unaffected by this scenario, particular attention must be paid to managing portfolio duration. Bund rates are currently pricing-in a high-risk environment, including political, geopolitical, macroeconomic and financial risks, which are unfortunately unlikely to abate in the near term. More specifically, key issues such as the future of the Eurozone in the context of the Brexit, amid a general rise of populism in Europe accompanied by protectionist leanings, are likely to cause nervousness in the markets, which of course will benefit the Bund as the ultimate safe-haven.

It is therefore becoming increasingly necessary to seek out diversification strategies, in order to increase portfolio returns while reducing the overall level of risk, and to guide investors through this progressively more challenging environment.

The only solution, over the course of the next few months, will be to continue providing flexible, proactive, conviction-based asset management!

Allianz Global Investors

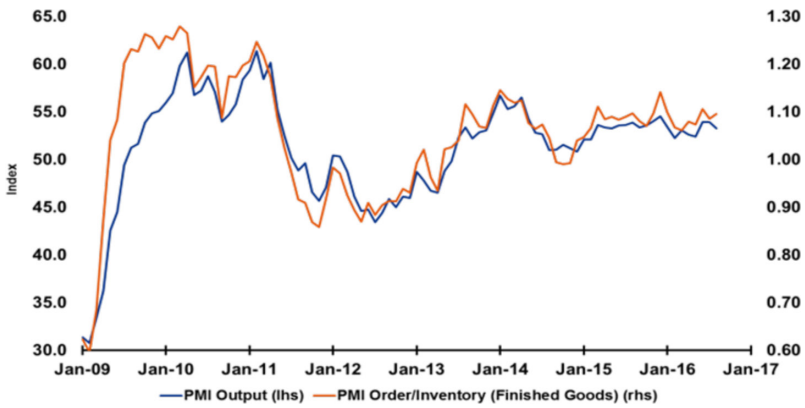
Key macro trends & investment strategy

Europe

It was a volatile quarter for fixed income markets globally. In Europe, yields fell further initially, with the yield on the 10-year German Bund touching a record low of -0.20% in early July amid a flight to safety. However, disappointment over a lack of any new policy stimulus from the European Central Bank and concerns that the Federal Reserve would soon raise rates caused yields to back up. By mid-September, yields had reached multi-week highs, with the 10-year German Bund trading back in positive yield territory. News that the Federal Reserve had decided to keep interest rates on hold helped yields to decline once more in the closing days of the quarter, ending the month close to their levels at the end of June.

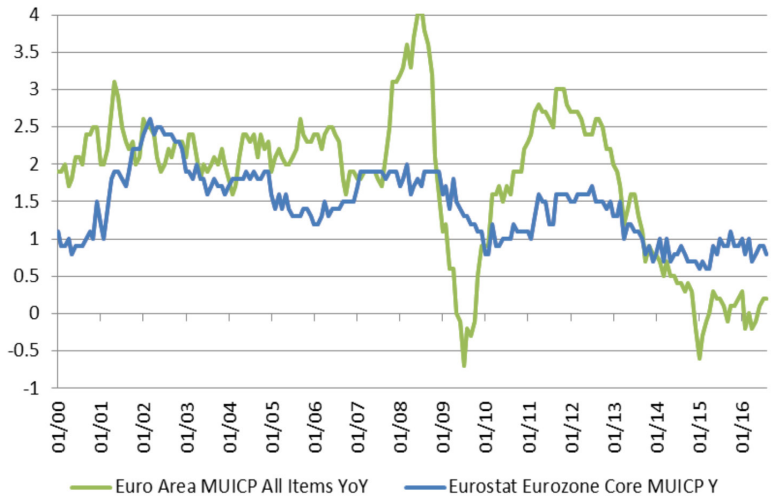
The European Central Bank decided not to amend either interest rates or its asset-purchase programme, but indicated it was monitoring developments closely and stood ready to act. The Bank of England cut interest rates following the UK's vote to leave the EU and announced a new GBP 70 billion bond-buying programme, which included the purchase of corporate bonds.

Manufacturing PMI Eurozone



Source: Bloomberg, October 2016

Eurozone core and headline inflation rates in %



Source: Bloomberg, October 2016

Overall, the euro area growth momentum is low but the UK referendum consequences have been well absorbed so far. Euro Area manufacturing PMIs rebounded to 52.6 in September to a three-month high, primarily on the back of stronger new orders. The rebound in manufacturing confidence was broad-based across countries. Nevertheless, the euro area quarterly average for Q3 stands at 52.1, marginally above the Q2 print, suggesting that manufacturing activity is unlikely to strengthen significantly in Q3 vs Q2. Amongst individual countries, French PMIs have shown some improvement whilst the Italian service PMI was weaker, dragging down the composite PMI. In the UK, after steep falls in July, surveys of economic activity rebounded in August and the trade deficit shrank as exports started to benefit from the fall in GBP.

Having started the quarter around USD 50 a barrel, oil prices fell to a low of USD 42 a barrel in early August amid concerns over a global oversupply. Prices subsequently recovered back towards USD 50 a barrel at the end of Q3 after Saudi Arabia and Russia indicated they would co-operate to stabilize the market and Opec reached a tentative agreement to cut production. With Brent oil prices remaining above $40, positive base effects on the energy price component would be likely to push up the euro area headline inflation rate above the 1% mark over the coming months. This would also support valuations of inflation-linked bonds.

USA

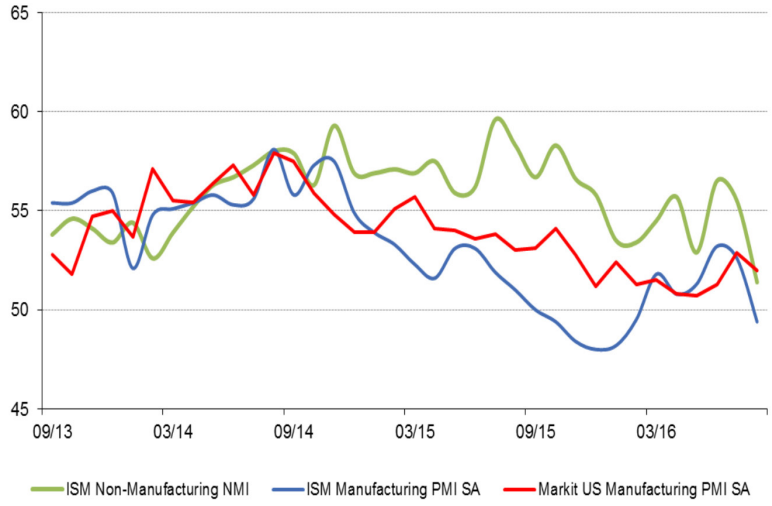
On balance, economic data in the US was positive over Q3, although there were signs that momentum was slowing in August - as shown by the decline in the Citi Economic Surprise index. The ISM manufacturing index fell below 50 in August, indicating activity was contracting for the first time in six months, while the non-manufacturing index signaled activity was expanding at the slowest pace in six years.

After May's weak report, employment rebounded, with 292,000 and 271,000 jobs added in June and July, respectively, but only 151,000 in August (revised upwards to 167,000 in September), followed by 156,000 in the September release – below consensus expectations of 172,000. Retail sales rose in June, but were lower than forecast in both July and August. Personal spending in August (released at 0%) was lower than market expectations. Consumers are still driving the US economy, but at a slower pace as the income trend is too weak to support a sustained acceleration.

Both the Atlanta Fed GDPnow and the NY Fed models point to a gradually slowing pace of US GDP growth: The GDPNow model forecast for Q3 GDP has decreased to 2.1% in the first week of October, from 2.8% at end-September. The NY Fed model forecasts a similar growth rate for Q3 at 2.2%. For Q4 GDP growth, the NY Fed model currently shows 1.3% - on the basis data published so far.

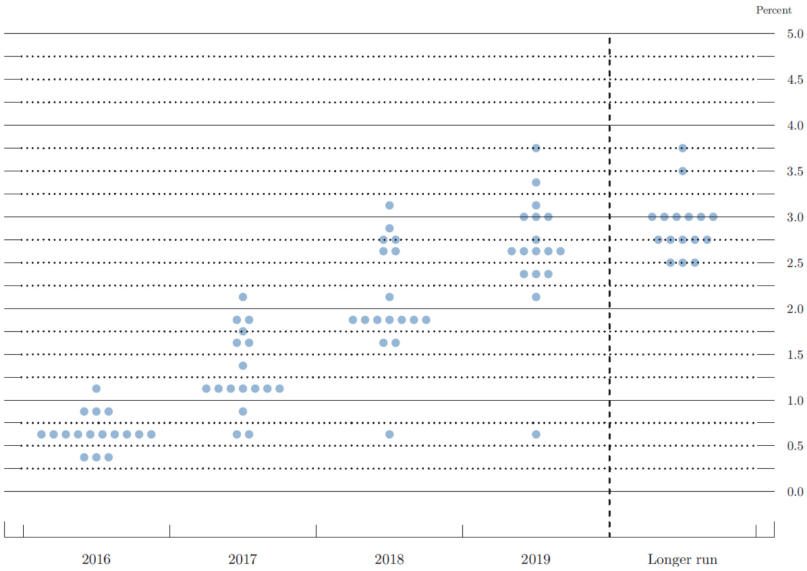
The Federal Reserve kept interest rates on hold throughout the quarter. In its September meeting, the Fed noted that, while the case to raise rates had strengthened, it wanted to wait for further evidence of economic progress. However, three FOMC officials voted to raise rates, the largest number of dissidents since December 2014. In addition, the Fed lowered its projection for the number of rate rises in 2017 from three to two.

US ISM and PMI indices



Source: Bloomberg, October 2016

FOMC participants' assessments of appropriate federal funds rate



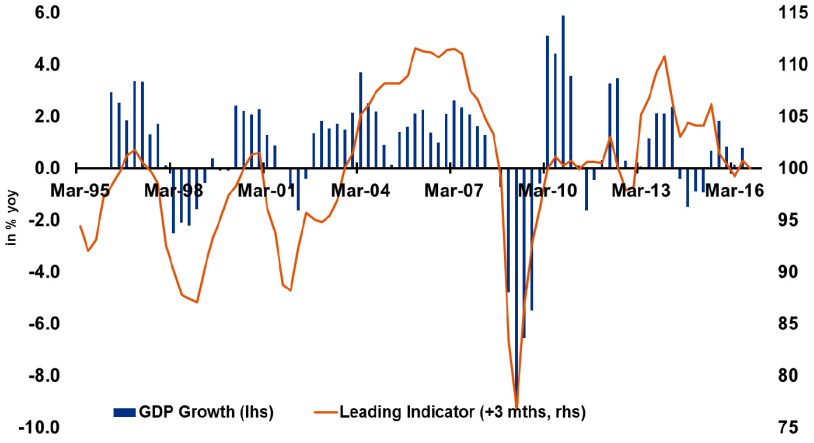
Source: Federal Reserve, October 2016

Japan and Emerging Markets

In August, the Japanese government announced fresh stimulus measures worth around JPY 28 tn (USD 45 bn). Whilst the Bank of Japan kept both the level of interest rates and the size of its quantitative easing programme unchanged, in September it took steps to help the nation's struggling banks by introducing measures aimed at steepening the yield curve. This included pledging to keep yield on 10-year Japanese government bonds at around zero and vowing to raise inflation to above the official 2% target.

The last Tankan report showed that large manufacturers don't see business conditions improving, but they don't see them getting worse either, at least for now. However, advanced indicators such as the manufacturing PMI in particular (back at >50 territory in September after dropping below 50 in August) and the PMI orders-to-inventories ratio are trending up. Furthermore, fiscal measures should offset the headwinds coming from the JPY strength.

Japan GDP growth and leading indicators



Source: Bloomberg, in % yoy, October 2016

Emerging markets

Emerging Markets put in another strong showing during the third quarter of 2016 with the sovereign JP Morgan EMBIG-D index tightening by -52bp, and returning +4.04% over the quarter. The JP Morgan corporate CEMBI-BD index tightened by -60bp during the quarter and returned +3.08%.

Investor sentiment was positive in the post-Brexit world as QE seemed set to continue for the foreseeable future, compressing yields in developed economies and forcing investors to seek yield in emerging markets and other risk assets. Inflows to the asset class continued apace throughout the quarter, bringing YTD inflows to hard currency emerging market debt to +US$39.2bn as of the 29th of September.

Idiosyncratic risks waned in countries like Brazil, which is moving beyond the corruption scandal and Venezuela, where the government has shown a willingness to service its debt. Even Turkey, which suffered a decline post the attempted coup d'état in July has stabilized and clawed back some of the initial losses.

Emerging markets were able to decouple the initial sell-off in oil in July and have been able to weather volatility in other commodities. That said, recent efforts to cap oil production should benefit the asset class in the coming months.

With the EMBIG-D sovereign index closing the quarter at a spread of ~335bp, the asset class still offers value to investors. At tighter levels, asset selection will be key to attaining outperformance. Our focus will remain on identifying and investing in structurally sound EM countries whose economic policies best position them for long term growth.

Currencies

EUR/USD has remained resilient in the third quarter against the backdrop of potential fallouts from the UK referendum result, political risks looming and the widening rate differential in favour of the USD.

In the course of Q3, the Japanese yen continued to strengthen against all major currencies. The BoJ decision to adopt 'QQE with yield curve control' does not seem to be a game changer for JPY. In the medium term, the JPY could continue to structurally benefit

EUR/USD vs 2y Government Bonds Yield Differential (in %)

Source: Bloomberg, October 2016

from a combination of attractive valuation, current account surplus and the attractiveness of JPY as a risk-off beneficiary.

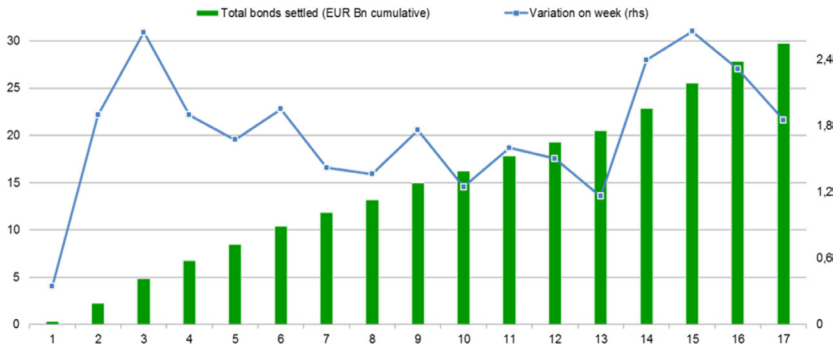
With the Bank of England cutting interest rates, the British pound also extended the losses it suffered at the end of the previous quarter following the EU membership referendum result. A current account deficit near 7% of GDP underscores the UK's reliance on overseas investments. Political and economic uncertainties will influence the extent of the risk premium foreign investors will require to continue funding the deficit.

Credit

Credit markets performed extremely well during Q3 within a context of low volatility until mid-September: Investment Grade and High Yield returned respectively +1.88% and +3.46% total return[1] over the period.

The ECB Corporate Sector Purchase Program (CSPP) is a strong supportive technical factor for the Investment Grade sector with total bonds purchase of €27.8bn since the beginning of the program on the 8th June 2016. The market was relatively quiet until the FED slightly delayed a potential rate increase and a resurgence due to an increase of idiosyncratic risk driven by Deutsche Bank. On the primary market side the tone was also soft with less activity than the previous quarter partly due to the summer period. Flows into the asset class remained positive with a cumulative amount of €7.9bn at the end of September (JP Morgan).

Weekly evolution of purchases under the CSPP



Source : AllianzGI, ECB, weekly data as of 30/09/2016

High yield markets benefited from IG investors' appetite for yield and a 2nd round effect of the ECB's bond purchase program pushing investors into the BB-rated bucket of the market. In term of valuation, yield reached a low point not seen since mid-2014 at 3.4%. In regards to new issues, September was the second biggest month in history for the European High Yield market with €14.1bn of issuance (JP Morgan). After a summer marked by positive inflows, the European High Yield funds had a cumulative flow amount of €573 million at the end of September (JP Morgan).
The fundamental environment remained attractive for credit asset classes with a stable economic situation and a low default rate on a 12-month trailing basis at 2.46% (Moody's).

[1] *1ER00 BofA ML Euro Corporate Index and HE00 BofA ML Euro HY Index*