Fundamentally Thought-provoking

Quarterly perspectives from Dr Hartwig Kos

Head of Multi Asset Fundamental Investing

Q3 2024

Goldilocks tra-la-la?!?

Looking at equity markets, the world seems to have become one giant rollercoaster, upward slopes, followed by freefalls, and then more steep climbs. While it is true that the past few weeks have been turbulent, the notion that the US appears to be going through a soft-landing scenario, with gently slowing economic growth and inflation pressures gradually abating is still intact. This also explains the stark recovery in risky assets since the sell off in early August. While the Goldilocks narrative has somewhat disappeared recently, we wouldn't be surprised if the main US equity index, the S&P 500, scratches the magical 6000 mark by the end of the year. Having said that, we wouldn't be surprised about a much more negative outcome either.

What does surprise us is that, for financial markets, the only thing that seems to matter is the United States. Investor focus has become very narrow in the past few years, which is concerning. Even more concerning, however, is the amount of fierce conviction that many market observers express in either direction, bullish or bearish, for we believe that the last couple of months have seen the most difficult and murky market environment in a long time. While we tentatively side with the bulls for the next couple of months, we believe that there are imbalances building, which are not currently properly priced by markets. But before getting into our investment convictions, let's first look at two key questions.

Can this risk-on environment continue?

Perhaps, but geopolitics could always trigger unexpected volatility. Also, both presidential candidates – Kamala Harris and her TikTok appeal , as well as Donald Trump and "Maganomics" – have just added fuel to the equity rally.

Are we witnessing a policy error by the Federal Reserve?

Possibly, but the nature of this potential policy error is not yet well understood.

Multi Asset observations and opportunities: our highlights

STRACTICAL PERSPECTIVE

As for our stractical, medium-term outlook, we believe it is time to consider shifting gear somewhat, away from buying into weakness towards a mindset of selling into strength.

We also believe that, in the absence of any greater exogenous shock, the current risk-on mood can stretch much further from here, perhaps well into November

But one must always be aware that it's a very fine line from a soft-landing scenario, or "Goldilocks", to one that looks much more like stagflation. So, sell the rally, but maybe not just yet.

GOLD

Be bold, buy gold. It is true that, again confirming this investment call just after the metal hit its all-time high, is difficult. Nonetheless, we believe that gold qualifies as the new government bond position in future multi asset portfolios.

After all, the precious metal has performed very well for most of the year, despite the US Dollar staying firm and real yields rising, particularly in the early parts of 2024. Now that these factors are reversing, gold might see more tailwinds. It's also an effective hedge against geopolitical tail risks.

BREAKEVEN INFLATION

Investors broadly seem to be of the view that the inflation monster is tamed; as a result, market implied US 10-year inflation expectations have fallen sharply to a level just over 2%. This is even lower in Europe.

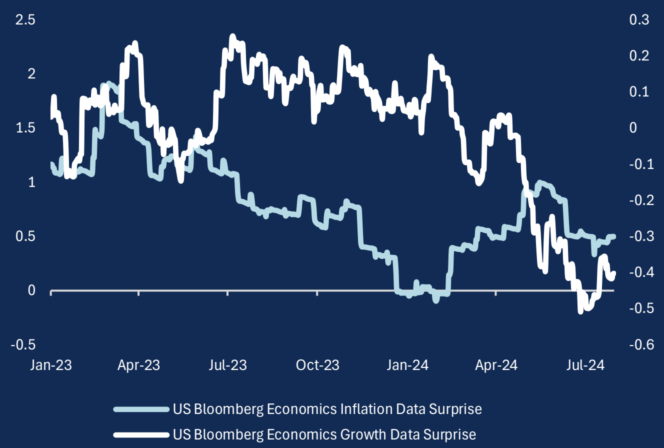
While we subscribe to the idea that the prevailing "soft landing" narrative can persist for a while, it's a bit of a stretch to think US inflation will return to its magical 2% target. Structural factors would suggest that inflationary forces are still present, offering a good entry point for inflation linked government bonds.

Can this risk-on environment continue?

For most of 2024, investors have worried about inflation lurking just above the Federal Reserve's comfort zone, and a US economy that has turned out to be much more resilient than policy makers anticipated. While equity markets have found themselves moving beyond monetary policy, looking to profits and earnings, bond markets have struggled considerably.

Over recent months, the economic picture has turned somewhat, with increasing evidence that the US economy is finally slowing, with the consumer starting to feel the pinch. Importantly though, inflation – which had surprised to the upside in the first few months of the year – is also starting to cool. A good visual representation of the economic backdrop in the US is shown below

Bloomberg economic surprise indices for US growth and inflation.



Source: Bloomberg Finance L.P; data as 31/7/2024. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

All of this seems terribly US centric, and indeed the economic situation elsewhere is very different. Yet financial markets tend to focus on a few factors at a time. Currently, it's all about softer US growth and US inflation risks subsiding. In other words, it is all about Goldilocks. The question now is: how long can this last? Well, if growth stabilizes, this soft-landing narrative can persist for a while. Whether equity markets could sustain their performance was somewhat of a question mark, given the heavy skew towards a handful of stocks. But a lot has changed since the market correction in early August , which has cleared out a good amount of frothiness in markets. So, positioning is clearer now and, in the absence of any exogenous shock coming from the geopolitical stage, financial markets are all set for a US-elections-induced autumn rally.

Regardless of who leads the polls, investors are seemingly taken by animal spirits, whether they latch on to Kamala Harris and her new-found social media appeal, or Donald Trump and his "Maganomics". The last few months in the run-up to a US election are often dominated by a good amount of risk taking. So, fasten your seatbelts, but don't forget some airbags; there is still the potential for a few bumps on the road.

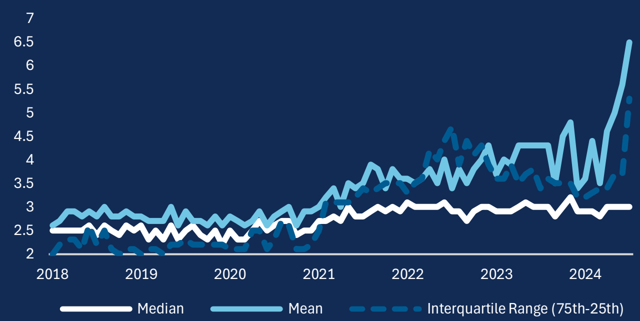
Are we witnessing a policy error by the Federal Reserve?

Ever since the FOMC meeting at the end of 2023, where Jay Powell warned of the risks of leaving interest rates too high for too long, investors have worried about such overtightening. But what if it was the other way around?

Fed policy is not as tight as it might seem. The fact that the US Treasury under Janet Yellen has issued much more treasury bills than longer dated bonds over the past few years has meant that the actions taken by the Federal Reserve to tighten monetary conditions, such as the tapering of bond purchases, were not as effective as one would have hoped. So, the starting point is one of ample liquidity, and monetary conditions that are mildly accommodative, meaning that there is no real need to cut. Furthermore, the world has become more populist, so fiscal policy has tended towards expansion. This, paired with ongoing geopolitical tensions and national political agendas geared towards curbing immigration, as well as imposing barriers to global trade, are all reasons why the global economic undercurrents are putting upside pressure on price levels. Artificial intelligence (AI) might well be deflationary in the long term, but in the near term, corporates that have made a huge amount of capex in AI will want to increase their prices in order make good on their investments.

Even though inflation prints have been coming in softer in recent weeks and months, longer-term inflation expectations have recently seen a great deal of volatility. The University of Michigan is providing monthly surveys about near-term and long-term inflation data. The outputs are usually represented as medians to mitigate the impact of extreme values. When looking at a time series of the average, as shown below, it becomes evident that the extreme values are rather pronounced. This can also be seen in the interquartile ranges (a measure of the dispersion or spread of data), which suggest an increasing skew towards an inflationary mindset.

University of Michigan Survey: Expected Change in Prices During the Next 5 Years



Source: University of Michigan 31.07.2024. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

In fairness there has been some change in the way the survey is conducted, which may have led to some distortions But the fact there is a substantial number of people in the US willing to say that their expectation for long-term inflation is 10%+ is concerning. Inflation is all about perception; if a large part of the population thinks that inflation will be in the double digits, well guess what, there is a good chance that it just ends up there.

Disclosures

The MSCI All Country World Index is a free-float weighted equity index, and includes both emerging and developed world markets. The FTSE World Government Bond Index- Developed Markets measures the performance of fixed-rate, local currency, investment-grade sovereign bonds issued in developed markets. The Bloomberg Dollar Spot Index tracks the performance of a basket of ten leading global currencies versus the U.S. Dollar. Each currency in the basket and their weight is determined annually based on their share of international trade and FX liquidity. The S&P 500® index includes 500 leading companies and captures approximately 80% coverage of available market capitalization. The MSCI EMU (European Economic and Monetary Union) Index is a free-float weighted equity index. The TOPIX, also known as the Tokyo Stock Price Index, is a capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries. J.P. Morgan's developed and emerging market indices track fixed rate issuances from countries spanning the globe. The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. S&P GSCI Crude Oil Total Return index is weighted based on world production and it uses Spot Prices to calculate the price. Bloomberg Commodity Index (BCOM) is calculated on an excess return basis and reflects commodity futures price movements. The Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index is composed of securities from the Bloomberg Barclays Capital Government/ Credit Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index. It is generally considered to be representative of the domestic, investment-grade, fixed-rate, taxable bond market. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. It is not possible to invest directly in an index.

Diversification does not guarantee a profit or protect against losses.

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 for Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations and is for information purpose only. This document does not constitute a public offer by virtue of Act Number 26.831 of the Argentine Republic and General Resolution No. 622/2013 of the NSC. This communication's sole purpose is to inform and does not under any circumstance constitute promotion or publicity of Allianz Global Investors products and/or services in Colombia or to Colombian residents pursuant to part 4 of Decree 2555 of 2010. This communication does not in any way aim to directly or indirectly initiate the purchase of a product or the provision of a service offered by Allianz Global Investors. Via reception of his document, each resident in Colombia acknowledges and accepts to have contacted Allianz Global Investors via their own initiative and that the communication under no circumstances does not arise from any promotional or marketing activities carried out by Allianz Global Investors. Colombian residents accept that accessing any type of social network page of Allianz Global Investors is done under their own responsibility and initiative and are aware that they may access specific information on the products and services of Allianz Global Investors. This communication is strictly private and confidential and may not be reproduced. This communication does not constitute a public offer of securities in Colombia pursuant to the public offer regulation set forth in Decree 2555 of 2010. This communication and the information provided herein should not be considered a solicitation or an offer by Allianz Global Investors or its affiliates to provide any financial products in Brazil, Panama, Peru, and Uruguay. In Australia, this material is presented by Allianz Global Investors Asia Pacific Limited ("AllianzGI AP") and is intended for the use of investment consultants and other institutional/professional investors only, and is not directed to the public or individual retail investors. AllianzGI AP is not licensed to provide financial services to retail clients in Australia. AllianzGI AP is exempt from the requirement to hold an Australian Foreign Financial Service License under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order (CO 03/1103) with respect to the provision of financial services to wholesale clients only. AllianzGI AP is licensed and regulated by Hong Kong Securities and Futures Commission under Hong Kong laws, which differ from Australian laws.

This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors (Schweiz) AG; in HK, by Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; ; in Singapore, by Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 199907169Z]; in Japan, by 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, the Investment Trust Association, Japan and Type II Financial Instruments Firms Association; in Taiwan, by Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan; and in Indonesia, by PT. Allianz Global Investors Asset Management Indonesia licensed by Indonesia Financial Services Authority (OJK).

AdMaster 3814713