September 2015

Capital Markets Monthly

A rainy autumn for the markets?

A late summer thunderstorm is lashing the global financial markets in the form of price drops and higher volatility. In particular, the "emerging markets/commodities/inflation" trio appears to be putting a damper on the holiday mood brought about by the agreement on a third rescue package for Greece.

1. A great deal of attention is currently focused on the economic weakness in a number of **emerging markets**, especially China, where the government is seeking to stem the massive capital outflows and distortions in the domestic equity market by economic policy interventions. However, the global economy has presented a geographically imbalanced picture for some time. Although the emerging markets basically continue to make up ground, their advantage over the industrial countries in terms of growth has decreased. The decline in the pace of growth in many emerging markets is due less to cyclical causes than to "homemade" structural causes, such as an increase in private sector debt and a shift from exports towards consumer-driven growth. In addition, countries such as Brazil and Russia are being hurt by the strong downward pressure on the commodity markets. Conversely, the following applies: how quickly the emerging markets return to higher growth rates depends largely on how eagerly they embrace reforms. In the short term, the emerging markets face a dilemma. While rate cuts would be necessary to give a boost to weakening economies, this would probably be accompanied by further capital outflows.
2. Concerns surrounding the emerging markets are very clearly being priced into in the **commodity markets**. While the decline in the oil price – which began in summer 2014 – was triggered mainly by structural global oversupply, market participants are now increasingly of the opinion that weaker demand prospects also play a role. It is quite the paradox: on the one hand the renewed decline in oil prices ought to act as an economic stimulus package for net oil importing regions such as China, India, the Eurozone and the US, but at the same time, the related concerns about a slowdown in the global economy might put a damper on sentiment.

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The trio "emerging markets/ commodities/ inflation" has put a damper on the holiday mood.

As of 31/08/15

Equity Indices	**Status**	**Interest Rates %**		
FTSE 100	6,078	USA	3 Months	0.33
DAX	10,259		2 Years	0.70
Euro Stoxx 50	3,176		10 Years	2.18
S&P 500	1,972	Euroland	3 Months	-0.03
Nasdaq	4,777		2 Years	-0.21
Nikkei 225	18,166		10 Years	0.73
Hang Seng	21,185	Japan	3 Months	0.17
KOSPI	1,941		2 Years	0.01
Bovespa	46,626		10 Years	0.39
FX	**Status**	**Raw Materials**		
USD/EUR	1.122	Oil (Brent, USD/Barrel)		49.8

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The Case for Alternatives

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3. Falling commodity prices, and the resulting decline in **inflation** expectations, mean that the industrial countries can probably expect inflation to remain subdued and that the G4 countries will maintain their ultra-loose monetary policies. As a result, there still seems to be some disagreement within the **US Federal Reserve** (Fed) on a first rate hike on 16/17 September 2015, although this is merely the first step in a gradual normalization of the Fed's monetary policy.

Conclusion: The focus of the markets is now increasingly shifting to the growing headwinds for riskier asset classes. Temporary setbacks and increased volatility should therefore continue to be expected. However, as long as the economic outlook does not suffer a sustained deterioration, this is not likely to be the start of a bear market, despite the price correction. A potentially stormy autumn on the markets makes it even more important to dress warmly and in layers, i.e. spread investments across all asset classes.

Wishing you a weatherproof portfolio.

Yours,

Ann-Katrin Petersen

Allianz Global Investors

Understand. Act.

Markets in Detail

Tactical Allocation, Equities & Bonds

- The continued expansionary monetary policy and economic growth that is in line with its potential are likely to support equity markets in the longer term.
- In an environment of low real returns, dividends should continue to be a major factor for overall returns on equities.
- However, a rather weak earnings environment, the ambitious valuations of a number of asset classes, the upcoming increase in interest rates by the Fed as well as persistent worries about the growth prospects of some emerging countries, particularly China, could temporarily create a headwind for risky assets and make a neutral weighting advisable.

German equities →

- The German economy recorded a slight acceleration in growth in the second quarter of 2015 (+0.4% compared to the previous quarter). Neither the Greek debt dispute nor the economic weakness in some emerging markets have slowed the German upturn thus far. In addition to consumption, the demand for exports, especially from the industrial countries, provided the principal support, while capital investments disappointed.
- Thanks to the upturn in employment, the continued low oil price and the weakness of the Euro (i.e. improved export opportunities), the outlook for the economy remains positive. In August, the ifo business climate index recorded its second consecutive increase.
- In terms of the cyclically-adjusted price/earnings ratio (Shiller P/E), valuations of German equities were slightly above the long-term average for developed market equities prior to the most recent sell-off.

Equities Europe ↗

- The Eurozone continues to recover, although the upturn lost a bit of momentum in the second quarter (+0.3% compared to the previous quarter). While the economic situation in France was disappointing, the former crisis countries Spain and Portugal continued to catch up economically.
- Lower commodity prices, the continued ultra-loose monetary policy of the European Central Bank (ECB) and the weaker Euro exchange rate should continue to have a positive impact. The purchasing managers' index for August 2015, for example, points to a continued economic recovery in the Eurozone. Outside the monetary union, the United Kingdom is likely to be among the industrial countries with the strongest growth this year.
- Equity market valuations in a number of Eurozone periphery countries and the United Kingdom can be considered attractive in terms of the Shiller P/E ratio.

US equities →

- As expected, the US economy has overcome its weak start to the year, which was due in part to special factors. Annualized GDP recorded strong growth in the second quarter of 2015, increasing 3.7% over the previous quarter.
- The continued positive trend in the US labour market, gains in real disposable income and the positive trend in the construction industry still point toward an economic upswing.
- The Fed is likely to change tack on interest rates during the second half of 2015. However, the pace of the rate hikes should be modest – and thus manageable for the financial markets and the economy.
- Despite the recent slump in equity prices, the US market remains generally expensive.

Japan equities →

- After the economic setback in the second quarter, due not least to weak exports, the purchasing managers' index for August underpins the expectation of a recovery in the third quarter – although there is uncertainty about the strength of demand among Japan's East Asian trading partners.
- Overall, despite the fluctuations in economic activity the Japanese economy remains on a moderate upward path. The Bank of Japan's monetary policy remains on the reflationary path – and thus a key pillar of the economy.
- Due to continuing doubts about the long-term success of Abenomics (among other things some structural reforms and important measures to curb the budget deficit have been postponed) this upward movement could prove to be a temporary phenomenon.
- Japanese equities continue to be supported by the weaker Yen and a recovery trend in profitability. In terms of the Shiller P/E ratio, however, the Japanese equity market remains in very expensive territory.

Emerging market equities ↘

- Given the loss of economic momentum, political challenges and the upcoming increase in key interest rates in the US, restraint continues to be called for with regard to emerging market equities.
- A weaker US Dollar, stabilizing commodity prices and other economic stimuli, especially from China, could turn the tide.
- Overall, however, this group of countries is proving to be very diverse, which makes selection necessary, for example, choosing between commodity-importing and exporting emerging markets or countries embracing or rejecting reforms.
- Equity market valuations in a number of emerging markets can be considered attractive in terms of the Shiller P/E ratio.

Sectors

- Constructive economic outlooks for the industrial countries remain a factor in favour of a moderate cyclical sector orientation with an overweight in technology stocks and an underweight in utilities.
- Gradually rising bond yields are likely to usher in a rotation at the expense of "expensive" defensive growth companies.
- Within the defensive sector universe, the very favourably valued energy companies should be able to compensate falling oil prices with lower capex and efficiency improvements in the medium term. Investors may, however, need some patience.

Investment Theme: "Alternatives"

- Given the waning of the 30-year bull market in bonds, the strong, multi-year recovery in equities and signs of higher volatility, the need for alternative sources of return is growing.
- By extending a traditional portfolio allocation to include (liquid) alternative investments, a wide range of investors could benefit from both higher risk-adjusted returns and from improved diversification and potentially lower market sensitivity.
- The universe of alternative investments includes different asset classes and investment styles, each with its own expected return-risk profile that can be used to build a customized portfolio.

International bonds ↘

- The UK inflation rate, which only recently rose above the zero mark, is likely to solidify expectations that the Bank of England will tighten its monetary policy no earlier than the beginning of next year.
- The Fed, meanwhile, is moving cautiously towards its first increase in key interest rates. While the timing is still unclear, the pace of the increase in key interest rates will in all likelihood be very gradual. Nevertheless, the bond markets continue to price in a less "hawkish" scenario. The associated potential for setbacks and the risk of falling prices in US Treasury bonds – particularly among shorter maturities – will thus remain one of the key investment themes for the coming months.
- Valuation models continue to point to an overvaluation of 10-year German and US government bonds. In particular Bund valuations remain very ambitious.

Euro bonds →

- While the ECB's massive purchase programme (QE) initially rendered traditional fundamental factors such as inflation and economic growth largely irrelevant, the sell-off in the Euro bond markets (April to June) showed that yield declines are not a one-way street.
- For now, however, the quantitative easing by the ECB should keep government bond yields at low levels, although this does not preclude increased volatility.
- Government bonds of the Euro periphery remain well supported by the accommodating ECB monetary policy, fiscal consolidation measures and the economic recovery. However, the scope for the further narrowing of spreads has become extremely limited.

Emerging market bonds →

- Structurally, the positive environment for hard currency bonds from the emerging markets remains intact (better longer-term growth prospects and more robust public finances in comparison to the industrial countries).
- On the other hand, mixed economic data and the expectation of a less expansionary US monetary policy will weigh on the asset class in the short term.
- For local emerging market bonds the positive real returns, which remain particularly high in comparison to the industrial countries, will provide support in the medium term.

Corporate bonds →

- The ambitious valuations of investment-grade corporate bonds and high yield segments in the Eurozone are being offset by a continued expansionary monetary policy and improving fundamentals.
- Credit risk premiums on US corporate bonds are near their historical average. Models based on economic data, liquidity and market volatility make the risk premiums currently priced in appear to be fundamentally attractive.

Currencies

- The international exchange rate system is still under the influence of both monetary policy (e.g. strong US Dollar, weak Euro and Yen) and commodity prices (e.g. Canadian Dollar and Norwegian Krone).
- Although the US Dollar is already expensive against most currencies from a fundamental perspective, the further overshooting of the greenback cannot be ruled out given the continued divergence in monetary policies.
- Among the commodity exporting nations, the currencies of the emerging countries (e.g. Russian Ruble, Brazilian Real) have been particularly exposed to increased selling pressure since mid-year.
- The Chinese Renminbi, in turn, which has generally been considered a stable currency with upside potential in the last decade, could be exposed to increased volatility in future given the adjustment to the exchange rate policy and increased risk awareness among investors. This is likely to have noticeable side effects, in particular for the Asia-Pacific currencies such as the Malaysian Ringgit.

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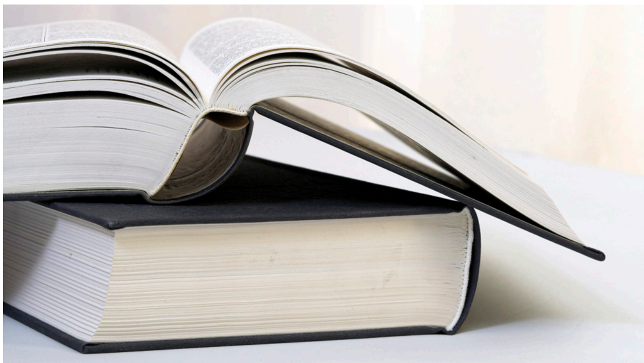

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Imprint

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