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Allianz Global Investors Insights

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Global View

6 Pressure Points for US Stocks

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Global Strategist

The eight-year US equity bull market has time and again confounded its many detractors, helping US stocks remain among the top performers since the global financial crisis began. With such a history of strong results, it is easy to argue why many long-term investors should continue holding this asset class in their portfolios.

At the same time, the US equity market is highly valued – the current Case-Shiller price-to-earnings ratio of 29.8 is almost double its long-term average – leaving other investors to question whether this is currently the place to pursue growth potential and protect purchasing power.

What might make the markets pull back?

The Dow Jones Industrial Average has fallen about 1 per cent from its all-time high, set earlier this year, and a growing chorus of market watchers is calling for an additional pullback. For our part, we have identified six factors that may encourage investors overexposed to US equities to review their positions.

1. Trumponomics could provide limited lift
Although the markets initially had high hopes for stimulative new policies from President Trump, the recent failure of his health-care bill has curbed some enthusiasm. Moreover, not all of Mr Trump's remaining proposals are measures that have historically been proven to boost the US economy. Tax reductions for corporations and the wealthy tend to offer only a small lift, while new infrastructure spending and tax cuts for lower-paid workers have proved to be substantially positive economic multipliers only in the medium term.

> The markets had high hopes for Mr Trump's policies, but his health-care bill's failure has curbed some enthusiasm

2. Higher inflation + higher rates = An unpleasant surprise?
US inflationary pressures could build much faster than the market expects, especially considering that the economy is almost at full employment and wages could soon start to rise convincingly. The US Federal Reserve is closely watching income and wage data – two data points that have historically been closely correlated. Depending on what it sees, the Fed could find itself way behind the interest-rate curve and move more aggressively, which would be an unpleasant surprise for the markets.

3. Trade could spell trouble for the US dollar
If Mr Trump begins implementing protectionist trade policies, there could be negative implications for the US dollar. The same is true of the failure of the Trans-Pacific Partnership, China's expansion of its "one belt, one road" initiative and rising

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Allianz Global Investors

Viewpoint

Battles Brewing Over US Budget and Taxes

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The new priorities of the US Congress and the Trump administration are designed to make US fiscal policy more pro-growth and pro-business. What these legislators will actually accomplish, however, is anyone's guess – particularly once political posturing and special-interest lobbying kicks in. On top of that, the federal budget process has many twists and turns that will ultimately dictate the timing, scale and scope of changes.

Complicating matters further, the Republican-controlled Congress and President Donald Trump have work to do before they can even get to next year's budget: They must approve new short-term spending bills that fund the government through September, the end of the fiscal year, and they will need to raise the debt ceiling to avoid a government shutdown. At every step along the way, they will be met by resistance from Democrats and many within their own party.

Before addressing the budget, Congress and Mr Trump must pass short-term spending bills and raise the debt ceiling to avoid a shutdown

Significant changes to government spending

Mr Trump's fiscal-year 2018 budget proposal, sent to Capitol Hill on 16 March, sets in motion formal Congressional processes that will determine the funding levels for federal agencies, programs and operations – and most of them have little chance of being approved. The proposal calls for unprecedented cuts in civilian non-defense discretionary spending and the elimination of 19 federal agencies to fund increased spending on national defense, veterans affairs and homeland security. As proposed, the budget would confine civilian non-defense spending to slightly more than 3 per cent of gross domestic product in fiscal-year 2018, a 56-year low.

Initial indications suggest that not only do congressional Democrats dislike the proposal, but much of the Republican base in both houses of Congress disagrees with the president's plan as well – with one prominent senator calling it "dead on arrival". Republicans on the political right already contend that the proposal, if enacted, would magnify the federal budget deficit; more moderate Republicans complain that severe cuts to programs important to their respective states or districts cannot be supported.

Democrats dislike Mr Trump's budget, as do many Republicans in both houses of Congress

Major tax reform in Republicans' sights

Even as they prepare for a fierce budget fight, Congress and Mr Trump have begun serious consideration of tax reform for businesses and individuals. These proposals could turn into the most comprehensive new tax legislation since 1986 and are expected to spark a new round of political battles.

By most accounts, Republican leaders in Congress will seek to enact reform legislation by no later than late summer, so the pressure will build quickly. Tax reform will focus not only on businesses: Plans call for reduced burdens on middle- and lower-middle-income households, and a broader tax base for higher-income tax filers, designed to eliminate net reductions in their effective rates. Legislation along these lines will put many moderate Democrats in a tricky situation: Positioning against the tax bill could look like a rejection of benefits for low- and moderate-income taxpayers, while voting for the bill could seem like capitulation to the Republican leadership in Congress.

Regardless of the timetable, passage of business and personal tax-reform packages seems inevitable this year, even if they fall short of the original goals of the administration and House Speaker Paul Ryan. Compromise will be needed because several components of the comprehensive package – such as the border adjustability tax – are highly controversial. Nevertheless, proponents of radical reform will push hard for changes to taxes, spending, health insurance and regulation, considering them overlapping parts of a comprehensive program that works only if all of the key provisions remain intact. Think of it as a stack of Jenga blocks.

Tax reform seems inevitable this year, but it will likely fall short of the Trump administration's original goals

Change is coming

In the end, the overall tax-reform package as proposed by the administration and congressional leaders will likely raise the federal budget deficit over the next decade. Yet the increase can be offset partially if the package stimulates economic growth sufficiently to boost tax revenue and shrink government spending. Either way, meaningful changes in spending priorities and major tax reforms can be expected well before the end of 2017. The markets should respond well if Mr Trump's pro-growth and pro-business policies become reality and the economy strengthens.

Perspective on Europe

Will Italy Spoil Europe's Election Celebrations?

Stefan Hofrichter, CFA
Chief Economist

On 29 March, the UK triggered Article 50 to begin the process of leaving the European Union. Does this represent a crisis point for the European project, as some commentators suggest? Or will Europe's "super cycle" of 2017 elections show that voters are resisting some of the more anti-EU forces? So far, at least, the pro-EU side seems to be winning:

- In the Netherlands' elections of 15 March, the anti-EU party founded by Geert Wilders lost out to Prime Minister Mark Rutte's centre-right, pro-EU party.
- In France, the reform-friendly, pro-EU Emmanuel Macron is expected to beat the radical right's Marine Le Pen in the presidential elections of April and May.
- In Germany, the outcome of September's elections should be a close call, but the resulting government and parliament will almost certainly be pro-EU and pro-globalization.

Such developments would be welcomed by the capital markets as positive steps for the EU, and they may help offset some of the uncertainty caused by Brexit. With Germany's economy doing well and the potential for stronger ties between Paris and Berlin, we could ultimately begin to see a stronger integration of the EU and euro area.

Pro-EU election results would be welcomed by the markets and should offset some Brexit-related uncertainty

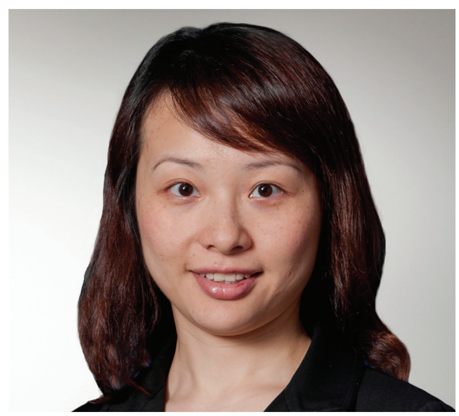
But Italy is the elephant in the room. It has an economy with weak growth rates, a weak banking sector, a governing party at risk of splitting up and a political mood that is increasingly turning anti-European. If the country doesn't hold a snap election this year, a regular election will be held in the spring of 2018. Given Italy's challenging economic straits, it is entirely possible – or at least not easily dismissible – that Italian voters will want to leave the euro and/or the EU. The markets seem to share this view: Spreads of credit default swaps, which can be an early indicator of severe market distress, have essentially doubled in Italy since early 2016.

Italy is the elephant in the room: CDS spreads, an early indicator of severe market distress, have doubled there since 2016

All told, the investment implications of Europe's super cycle are mixed. The positive view is that European political uncertainty has marginally eased and should improve further if the election outcomes in France and Germany turn out to be benign; the euro and euro-area assets could benefit from this development over the course of 2017. The more challenging possibility is that political risks will continue to impact capital markets – and not only because of Italy. In the US, UK and other parts of the Western hemisphere, the populist trend that opposes globalization and supports stronger nation-states does not seem to be abating. There may be no early respite from the ongoing uncertainty and instability for the markets.

Grassroots℠ Research

China's Banks Are Looking Less Shadowy



Joey Wong
Grassroots℠ Research Analyst

For years, some market-watchers have voiced concerns about the health of China's banks and questionable sales of wealth-management products (WMPs). These investment vehicles offer attractive yields and imply backing by the issuing banks, yet their portfolios are not always transparent and banks frequently do not record them on their balance sheets – giving rise to fears of systemic risk.

When our Grassroots℠ Research team recently talked to bank branch managers in China about these issues, we found that demand for WMPs remains strong. But there is growing consumer interest in a new, more transparent product. We also found ample evidence of a healthy mortgage market that supports our generally constructive perspective on these banks.

Demand is strong for WMPs, with NAV-type products gaining traction

Among our key findings:

- Most of our sources said WMP sales trended up between December 2016 and February 2017 – by an average of 11 per cent – as other investment options, such as stocks and housing, remained unattractive.
- Loan quotas are expected to stay unchanged this year due to government efforts to curb the overheated housing market and general concerns about China's business environment.

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Global View

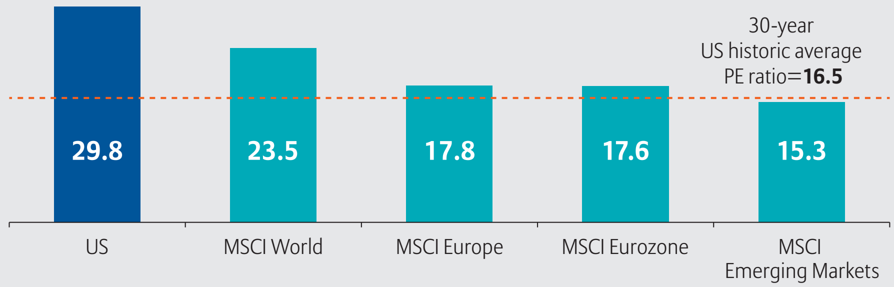
oil prices. The imposition of a potential US border adjustment tax could also hurt corporate profits and economic competitiveness by further boosting the dollar.

A US border adjustment tax could hurt corporate profits and economic competitiveness by boosting the dollar

4. Cost of servicing debt stands to rise
The level of indebtedness in the US and around the world is significant, and it has been made affordable only because of extremely generous monetary policies. Even with a doubling of the US debt level in recent years, the annual cost of servicing it has remained around USD 425 billion. As interest rates move higher, Mr Trump's financial wiggle room could diminish as the US government spends more to service its debt burden.

5. Demographics heading in the wrong direction
Ageing populations are a challenge all over the world, and the US is no exception. Its economy could increasingly feel the drag of productive older workers leaving the workforce, replaced by a younger generation that is less well paid and more exposed to the forces of globalization. Moreover, by subjecting immigration to the whims of politics, America's famously flexible workforce could become less of an economic advantage as lower levels of immigration, a shrinking talent pool and reduced relocational flexibility take their toll.

The US Equity Market Is Highly Valued
The current price-to-earnings ratio of the US market is significantly higher than its 30-year average.



Source: Datastream, MSCI, Shiller, AllianzGI as at 1 March 2017.

6. Technology is doing less with more
Despite some populists' assertions, it is not really globalization that hollowed out America's jobs market, but the rise of job-killing technology – a trend that is certain to grow as companies invest more in robotics and artificial intelligence. In addition, the multiplier effects of new technology and social media, where the US is a leader, are much smaller than those of previous industrial innovations – and much more disruptive to existing businesses. In the end, we may find that many high-tech innovations are better at creating vast wealth than vast employment.

Job-killing technology is on the rise as companies invest more in robotics and artificial intelligence

Key considerations for investors
Even in a world where low interest rates have inflated valuations almost across the board, the US equity market is expensive. Add to this the fact that the US dollar is overvalued by perhaps 20 per cent, and the question may be when – and not if – the US equity market will pull back before starting a new cycle. With this in mind, here are several investment approaches to consider.

- Keep an eye on Asia: China, India and Indonesia offer the prospect of sustainable economic growth, as billions of people move toward middle-class careers.
- Monitor reforms in developing nations: Structural reforms provide investors with strong signals about the potential for future returns.
- Guard against interest-rate sensitivity: US bond markets are already shorting 10-year US Treasuries in the hopes of higher rates.
- Follow the money: Many US corporations are already buying attractively valued assets in Europe and Asia.

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Grassroots℠ Research

- Our sources expect mortgage loans in 2017 to remain the main source of loan business, while property-backed consumer loans should see significant growth.
- Two-fifths of our sources expect the loan default rate to remain flat in 2017, but half expect it to trend higher.
- Still, most believe the overall loan default rate will stay low, and we did not find any sign of default risk increasing in recent months.

Mortgages are considered a healthy and lucrative business for the banking sector

Our Grassroots℠ study also found that net-asset-value–type WMPs have gained traction among banks and customers, which Research Analyst Helen Ye found interesting: "NAV-type products remove the implicit-guarantee obligation from banks and require them to educate customers about their own risk exposure."

The findings about muted loan growth and continued reliance on mortgages as the primary source of new loans are similarly encouraging. "Mortgages are considered a healthy and lucrative business for the banking sector," said Ms Ye. "These results run counter to the market's concerns about continued excessive credit growth in China's economy and are supportive of our investment perspective on China's banks."

Most of our sources believe the overall loan default rate will stay low

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