January 2017
Capital Markets Monthly

What the Year of the Fire Rooster holds in store for us

In the Chinese calendar, the current year – the Year of the Fire Monkey – is also drawing to a close. The prediction that it would be a year full of changes that could affect coming years arguably has proven to be true. Unexpected political events, including the Brexit vote and the results of the US presidential election, shook the capital markets, yet none of these headlines resulted in any severe, lasting market disruptions. With regard to (geo)politics, the global economy and monetary policy, will the focus now shift back more toward fundamental drivers?

- To begin with, the new year also promises to be a highly political one. In the US, President-Elect Donald J. Trump will take office on 20 January 2017. So far, it is unclear which of his campaign promises Trump will ultimately be able to fulfil. In Europe, the Dutch, French, Germans and possibly even the Italians will go to the polls and in the spring the Brexit negotiations are set to begin. Worries about gains by populist parties may cause politicians to focus more on pandering to voters and less on implementing structural reforms in super election year 2017.

- Nevertheless, the global economy has proven to be quite resilient in the face of the recent unexpected developments. In virtually every major region, the economy is now trending upward or has at least stabilized. This, combined with a recovery in commodity prices, should mean that consumer prices will continue to increase over the next few months; i.e., for the time being, signs seem to be pointing toward reflation instead of deflation.

- Unlike in the US, though, inflation in the Eurozone and Japan should be significantly lower than the central banks’ targeted level. The divergence in monetary policy on different continents therefore continues to be a central theme for investors. All in all, global monetary policy remains expansionary. However, as inflation rates gradually return to normal, there are increasing signs that central-bank liquidity may reach its peak in the foreseeable future – possibly by the beginning of 2018.

As far as (geo)politics, the global economy and monetary policy are concerned, fundamental drivers will increasingly come to the fore.”

Ann-Katrin Petersen
Vice President
Global Capital Markets & Thematic Research

New Publication
Profit when inflation rises
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What does this augur for the financial markets?

- The prevailing “reflation theme” is currently supporting the equity markets. Still, the super election year 2017 could cause some surprises and occasional financial market volatility (although investors seem to have grown accustomed to the unexpected).

- With inflation expected to increase and central banks likely not to adopt further expansionary measures, upward pressure on yields in the bond markets will persist, especially in the US. For the time being the Dollar’s strength should continue, given diverging monetary policies.

- In an environment of lower trend growth, alpha will continue to predominate.

One thing is certain: 2017 will be another exciting year. It’s a good thing that the Chinese calendar year beginning on 28 January is the Year of the Fire Rooster – because strong-willed fire roosters remain cool-headed, even when facing unexpected situations.

Ann-Katrin Petersen
**Markets in Detail**

**Tactical Allocation, Equities & Bonds**

- Global capital markets continue to be dominated by “reflationary expectations”. Improving economic data, the anticipated fiscal stimulus in the US and gradual interest-rate hikes by the Federal Reserve System (Fed) currently point toward rising equity markets and weaker bond markets.
- However, corporate earnings estimates for 2017 still appear to be too ambitious. In addition, political factors will continue to exert influence on performance in the capital markets. Investors should continue to expect higher volatility.
- Generally speaking, investments should focus more on capital income (e.g., dividends) and less on price gains.

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<th>German equities</th>
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<td>- Based on the positive results of year-end corporate surveys such as the IFO Business Climate Index and the Purchasing Managers’ Index for December 2016, the German economy is expected to get off to a buoyant start in 2017.</td>
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<td>- Export-oriented companies should enjoy a further boost from the global economy. In contrast, consumer confidence is expected to suffer somewhat due to increasing inflation and the recovery in the oil price. Nevertheless, given the robust state of the labour market, there are no grounds for scepticism here. Within the Eurozone, Germany continues to have the lowest unemployment rate (4.1% in October 2016).</td>
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<td>- On the other hand, political developments could cause uncertainty amongst business leaders, leading to a decrease in capital expenditures.</td>
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<td>- In terms of their long-term average, German equities appear to be slightly undervalued according to the Shiller price/earnings (P/E) ratio.</td>
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<th>European equities</th>
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<td>- Europe remains under threat of increased political risk. The Netherlands, France and Germany – and possibly Italy – will hold elections in the months to come.</td>
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<td>- To date, Eurozone economies have remained stable despite the political challenges. Sentiment indicators for the first quarter of 2017 point to further solid economic performance, driven primarily by domestic demand. Although the gradually increasing inflation rate will decrease purchasing power, the steady increase in employment will support consumer spending. For the first time in more than seven years, the unemployment rate in the Eurozone has fallen back into the single digits (October 2016: 9.8%).</td>
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<td>- Following the shock of the Brexit vote, the UK economy to date has proven to be surprisingly robust. However, there is still a great deal of uncertainty about the long-term economic consequences of leaving the EU.</td>
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<td>- Based on their cyclically-adjusted Shiller P/E ratios, European equities rank among the more attractive markets.</td>
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<th>US equities</th>
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<td>- The latest economic data fully support the current strong condition of the US economy. Although it is yet unclear which of his campaign promises Trump will ultimately be able to fulfil, it is already clear that the policy mix will change (more expansionary fiscal policy; more restrictive monetary policy). In general, “Trumponomics” may boost the US economy over the course of the year – despite the dampening effects of increasing inflation, somewhat higher interest rates and appreciation of the trade-weighted US Dollar.</td>
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<td>- Overall, improved economic prospects, recovery in the energy sector and impending tax reductions should have a positive impact on corporate earnings. In contrast, a strong US Dollar and rising unit labour costs will negatively affect the earnings outlook for 2017.</td>
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<td>- In terms of valuations, US equities are not prepared for growing political and – over the medium term – economic risks.</td>
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<td>- The improved sentiment in Japanese industry – the first such improvement since June 2015, according to the Tankan survey – confirms the better overall state of the Japanese economy, although the economy continues to be weak.</td>
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<td>- Despite anaemic growth, the Japanese unemployment rate is trending lower, which will probably prompt demands for wage increases over the medium term. Nevertheless, achieving the price-stability target of 2% will probably remain out of reach for the Bank of Japan for the time being. It will continue to follow its policy of “quantitative and qualitative easing with yield curve control”.</td>
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<td>- Japanese equities remain hostage to the Yen. Uncertainties surrounding the effectiveness of the change in the Japanese central bank’s strategy are currently being over-compensated by the weakness of the Yen caused by the Dollar.</td>
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<th>Emerging market equities</th>
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<td>- In the emerging markets, the signs are pointing to a moderate acceleration in growth. This is mainly because the economies of the two heavyweights, Russia and Brazil, are stabilizing – in part thanks to the recent recovery in commodity prices – and because of the continuation of China’s loose economic and fiscal policy.</td>
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<td>- Nevertheless, there are still risks. Indeed, in a number of emerging markets, expansionary economic policy is accompanied by growing imbalances, in particular a high and increasing level of private debt and inflationary property prices. In addition, the stronger US Dollar will have a temporary negative impact, inasmuch as the cost of servicing debt will increase in local currency for the large number of Dollar-denominated loans.</td>
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<tr>
<td>- In terms of the Shiller price/earnings ratio, valuations of emerging market equities continue to be relatively attractive.</td>
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**Sectors**

- The improved cyclical environment and hopes of reflationing and stimulating policy measures should favour more cyclically oriented value sectors over the foreseeable months, and especially banks, which have been shunned for a long time (with focus on US banks).
- Commodities are exposed to various influences. Prices for industrial metals, for example, should benefit from Trump’s victory and the prospects for potential infrastructure investment. In contrast, precious metal prices have declined recently in expectation of interest rate hikes by the Fed.
- Structurally, we still recommend the dividend style, because in an environment in which overall long-term growth prospects are sluggish, dividends remain an important factor for equity returns.

**Investment theme: “Reflationing”**

- The world’s equity markets continue to be dominated by “expectations of reflationing”. Indeed, in view of stabilizing commodity prices – and the associated base effects – as well as improving global economic data, inflation rates in OECD countries should increase markedly over the next few months.
- Moreover, signs of a trend toward deglobalization could, with a time lag, be accompanied by higher tariffs, lower price-related competitive pressure and weaker productivity growth. In this respect, deglobalization will have an inflationary impact.
- As far as government bonds in the western hemisphere, in particular, are concerned, “reflationing” should favour a cyclical yield increase. Inflation-indexed bonds and shorter durations, especially in the US Treasuries segment, have become more attractive.

**Euro bonds**

- At its December Council meeting, the European Central Bank (ECB) announced that it is extending its asset-purchase programme (“QE”) until the end of 2017, reducing the volume of monthly purchases to EUR 60 billion from April (see also our in-house QE Monitor). Despite initiating this “QE exit”, the ECB’s monetary policy remains extraordinarily loose.
- From an investor’s perspective, the power struggle on the Euro bond markets continues: while the negative interest rate policy is keeping yields on short-term debt securities anchored at low levels, the ongoing demand from the Euro system continues to exert downward pressure on yields at the longer end, too. However, investors should keep an eye on yield drivers such as increasing expectations of inflation, the Fed funds rate-hike cycle in the US and the expected medium-term cessation of quantitative easing – although there probably won’t be a sharp upsurge in yields.
- Bonds from the Eurozone periphery will continue to be supported by the ECB’s expansionary monetary policy, the accelerating economic recovery and (still moderate) consolidation of government finances, while negatively affected by higher political uncertainty.

**International bonds**

- In December 2016, the US Federal Reserve implemented its second rate hike, which had been postponed several times. The notion that fiscal policy will probably be more expansionary under “Trumponomics”, along with a more restrictive monetary policy, should further encourage the cyclical increase of US Treasury yields.
- In the medium term, the US yield curve should continue to flatten out, driven by the short end. Given that the US economy is already operating close to full employment and wages are rising, the US money market appears to have not yet adequately priced in the Fed’s rate-hike cycle within the context of the imminent change in the Administration. Even following the recent correction, US Treasuries are still too expensive from a fundamental perspective.
- In Great Britain, continuing the loose monetary policy following the Brexit vote should help to support the Gilt markets. At the same time, though, higher import-price inflation due to the exchange rate should not be ignored.
- There are no signs of pressure on Japan’s government bond yields, particularly as the central bank is anchoring yields on 10-year bonds at 0%.

**Emerging market bonds**

- Negative structural factors (e.g., high levels of debt, slower growth potential in numerous emerging markets and protectionist trends in the US) have clouded the secular outlook for EM government bonds.
- Moreover, expectations of less expansionary monetary policy in the US over the medium term are weighing on this asset class.
- In contrast, the economic environment has recently stabilized, albeit not across all countries, but rather driven by China, India, Russia and Brazil.

**Corporate bonds**

- Investment grade and high yield bonds are being pulled in two directions – between accommodating monetary policy on the one hand and a challenging macroeconomic environment (price trends) and fading support for valuations on the other.
- Risk premiums on US corporate bonds (incl. high yield) can still be classed as moderately attractive, based on current fundamental and market data.
- The “pure” credit risk and liquidity premiums (estimated on the basis of market-based implicit vs. historic cumulative default rates) indicate a largely neutral valuation of investment grade Euro corporate bonds and a more ambitious valuation of Euro high yield bonds.

**Currencies**

- Overall, the international exchange rate system is still under the influence of diverging monetary policies (e.g., the US rate hike vs. the continuation of low interest-rate policies in Europe and Japan) and commodity prices (e.g., appreciation of the Russian Rouble).
- The recent surge in the US Dollar reflects the expectation that the change in the US Administration will lead to an increase in cyclical differences and international interest-rate differentials. The prospect of a US economic policy that will focus more on domestic concerns is also putting pressure on emerging-market currencies, albeit with significant differences from region to region.
- In light of the massive current account deficit and likelihood of dwindling capital inflows, Pound Sterling is in danger of further drastic weakening.
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