Mid-Year Outlook: Be More Selective in the Second Half

July 2017

After a strong first half to 2017 for equities, the message for the remainder of the year is to look for returns more carefully in the second half. The "country factor" will be key: Investors can no longer rely on a rising tide of cyclical data to lift all boats.

Key takeaways of our mid-year 2017 outlook

The return of the "country factor"

For the past 12 months, a rising tide of strong synchronised cyclical data has been lifting most asset classes. We expect that to change: The EU and Japan should strengthen while the US, China and the UK slow or stall.

Europe is a bright spot

With many European corporations – particularly in the financial, utility and telecoms sectors – trading at large discounts to their US competitors, European equities may present a contrarian opportunity, after six years of near-chronic underperformance.

You must take risk for the potential to earn a return

Brexit, President Trump and geopolitics remain some of the key risks on the horizon. But with yields globally still repressed, and central banks looking to taper or even raise interest rates, traditional low-risk investments may not protect one's wealth.

At the mid-year point, US equities seem expensively valued in the face of dull economic growth and rising rates. By contrast, Europe looks attractive, as some of the key political risks fade, and the positive momentum surrounding President Emmanuel Macron's election provides new energy. Meanwhile, the UK continues to labour under a troubled political outlook driven by Brexit-related uncertainties. In Asia, a burgeoning middle class of enthusiastic consumers is extending the investment story beyond China.

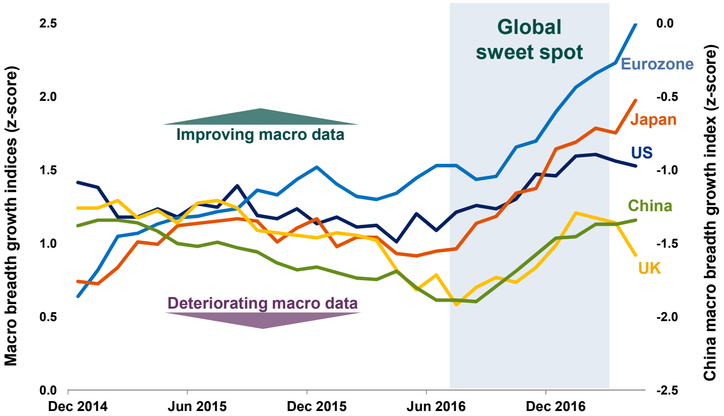
Geopolitical factors, including ongoing tensions with North Korea, continue to play on investor sentiment. In our 2017 Risk Monitor study, 59% of institutional investors say that recent political events have caused them to increase their focus on risk management. Overall, more than 9 in 10 are worried about event risk – up from three-quarters last year[1] – reinforcing the importance of taking an active approach to investment to keep portfolios on track as 2017 unfolds.

Allianz Global Investors

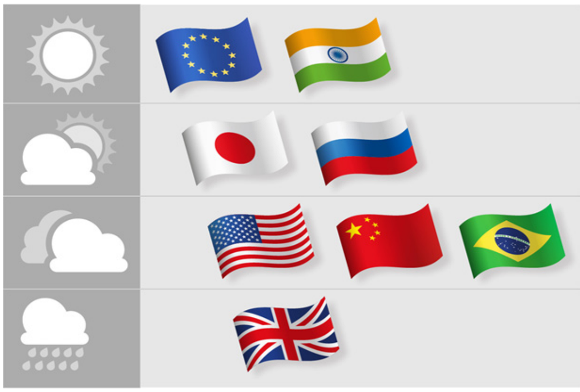
What to expect in the second half

The global economy has been in a cyclical "sweet spot" for more than a year. But now, actively differentiating between regions and countries will become more important for investors.

Following a global cyclical sweet spot...



...regional/country differentiation will become more important for investors



Cyclical economic backdrop in H2/2017

Note: Macro breadth growth indices track the direction of important economic sentiment and activity data on a monthly basis.
Source: Thomson Reuters Datastream, Bloomberg, AllianzGI Global Capital Markets & Thematic Research, as of June 2017. The above graphs are used for illustrative purposes; they are not a recommendation nor investment advice to buy or sell any shares of securities. Past performance is not a reliable indicator of future results.

Global macroeconomic view

- The steady flow of macroeconomic news – not monetary policy or political events – has been the primary cyclical driver of financial markets in recent years.
- Global growth continues at around 3%, and we expect moderately higher core inflation over the medium term.
- While the economic landscape remains solid globally, it is expected to become somewhat patchier over the months ahead. Country-specific risk factors will become more important to asset-allocation strategies.
- Central banks in the US, the euro zone and the UK have embarked on a path towards normalization – or are, at least, talking about it. Fading bond reinvestments by the Fed (starting September/October 2017), proper tapering by the European Central Bank (from early 2018 on) and an already visible slowdown in Japanese government bond purchases by the Bank of Japan is expected to culminate in a global central bank "peak liquidity" during the first half of 2018.
- Apart from ambitious valuations in most asset classes, signs of market complacency have grown. While we remain risk-on for cyclical reasons for the time being, we are fully aware that the risks for a setback have increased.

Mid-year 2017 outlook by region

US: Financial markets continue to ignore the risk of further rate increases by the Federal Reserve; we expect to see **more hikes than the market has priced in**. This should support lower prices and higher long-term bond yields, despite the recent rally in Treasuries. This year the Russell 1000 Growth Index has outperformed the Russell 1000 Value Index by **8 percentage points** (to 3 July), led by the strong tech rally. This is the widest such differential in a decade and supports a case for value equities.

UK: The **uncertainty of Brexit** was made worse with the UK election in June. We don't expect a deal with the EU to be reached by 2019; transition arrangements will likely be necessary. While the British pound sterling has strengthened against the US dollar in 2017, it is still **roughly 12% weaker** than before last year's Brexit vote and may weaken further on the back of UK economic uncertainty.

Europe: The euro zone remains in a sweet spot of a self-sustained recovery with **growth rates of 2%** or more. **Yields near 0%** increase the risks for government bonds while lowering return expectations, and may soon force a "great rotation" from bonds to equities. The likely reaffirmation of Chancellor Angela Merkel in Germany's **September 2017** elections should result in a pro-EU outcome, and should lead to a constructive "**Merkron**" alliance with French President Emmanuel Macron. Italy's elections, though, in **spring 2018** could yet produce an anti-EU result.

China: China's GDP growth is set to stabilize at **above 6.5%** for 2017. MSCI's decision to **include China A-shares** in its emerging market index is another milestone in the liberalization of Chinese stock markets. Corporate **earnings growth has reaccelerated** since 3Q 2016. Chinese regulators started the **financial deleveraging** process by raising repo rates and reining in shadow banking. The new **Bond Connect** initiative will help foreign investors trade in China's debt markets for the first time without onshore accounts.

Investment implications

Our message remains: "If you take no risk, you will earn no return". In today's markets in particular, that means using active management to identify opportunities for income and capital gain, and to control the periods of volatility that may arise.

Europe looks undervalued

European corporations tend to be more long-term focused than their US counterparts, and haven't re-levered in the same way in recent years. They are positioned to invest to improve innovation and productivity. This may translate into annual returns in the 8-10% range in the coming years. Half of this may be dividend income that tends to be less volatile.

Invest in China's rebalancing for the long term

Global investors are heavily underweight China. While this reflects the current stabilizing growth picture, equities have reasonable valuations and the longer-term outlook is positive. While leverage of the corporate sector is a reason for concern, we expect Chinese policymakers to manage potential adverse developments.

Look for low-P/E names in the US

US earnings growth has picked up after several dull years. Given this resurgence and recent lagging performance, investors should focus on value equities. Inexpensive, low-P/E stocks can be beneficial to portfolios when profit growth broadens and becomes more abundant.

Watch for a UK slowdown

The UK seems set to endure a significant period of economic uncertainty and weakness now, which may weaken sterling further. Consider taking profits on highly priced overseas earners and look to reinvest into high-quality domestic earners if an economic slowdown creates opportunities.

Capitalize on disruption

New developments in computing centred around deep learning and artificial intelligence are enabling machines to see, hear, and navigate environments in ways that were not previously possible.

Look to dividends and corporate bonds for income

With persistent low rates, the hunt for income continues: Investors should find attractive levels of yield from emerging market debt and European equities.

Keep an eye on currencies

Both the euro and sterling are undervalued against the US dollar. We expect the euro to strengthen from here, while sterling may have further to fall thanks to UK economic weakness and Brexit-related uncertainty. All eyes will be on how global monetary policy plays out in the remainder of the year.

[1] Risk Monitor 2017, conducted for Allianz Global Investors by CoreData. Based on a survey of more than 750 institutional investors in April-June 2017.