September 2011

Capital Markets Monthly

Information for fund distributors and institutional investors. Not for circulation to private investors.

There are limits to growth …

… declared the Club of Rome at the beginning of the 1970s. Their analysis could hardly have been more off target. But there is once again talk of limits to growth, though this has to do with the state of the economy and thus takes a much shorter view of the matter. However, the data in recent weeks have been unsatisfactory: virtually every economic indicator has come in weaker, lagging behind even prevailing moderate expectations. In addition, signs of nervousness remain, as can be seen, for example, in the renewed rise of risk premiums on US mortgage bonds. The iTraxx Europe for the financial sector has hit new highs for a crisis, exceeding even the peak reached during the crisis in the first quarter of 2008. At the same time, CDS premiums on German government bonds continue to rise significantly[1]. This is a warning signal regarding the market's expectations on creditworthiness. The EU debt crisis demands its tribute.

It is true that risks have risen, but it remains highly likely that this is just a temporary phase and does not signal an economic crash: the strong growth of the emerging markets and loose interest-rate policies with historically low real interest rates are two reasons to take this view; in addition, the falling oil price is reducing pressure, and solid cash flows and low corporate debt ratios continue to support investment. The current drop in the economic sentiment indicators may be nothing more than a reaction to the strong correction on the equity markets, and it seems to exaggerate the actual economic slowdown. The "hard" activity data, such as new orders, do not reflect the rising fear of recession. The "surprise indicators" for the US and Japan have also begun to turn around. These reflect the discrepancy between actual developments and analysts' expectations. The limits to growth are likely to be reached more quickly as the industrial countries reduce their debt, but growth can still be expected.

Wishing you real growth in returns,

Hans-Jörg Naumer

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Sentiment indicators may well be overstating the economic slowdown.

as of 29.08.11

Equity Indices	Status
FTSE 100	5,256
DAX	5,670
Euro Stoxx 50	2,253
S&P 500	1,210
Nasdaq	2,562
Nikkei 225	8,851
Hang Seng	19,865
KOSPI	1,830
Bovespa	54,861
FX	**Status**
USD/EUR	1,449

Interest Rates %		
USA	3 Months	0.32
	2 Years	0.20
	10 Years	2.19
Euroland	3 Months	1.54
	2 Years	0.64
	10 Years	2.13
Japan	3 Months	0.34
	2 Years	0.13
	10 Years	1.05
Raw Materials		
Oil (Brent, USD/Barrel)		112.6

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[1] "CDS" stands for "credit default swaps." These instruments reflect the hedging costs of their underlying securities. "iTraxx" represents a family of indices that reflects the development of the CDS markets.

Allianz Global Investors

Markets in Detail

Tactical Allocation, Equities & Bonds

- In terms of price/earnings ratios, the equity markets are already anticipating an economic decline and a drop in earnings. Equities now look distinctly cheap relative to government bonds, although there are regional variations here, too.
- Concerns about the economy and the (EU) debt crisis dominate the picture and are apparently also beginning to have an effect on real economic sentiment indicators. This widespread pessimism provides room for positive surprises.
- The medium- to longer-term outlook for equities is positive. However, given the current uncertainties, not least about progress in resolving the debt crisis, it is advisable to retain a neutral weighting between equities and bonds.

The arrows are indicating the advised weighting of segments inside the individual asset classes (Regions, Sectors, Bonds).

Germany ↗

- The latest gross domestic product (GDP) figures have been influenced by special factors that underscore the growth.
- The robust order books, in particular, highlight the fact that the economy has greater momentum than the most recent GDP figures would indicate.
- The price/earnings ratios based on expected earnings for the next 12 months appear to have already priced in a significant drop in earnings. At the same time, the signs are good that the expected decline will not take place.
- The price/book ratio is approaching one.

Europe →

- In the Eurozone, continued robust growth can be expected in the core countries in spite of a slight cooling, while the peripheral countries remain a potential negative factor.
- The debt crisis is not over yet, but the political solidarity seems to have remained stable, which makes a "hard" default by individual countries unlikely.
- In terms of valuation, European equities have an advantage over US equities, but the revision momentum in earnings outlooks has turned more positive again.

US →

- The decline in the most recent economic sentiment indicators may be little more than a reaction to the strong correction on the equity markets, and it seems to exaggerate the actual economic slowdown.
- The strong industrial and automobile production figures in the US in July 2011 do not point to a renewed recession.
- In spite of their higher valuations, US equities should not be underweighted, primarily because of the defensive character of the US equity market.

Japan →

- Japanese economic data point to an exemplary recovery of the economy from the devastating spring earthquake.
- The reconstruction activities required should provide additional support to the Japanese economy.
- However, the strength of the Yen is likely to continue to be a drag on the performance of export-oriented companies.

Emerging Markets →

- Following the correction, valuations in the emerging markets seem to be at reasonable levels.
- From a global point of view, the emerging markets will likely remain the mainstay of the world economy in the coming years in spite of the current drop in economic momentum.
- Because of their lower level of debt and higher key interest rates, these countries have plenty of room for monetary and fiscal policy support measures in the event of a significant economic slowdown.
- However, the economic picture in the various countries is extremely mixed. In comparison with the other emerging market regions, Eastern Europe is relatively weak and more susceptible to shocks. The growth in productivity is lower, while the level of debt is higher.

China ↗

- The trend towards slightly more moderate growth rates in the Chinese economy is likely to continue in the second half of the year. The country's real gross domestic product is expected to increase by 9.3% for the whole of 2011 after rising 9.6% in the first six months. The purchasing managers index has fallen, but remains in the expansive zone.
- China continues to face the fortunate problem of having to apply the monetary brakes to growth that is too strong for a return to greater price stability.
- However, the slowing growth in credit makes it likely that the pressure to take monetary action will drop in the coming months.

Sectors

- After the most recent price correction, more emphasis should be placed on cyclical sectors in sector allocation. Commodity and energy stocks seem to be particularly interesting. Higher commodity costs mean that these are the sectors with the most scope to pass them on to customers and that are expected to continue to profit from the recovery in the growth countries.
- Since concerns about the economy, which had been a particular drag on these sectors, appear to have been generally exaggerated, these sectors are likely to have the best chance of recovery in the event of an economic revival.

Investment Theme: Dividends

- The low-interest rate environment with simultaneous low equity weightings is expected to put institutional investors under particular pressure to seek alternatives to the bond segment.
- There is simply no way around equities – particularly dividend strategies, which offer the advantage of higher distributions.
- As a study by Allianz Global Investors Capital of the broad US equity market has shown, equities with steady or increasing dividend distributions have historically outperformed in an environment of higher inflation.
- The Standard & Poor's 500 also shows that dividends, particularly in periods like the 1930s and the first decade of this millennium, made up most of the losses caused by price fluctuations as the respective decade went on.

Euro Bonds ↘

- Interest rate cuts of up to 0.5% through the middle of 2012 have been priced into the money market since the most recent "flight to quality". The more the current debt crisis calms down, the stronger the likelihood that the money market will cease to reflect such expectations.
- Longer-term real returns are near their historic lows. The level of real interest rates has thus become increasingly decoupled from the macroeconomic environment.
- The market support measures by central banks and continued loose monetary policies make it likely that yields on longer maturities may remain below the expected interest rate, given actual growth and price developments. However, the interest rate risk persists, which shifts the focus to shorter- and medium-term maturities.

International Bonds ↘

- With its clear focus on the economy and the labour market, while simultaneously ignoring inflation risks, the US Federal Reserve (Fed) has continued to shift the weighting of its dual targets: away from price stability, toward economic management.
- Negative real returns combined with monetary reflationary policies provide fertile ground for "financial repression". Real interest rates seemingly remain low; inflation is eroding investors' purchasing power.

Emerging Market Bonds ↗

- The emerging markets are considerably further along in their cycle of interest-rate hikes than the industrialised countries. Yields on emerging market bonds thus now appear more attractive than the historically low yields in more mature markets.
- While industrialised countries are struggling with rising public debt, many emerging markets are in a position to lower their level of debt in relation to their gross domestic product.

Corporate Bonds ↗

- Solid liquidity reserves and the ongoing trend in the coming year of conservative corporate financial policy should continue to provide a positive environment for corporate bonds.
- The trend towards lower debt remains in place in the financial sector as well as in other sectors.
- While mergers and acquisitions (M&A) activity and shareholder-friendly attitudes are expected to gain in significance, they should not act as a drag on the entire segment. However, in the coming months, economic data are expected to have a negative effect.
- Corporate bonds will likely remain well supported in terms of valuations.
- The segment is being supported by the drop in implied default rates.

Currencies

- A neutral Euro position against the US Dollar is recommended: while the Fed's promise to keep interest rates near zero until 2013 has made the US Dollar less attractive from an interest rate point of view, the Euro continues to suffer from the effects of the debt crisis.
- The Yen is overvalued. The situation is not expected to normalise for quite some time, as the low interest rate policy of the Fed is not likely to shift the interest rate difference to a significant degree in favour of the US Dollar. In addition, the US should be considered every bit as likely as Japan to be willing to undertake further quantitative easing.
- Structurally, the currencies of the emerging countries are expected to appreciate against the US-Dollar, Euro and Yen, primarily as a result of gains in productivity and high growth. In the short term, if risk aversion remains high, the risk of the withdrawal of the capital invested in the emerging markets should be taken into account.

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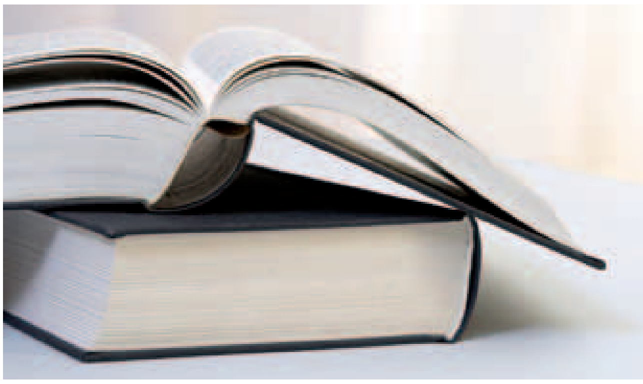

Imprint

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