November 2011

Capital Markets Monthly

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

The End of Triple-A

If you think about how ratings have developed in the industrial countries over the past few months, you have to ask yourself the question: Is the end of triple-A near? It is a paradoxical situation. While investors are increasingly looking for "safety", top-rated government bonds are becoming increasingly scarce. The United States has already lost triple-A status. Now France is also under close review by rating agency Moody's. If France loses its top rating, then Germany, the United Kingdom and Canada will be the only countries among the seven largest industrial nations (G7) to retain their AAA rating. At the same time, while the credit ratings of the industrial countries have fallen or at best remained steady since the onset of the debt crisis, the credit ratings of the growth countries have bucked this trend and are rising.

To regain the confidence of markets and lenders, structural reforms aimed at achieving more sustainable debt reduction and the stabilisation of financial markets must be implemented. Important steps in this direction were decided at a meeting of Eurozone government leaders in late October:

– Greek government bonds are being traded in on a voluntary basis for new bonds that will receive a partial guarantee from the EFSF. This is expected to result in a 50% haircut, making the debt burden seem to be somewhat more viable, although the debt ratio in Greece is still likely to be around 120% in 2020 (currently 170%).
– With its funding raised to more than EUR 1 trillion, the EU bailout fund EFSF is being further strengthened in order to avoid possible contagion risks within the EU countries.

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Credit ratings are slipping in the industrial countries and climbing in the growth countries.

As of 28/10/2011

Equity Indices	**Status**
FTSE 100	5,652
DAX	6,346
Euro Stoxx 50	2,430
S&P 500	1,285
Nasdaq	2,737
Nikkei 225	8,988
Hang Seng	19,865
KOSPI	1,929
Bovespa	59,513
FX	**Status**
USD/EUR	1.416

Interest Rates %		
USA	3 Months	0.43
	2 Years	0.32
	10 Years	2.39
Euroland	3 Months	1.59
	2 Years	0.60
	10 Years	2.16
Japan	3 Months	0.34
	2 Years	0.14
	10 Years	1.01
Raw Materials		
Oil (Brent, USD/Barrel)		112.4

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– The recapitalisation of banks is being promoted by, for example, requiring a core capital ratio for banks of 9% by the end of June 2012.

Despite these resolutions, volatility in the markets is expected to remain high in view of the uncertain outcome of the possible Greek referendum. As a result, fundamental factors in the corporate sector are now being largely ignored. With a view to the reporting season in the third quarter – over 70% of US companies have exceeded expectations – corporates have fared relatively well. And finally, valuations seem to have already priced in quite a bit of pessimism. Price/earnings ratios are in the single digits in many regions and dividend yields in Europe are twice as high as yields on German government bonds.

Wishing us all triple-A performance,

Dennis Nacken

Allianz Global Investors

Markets in Detail

Tactical Allocation Equities & Bonds

- Despite these resolutions, volatility in the markets is expected to remain high in view of the uncertain outcome of the Greek referendum. As a result, fundamental factors are now being largely ignored.
- This is unfortunate because the latest data points offer reason for hope: First, the most recent economic data from the US, such as retail sales and industrial production, have been better than expected.
- In addition, based on the reporting season so far, companies are doing quite well. The valuations seem correspondingly attractive.
- The political uncertainty premium and therefore market volatility are expected to remain high, making an underweight in equities advisable. Long-term investors should open new positions on the equity market –only gradually.

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

Germany ↗

- Many of the falling leading indicators are signalling a further weakening of the economy.
- However, with its recent solid levels of exports, better-than-expected industrial production and low unemployment, the prospect of a recession in Germany seems extremely distant.
- At the same time, market participants seem to have already priced in a fall in profits. As a result, German companies are now valued at near the book value of their equity capital.

Europe →

- In the Eurozone – this applies particularly to the periphery states – and in the United Kingdom, fiscal consolidation pressures and the delayed implementation of reforms are taking their toll.
- This is why leading indicators continue to slide downwards in Europe. At 47 index points, they are in the contraction zone, meaning that the risk of a recession developing in 2012 has increased in some European countries.
- However, European equities, which are trading at a discount of more than 30% compared to their 10-year average (based on price/book ratios), seem to be relatively well supported.

US →

- Many real economic indicators for the US have provided positive surprises recently. Both industrial production and retail figures were up against the previous month in September.
- While the US reporting season turned out better than expected for the third quarter of 2011, uncertainty about the direction the economy will take could mean companies will be reluctant to invest.
- In spite of their higher valuations, US equities should not be underweighted, because thanks to its defensive character, the market should remain in the focus of investors.

Japan →

- Japan has seen significant recovery since the earthquake, although economic data from that country have recently been slightly weaker.
- The strength of the Yen is, however, likely to continue to be a drag on the performance of export-oriented companies. Yet over the medium term, the Yen will probably lose strength.
- The Japanese capital market could be hit hard by a global economic downturn, since the country's equity market is strongly cyclical with a high percentage of exports. So in spite of the low price/book ratio of Japanese equities, neutral positioning is recommended here.

Emerging Markets →

- With falling prime rates in some emerging countries like Brazil and Indonesia, monetary measures have already been taken to strengthen their domestic markets in the wake of the slowdown in economic growth.
- In contrast with most of the industrialised states, these countries have plenty of room for monetary and fiscal policy support measures because of their lower level of debt and higher key interest rates.
- In the wake of the underperformance of emerging market equities (MSCI Emerging Markets compared to MSCI World) in the last three months, valuations have become noticeably cheaper.

China ↗

- Contrary to fears, China's economy continues to be very robust: Gross domestic product rose 9.1% in the third quarter, and industrial production and retail sales were up 13.8% and 17.7% respectively over the prior year.
- Recent declines in food and energy prices indicate that pressure on consumer prices is easing. There have also been recent declines in prices on the housing market.

- The cycle of interest-rate increases appears to be drawing to a close, particularly since credit growth in the Middle Kingdom has also slowed considerably.
- These are all factors that could give the Chinese equity market an additional boost.

Sectors

- Even if pressures continue to ease, the defensive orientation of the portfolio should be maintained. Pharmaceuticals and telecoms should remain in favour, not just because of their attractive dividend yields.
- In addition to a sector allocation, it is advisable to invest in shares of high-quality companies with long-term growth strategies and high dividend yields.

Investment Theme: Demography

- On 31 October 2011, the world greeted its 7 billionth citizen. Meanwhile, life expectancy is rising and the world population will grow by an estimated 30% by 2050.
- Properly understood, the global trend demography is an investment opportunity. While India and some African countries should benefit from the demographic dividend because of their positive population growth and young population structure, the population decline expected to set in soon in the industrialised countries in particular will inhibit growth there.
- Investment considerations derived from the megatrend demography mean that investors should invest globally and focus on industries that benefit from demographic change.

Euro Bonds ↘

- The political will for a timely, sustainable solution to the crisis has led to a decline in risk aversion and rising yields on government bonds.
- Simultaneously, the risk premiums on French vs. German government bonds increased more than 100 basis points in late October because of the risk of France losing its triple-A rating.
- Although the chances of a rate cut in coming months have risen in the wake of the economic downturn, the ECB will probably take this action only after exhausting other non-traditional instruments.
- Duration should continue to be shortened because of ambitious bond valuations in the core countries.

International Bonds ↘

- Declining recession fears as a result of better than expected economic data and growing expectations of a more sustainable solution to the Eurozone fiscal crisis led to an increase in yields on US government bonds last month.
- Negative real returns combined with monetary reflationary policies provide fertile ground for "financial repression". Real interest rates remain low; inflation is eroding investors' purchasing power.
- Due to the extreme valuation and the normalisation of the market expected over the medium-term, bonds with long maturities, in particular, appear unattractive.

Emerging Market Bonds ↗

- Some countries such as Brazil and Indonesia have already made initial interest-rate cuts. In countries like China and India, the central banks' cycles of interest-rate increases also seem to have peaked.
- Simultaneously, risk premiums have declined in this segment on generally positive economic data as well as decreasing risk aversion in the last month.
- Overall, yields on emerging market bonds thus appear more attractive now than the historically low yields in more mature markets.

Corporate Bonds ↗

- Corporate bonds reacted to the decline in risk aversion in October by significantly narrowing spreads.
- Low default rates, solid liquidity reserves and the ongoing trend in the coming year of conservative corporate financial policy should continue to provide support (for now). In contrast, the negative rating trend is acting as a drag.
- On the sector side, defensive sectors such as pharmaceuticals and consumer-related sectors continue to be good investments, while construction-related securities and automobiles appear less attractive.

Currencies

- Hopes for bold policy initiatives in the Euro debt crisis pushed the Euro up ahead of the EU summit.
- Nevertheless, the recent package of measures has not moved the EU debt crisis off the table. With the outcome of the possible Greek referendum at the beginning of 2012 unclear, the Euro is likely to trend weaker again until then.
- Instead, it would be better to overweight structurally stronger currencies, such as the Australian Dollar or Chinese Renminbi.

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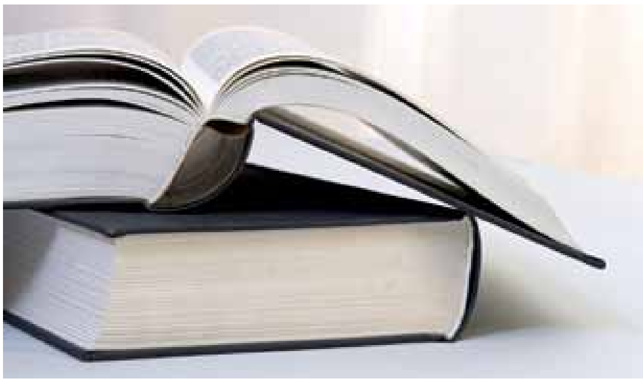

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