Allianz Global Investors

JULY 2024

House View Q3 2024

Act on volatility

This document reflects the views of Allianz Global Investor’s investment leadership going into Q3 2024. Past performance does not predict future returns.

What's included in our House View

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Our view of global markets

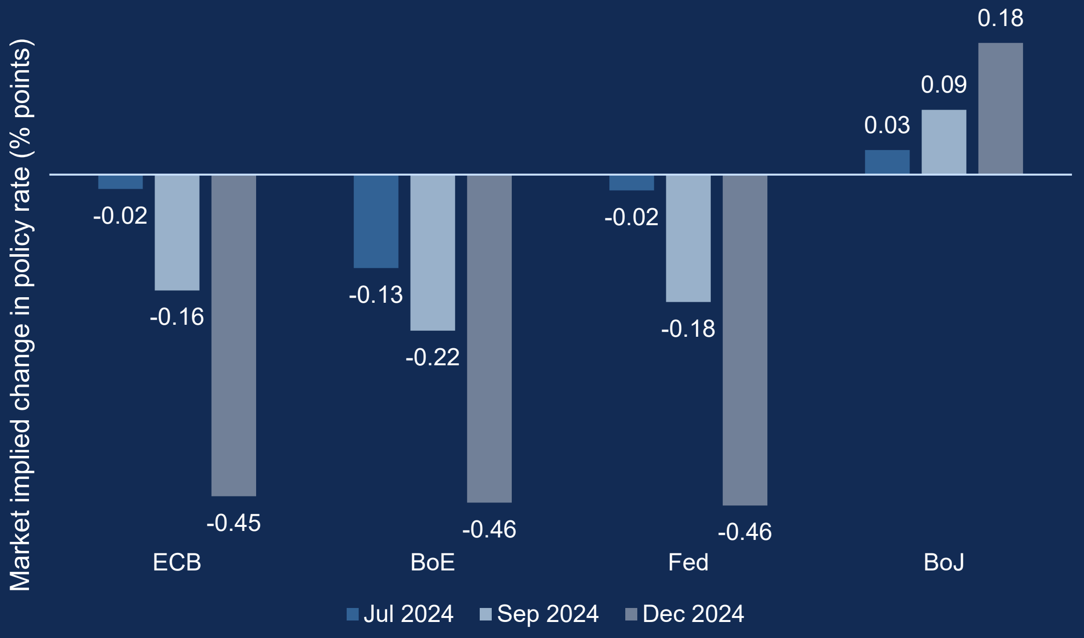
Take the positives of a soft landing

- **Markets are on divergent paths.** A spike in political risk – with elections in France and the UK in Q3 and the US poll looming in November – adds to a theme of regional differentiation.
- Data increasingly points to a **regional shift in growth expectations.** We think this **desynchronisation** may generate opportunities across economies and asset classes.
- Our conviction strengthens around a **soft landing in the US and global economies, where growth slows – and inflation comes down – without risking a recession.** This scenario will likely be positive for equities, which are set to benefit from positive earnings growth. **But watch for volatility around market and political news.**
- **Markets expect only 40bps of aggregate global rate cuts this year** – down from three times that figure in early January. Different growth and inflation backdrops mean central banks have varying leeway to adjust their policy stance.
- **A rate cut in the US is now likely in September, in our view.** We think markets are too cautious on further cuts, and investors should use this disconnect to strengthen positions in yield curve steepening and duration.

CHART OF THE QUARTER

That desynching feeling…

The European Central Bank (ECB) cut rates in June and markets anticipate the US Federal Reserve (Fed) and Bank of England (BoE) will follow – at varying speeds. The Bank of Japan (BoJ) is expected to move the other way.



Source: Allianz Global Investors Global Economics & Strategy, Bloomberg. Data as at 18 June 2024

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Our view of global markets

Stay agile while being wary of political risks

- **The overall economic and market environment remains supportive of equities and bonds**. A soft landing with lower inflation risk allows central banks to cut rates. In addition, company margins remain solid.
- **Political risks are acute.** France's elections may spark caution from European investors, at least in the near term. November's US elections could mean the re-election of Donald Trump whose **policies may have far-reaching consequences, including on tariffs** where fault lines within Europe are already evident.
- Progress has been made on inflation, but the last mile is often the hardest. While not our core scenario, we recognise **the risks of a "no landing"** – where the economy continues to run hot – which could be negative for bonds (and ultimately possibly for equities too).
- **But this is not a time to sit on the sidelines.** US inflation is approaching target for the first time in two and a half years and improved Fed guidance allows the market focus to switch to politics and growth.
- Even against the backdrop of overall slower global growth, an **orderly rotation of growth expectations from region to region** may be a healthy and stabilising development that supports the extension of the current expansion.

Consider the following

- **Equities:** We are positive about the enablers of AI adoption (eg, data centres, cloud providers) and green transition. Select European small caps stand out for their high-quality balance sheets. We think the UK looks cheap and politically benign.
- **Asia:** Japan benefits from improving corporate governance. Investors might use volatility to target the more innovative and higher-yielding parts of China markets. We also like China government bonds.
- **Fixed income:** Picking up the divergence theme, we prefer yield curve and cross-market relative value including curve steepeners in the US and euro area (eg, Germany). We are positive on UK rates given underlying fundamentals and political outlook.

→ See pages 10-14 for more details of our asset class convictions.

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Different growth and inflation backdrops globally will give central banks varying leeway to adjust their policy stance. This environment could make for fertile hunting ground for active investors – but watch for political risk.

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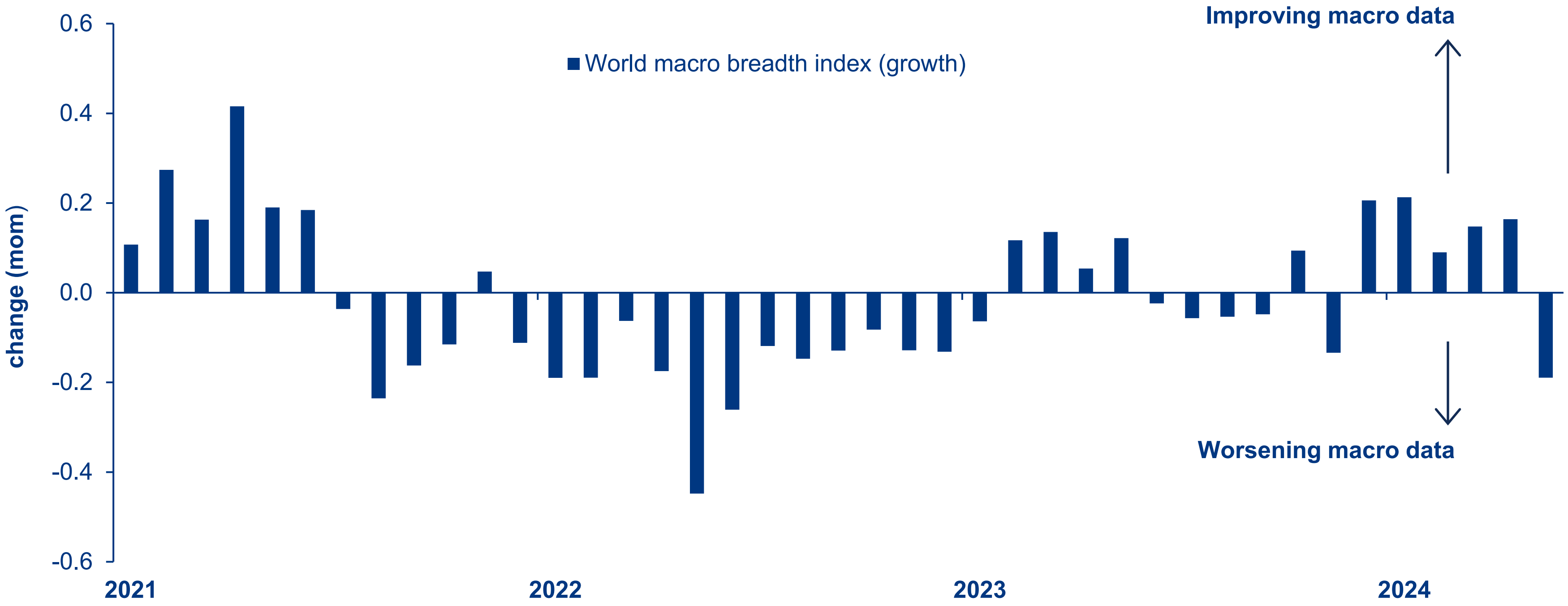
Economic growth: healthy normalisation

Our Macro Breadth Growth Index[1], measuring macroeconomic data from around the world, has fallen for the first time in six months:

- Underlining a loss of global momentum, macro data deteriorated across most of the developed world in May, most markedly in the US. We think this points to a healthy normalisation of the global economy rather than a more severe weakness.
- The fall in US growth data was the steepest in four years. The euro zone and Sweden were the notable exceptions as growth persisted.
- Chinese data dipped for the first time in nine months, while other emerging markets suffered similar setbacks. The data reinforces our view that a rebound in manufacturing has yet to take hold.



1) Our proprietary Macro Breadth Growth Index tracks the direction of 354 global, regional and country macroeconomic data on a monthly basis. The monthly change of the index is scaled from -1 to 1, with a value of 1 (-1) implying an increase (decrease) of all underlying indicators. By focusing on the direction rather than the magnitude of change, the indexes enable the evaluation of the broadness of underlying macro trends and are less prone to any historical revisions of the underlying data. Source: Allianz Global Investors Global Economics & Strategy, Bloomberg, Refinitiv (data as at 31 May 2024).

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In short: key data by region

US

The US economy is within touching distance of a soft landing as momentum starts to fade. Productivity and labour supply are set to falter in the coming quarters, but we are certainly not overly gloomy: we think the US economy will remain a standout performer in the developed world, with only a minimal chance of recession. **With inflation lingering, we now expect the Fed to begin lowering rates in September, delivering 25-50bps in cuts in 2024.**

Europe

Tentative signs of recovery have boosted the outlook for the euro zone economy after a period of stagnating growth. Lower interest rates should provide a further boost: **the ECB cut by 25bps in June, and we see room for one or even two more cuts of the same size by year end.** As inflation pressures in the UK ease, we think the Bank of England may start to lower rates in August.

Asia

China's manufacturing and industrial clout should help the economy reach its growth target for 2024 of around 5% – even as property market challenges persist. Japan's economy has picked up incrementally in recent months and we expect further steps by the central bank to raise its policy rate and scale back its bond-buying programme after abandoning its long-held negative interest rate policy.

[1] Allianz Global Investors 2024 forecasts are broadly in line with consensus, apart from GDP growth in Germany, the euro zone and the UK, where we're more optimistic. 2023 forecasts shown represent Bloomberg consensus. Data as at 31 May 2024.

Economic growth: the outlook for 2024 has improved in recent months
Real GDP, year-on-year %

	2023	2024 Bloomberg consensus[1]
World	3.0	3.0
US	2.5	2.4
Euro zone	0.5	0.7
Germany	-0.1	0.2
UK	0.3	0.6
Japan	1.9	0.4
China	5.2	4.9

Inflation: price pressures are easing – gradually
Inflation, year-on-year %

	2023	2024 Bloomberg consensus[1]
World	6.0	4.4
US	4.1	3.2
Euro zone	5.4	2.4
Germany	6.0	2.5
UK	7.3	2.5
Japan	3.3	2.4
China	0.2	0.7

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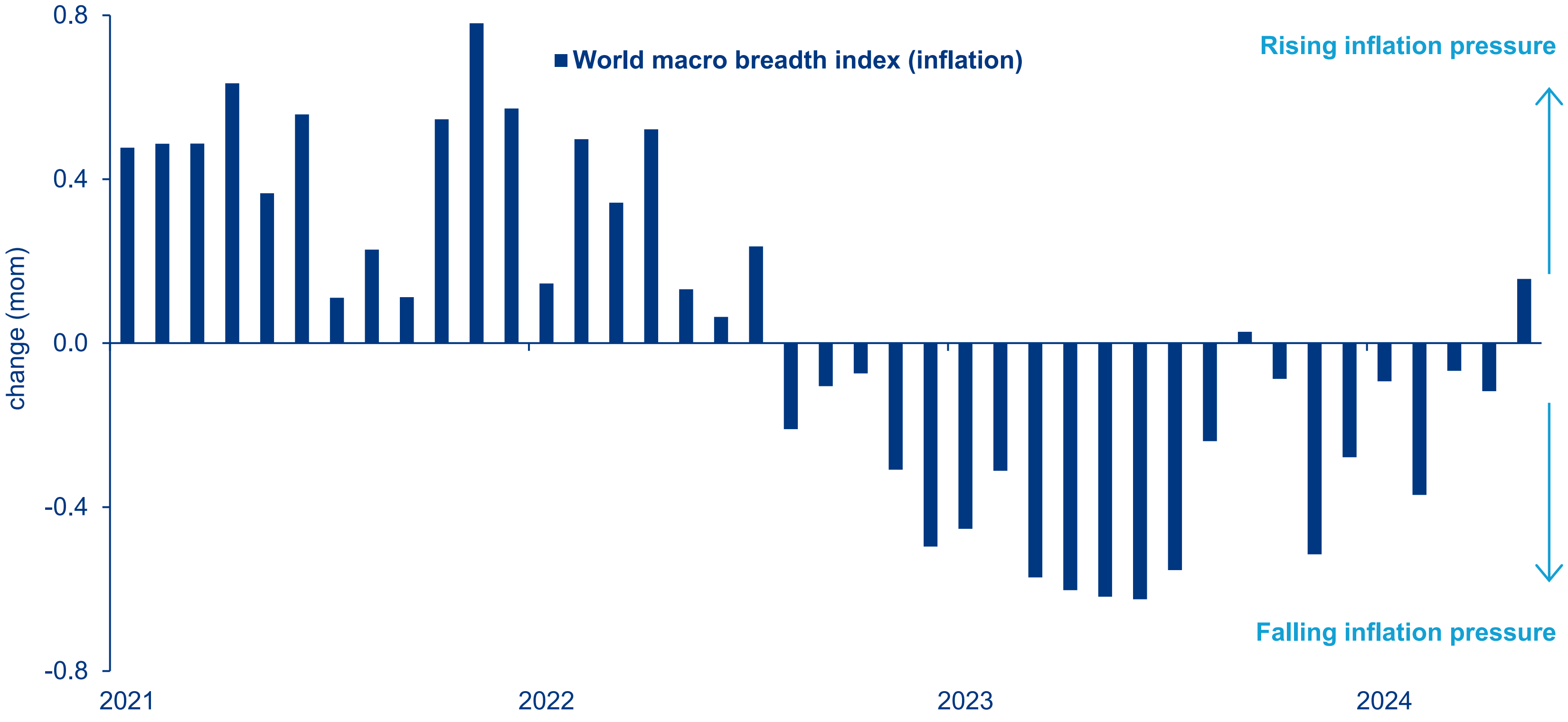
Inflation: core pressures linger

Inflationary forces have not yet been tamed. Our Macro Breadth Inflation Index[2] shows them jumping by the largest margin in two years:

- Central banks have fought inflation for more than two years. Despite significant progress, our data is a reminder that the battle is not yet won. Stubborn inflation was a factor in the Fed's decision to delay rate cuts beyond July when we (and markets) had originally expected a cut.
- Global readings point to a halt in disinflation since the start of 2024 and stickiness in core services inflation (including everything from medical care services to motor insurance). We are waiting to see if this is merely a bump in the road towards continued disinflation.
- Over the medium term, we see global core inflation settling at rates above central banks' targets. Factors include the regionalisation of supply chains, decarbonisation and ageing populations.



[2] Our proprietary Macro Breadth Inflation Index tracks the direction of 354 global, regional and country macroeconomic data on a monthly basis. The monthly change of the index is scaled from -1 to 1, with a value of 1 (-1) implying an increase (decrease) of all underlying indicators. By focusing on the direction rather than the magnitude of change, the indexes enable the evaluation of the broadness of underlying macro trends and are less prone to any historical revisions of the underlying data. Source: Allianz Global Investors Global Economics & Strategy, Bloomberg, Refinitiv (data as at 31 May 2024).

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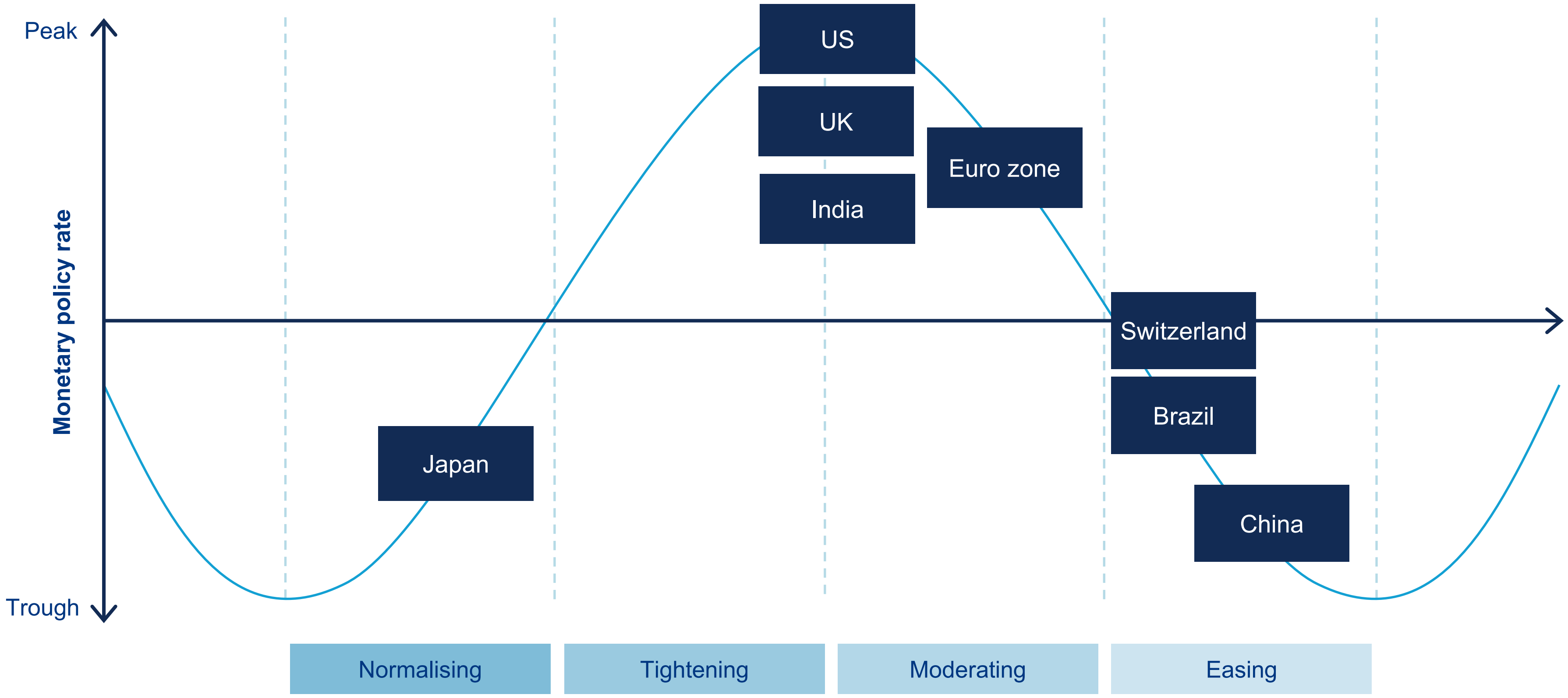
Interest rates: ECB cuts rates for the first time in five years

The Fed and BoE are expected to follow suit – but we do not expect a rapid cycle of rate cuts

- As inflation falls around the world – albeit unevenly – more central banks have begun lowering rates. May was the seventh month in a row that the number of central banks in our universe that cut rates exceeded those that hiked. The Swiss National Bank, ECB and Bank of Canada were among the latest.
- We expect the US and the UK to be next. Japan remains the outlier for now.
- But we do not foresee a sudden downward spiral in rates. We expect policy makers to cut at different speeds and, overall, see rates staying high for longer over the next two years as inflation persists.



Source: Allianz Global Investors Global Economics & Strategy, Bloomberg (data as at 24 June 2024). We track the monetary policy cycles of up to 37 central banks depending on the respective analysis. The chart represents a sample of the banks in our universe.

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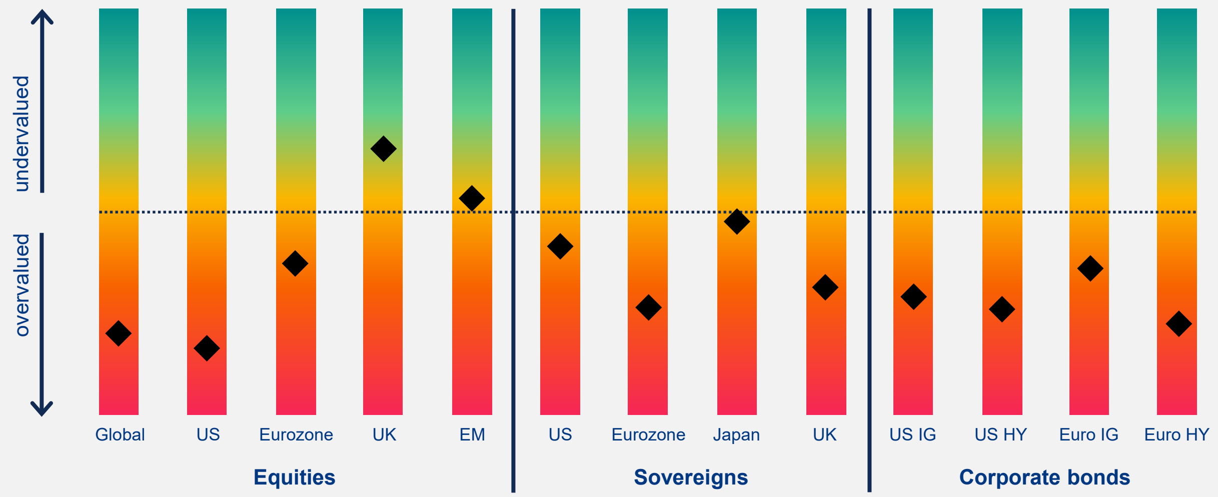
View on valuations: focus on select areas

More buying opportunities may emerge

- We think many assets are at relatively lofty valuations by historical standards. But we see select opportunities and think more may emerge as major global economies and assets increasingly move at a different pace.
- UK and emerging market equities stand out as undervalued in an equities universe where the premium for investing in US and global stocks currently looks significant. Cooling economic growth may create further buying opportunities.
- US and Japan sovereign bonds are not far from fair value. We see the potential for other sovereign fixed income valuations to adjust as elections and desynchronised interest rate moves raise the possibility of market volatility.

End of May 2024



Calculations by our Economics & Strategy team. Valuation score = current score relative to historical distribution of scores. Equity valuation based on Shiller-PE, price/book, 12-month forward PE. Sovereign valuation based on 10-year real interest rate and term premium. Corporate bond valuation based on implicit default probability and respective sovereign valuation. Source: Allianz Global Investors Global Economics & Strategy, Bloomberg, Datastream (data as at 31 May 2024). Past performance is not an indicator of future results. The statements contained herein may include statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. We assume no obligation to update any forward-looking statement. Valuations are based on the latest assumptions about the economic growth outlook.

Asset class convictions: Equities

Political vs economic cycles: volatility makes quality essential

Going into 2024, it was clear that this would be a major year for elections, with around 50% of the world population going to the polls. But the year continues to throw up political curveballs such as the snap election in France. Geopolitics have become omnipresent for markets.

This is against the backdrop of a more benign macroeconomic environment. The recent meeting of the Fed increased visibility on monetary policy. The takeaway for investors: while the economic cycle is crucial, greater clarity on the unfolding environment means the focus can shift to the political cycle. This message is coming loudest from the US, where the election looms in November and the re-election of Donald Trump could have global implications.

The interplay of the political cycle vs. the economic cycle is set to create more volatility for investors. While this volatility will likely offer entry points, it reinforces the need for quality in portfolios and careful portfolio construction. Focus on quality indicators, such as strong balance sheets and company leadership, when evaluating companies across growth, value and income styles.

Against this backdrop, here are several investment ideas we currently favour.

Tech: focus on the enablers and second wave of AI impact

Technology remains an interesting sector. Some stocks are richly priced – not least the Magnificent Seven companies that have been a major stock market driver in the US, particularly thanks to the boom in artificial intelligence (AI). So, we would look further afield within the sector, particularly at those companies that specialise in the enabling technologies of the AI boom such as cloud computing, data centres and application programming interfaces (APIs) – crucial parts of the AI "plumbing".

In addition, while the development of the AI ecosystem is still in its early phases, the impact of applied AI on companies via productivity increases will be the next phase to be recognised by capital markets – AI's second wave.

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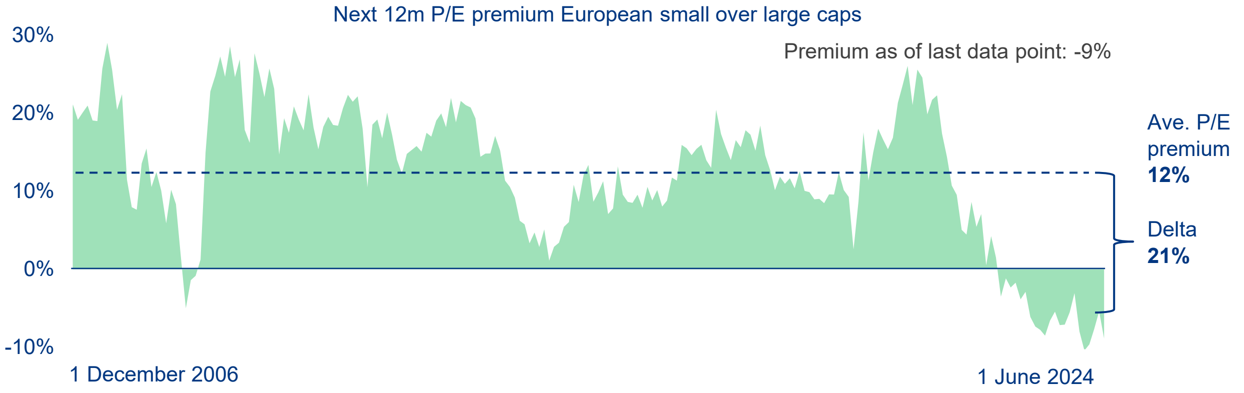
Asset class convictions: Equities

European small caps: small is beautiful

Europe's approximately 5,000 listed small-cap companies include global leaders in attractive growth segments. Highly weighted in sectors such as capital goods and transport, small caps tend to be more cyclical and domestic than larger firms. This means they typically outperform when euro area growth accelerates. Hence the time to be positive on small caps could be when growth momentum is troughing and Purchasing Managers' Indexes begin to rebound.

Perceived to be disproportionately reliant on credit, they have not participated in the cyclical recovery of recent months amid tighter credit conditions. But the environment could be turning in their favour as the ECB starts cutting rates. Furthermore, we think relatively low coverage by sell-side analysts could open up alpha opportunities for active investors looking for quality names.

Current relative value of large vs. small caps in Europe



Source: Allianz Global Investors, 9% valuation discount based on 12m forward PE vs. historic premium (+12%).

Asia: cheer for China equities – and is Japan the land of the rising markets?

We think there are reasons to be cheerful about Chinese equities over the longer term. The China A equity market is showing year to date gains after three years of bear market performance. Valuations are at historically low levels and forecasts for earnings growth are accelerating. The market is "under owned". Plus, the government is sounding encouragingly proactive on boosting the economy and employment. Still, questions hang over the sustainability of growth, as well as the future of the beleaguered property market.

It is prudent to take a selective approach to Chinese equities, particularly as volatility may increase in the run-up to November's US election and beyond. This means a focus on higher-yielding parts of the market: companies with higher dividends and share buybacks. Businesses boosting free cash flow by reducing capex requirements are attractive. We're also looking to key growth areas supported by self-sufficiency, AI penetration and innovation. These may include firms operating within power grid infrastructure, semiconductor supply chains, AI-related fields and nuclear power.

We are also positive about Japan. The market experienced a major structural overhaul with "prime" companies required to meet new listing rules on liquidity, business performance and corporate governance. We think Japanese equities combine a reasonable valuation and strong recent earnings with a supportive growth environment amid the central bank's continued efforts to stimulate growth.

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Asset class convictions: Fixed Income

Watch for the yield curve to steepen

The economic landscape has changed considerably in recent years as inflation and interest rates have moved up. Yet, the US Treasury yield curve (among others) has not reflected the shift, staying remarkably flat relative to history. We think that is about to change.

We expect the US and German yield curves to steepen over the remainder of 2024. The catalyst? Central banks are embarking on rate cuts, prompting a re-pricing of front-end yields. Consequently, we expect the "term premium"– the extra yield investors demand for holding longer maturity bonds over shorter ones – to rise, weighing on ultra-long maturity bonds.

US and German yield curve steepening trades should benefit. In contrast, in Japan, we expect policy interest rates to be normalised over the coming years in the face of rising inflation expectations – a move that should drive a flattening in the government bond curve.

Flat vs steep curves: US 5s30s and Japan 7s30s, bps

Source: Allianz Global Investors, Bloomberg, 31 May 2024.

Opportunities of divergence

Market participants might be forgiven the occasional yawn in recent years as major developed government bond markets have moved virtually in lockstep. But this is no longer the case.

Opportunities now abound as countries and regions move in a less synchronised way. We see differences emerging in monetary and fiscal policy, exacerbated by political tremors. And government debt burdens may diverge. The shifts could present attractive returns from relative value positions in the months ahead.

As an example, the strength of the US economy has led to a dramatic scaling back in the market's expectations for 2024 interest rate cuts. Dynamics in the UK economy are different. Below-trend growth, fiscal restraint and an attractive valuation backdrop, given restrictive real rates, favour an allocation to UK gilts on a cross-market basis.

We see other similar opportunities emerging – giving market participants plenty to think about.

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Asset class convictions: Multi Asset

UK: back to being boring?

After Brexit, the short-lived Liz Truss premiership, and multiple changes of prime minister, the UK may – finally – be regaining its reputation for being boring. Its relative stability now compares favourably with the upheavals seen elsewhere.

This new-found predictability, combined with its status as one of the cheapest markets in the world – even on a sector-adjusted basis – could make the UK worth a serious re-evaluation, particularly as earning revisions start to improve. Other factors in its favour include:

- Macro data is improving, showing more positive upside surprise than other regions.
- Better business and consumer confidence data is starting to translate into improving retail sales.
- Many investors are currently underweighting the UK and so as growth continues to improve, and the political noise of July's election is out of the way, there's potential for investors to reallocate.

Surge of interest in European banks

The re-emergence of significant positive interest rates has been a game changer for European banks. After a decade of trending down and reaching effectively zero just two years ago, interest rate margins of historically "normal" levels are now attainable again.

This regime shift has resulted in very strong earnings growth, and profits in 2023 reached three times the average of the preceding decade. Banks are likely to maintain similar profit levels for as long as interest rates stay above roughly 2%, where they can defend their margins – which builds the structural investment case.

Naturally, there are also risk factors that require close monitoring including higher-than-expected loan losses, the political situation in France, and the possibility of taxes on "windfall profits".

Nonetheless, we believe this could be an overall attractive opportunity as, despite the strong momentum (+23% year to date), European banks still look far from expensive: at less than 7x earnings (US banks: 12x) they have substantial room to re-rate, especially given the current improvement in European economic data.

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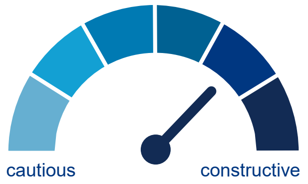
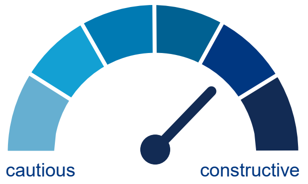
Asset allocation views: Multi asset



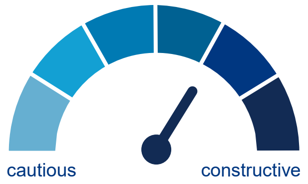
Overall risk

- The prospect of a soft landing with a healthy normalisation in growth and inflation indicators trending lower is a sweet spot for markets. "No landing" scenario a risk for government bonds, less so for equities.
- We maintain a constructive view on risky assets, with momentum and earnings as key drivers, supported by central bank cuts.



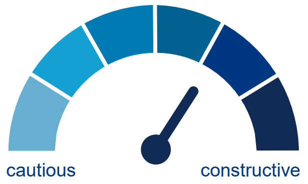
Equities

- We are constructive on equities. We continue to be positive on Japanese equities – amid appealing valuations and shifts to a more shareholder-focused capital market – while also eyeing the UK which is under-owned. Tech is driving the US.
- While European fundamentals are strong, we wait until the picture in France is clearer.



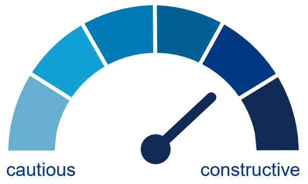
EM equities

- EM equities look attractive on many metrics, especially valuation, but earning trends are not convincing yet.
- Chinese equities have been a rollercoaster recently. Valuations are positive and the government has taken important steps to stabilise the real estate market, but sentiment is low. We are positive long-term.



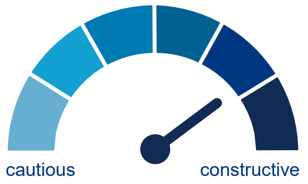
Government bonds

- Global sovereigns are supported by softer data in the US economy and benign inflation expectations.
- We are fundamentally constructive on euro zone government bonds but await more signals from the ECB. Momentum is a negative for most markets, especially for Japanese government bonds, which may weaken in the coming quarters.



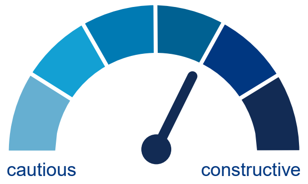
Credit

- We are generally neutral on credit given valuations despite attractive carry.
- Investment grade preferred over high yield, especially in Europe. Emerging markets have been lifted thanks to solid fundamentals and attractive spreads in selected segments. US dollar strength is a risk for the region.



Commodities

- Our outlook for commodities remains positive overall. We have reinforced our already substantial position in gold on positive long-term factors.
- Ongoing geopolitical tensions are expected to contribute to increased volatility in precious metals.



US dollar

- We reduced our overweight of the USD versus the EUR due to valuation, even though yield differentials will still help the former in the nearer term. While still at risk in the short term, over 12 months contrasting interest rate outlooks could make the JPY attractive versus the USD.

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