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To fight inflation, hunt for income

May 2019

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Investment income provides many benefits – including guarding against inflation – but today's "safe" bonds may offer no or ultra-low returns. We suggest investors hunt for income among "riskier" income generators like corporate bonds, emerging-market debt and dividend-paying stocks.

Today's investors can feel inundated with information about all the ways their portfolios can be derailed – including a steady drumbeat of geopolitical crises. In our view, many of these risks will ebb and flow over time, and they are often binary: they either happen or they don't happen. As a result, they can be difficult to hedge or invest around.

A less discussed danger is that these concerns could prevent investors from pursuing their long-term goals or deter them from taking sufficient risk in their portfolios. Some investors could even be ignoring serious risks that are less tangible, like climate change or inflation, but that can nevertheless be incorporated into an investment strategy.

Inflation can be a stealth threat

Given the relatively low levels of inflation in many economies, it's understandable why it may not be at the forefront of investors' minds. However, even small amounts of inflation can significantly erode purchasing power over time through the power of compounding. As the following table shows, a 2% annual inflation

Key takeaways

- Inflation is an overlooked risk that can feel higher than official inflation numbers – but even 2% annual inflation can reduce purchasing power by almost 20% over 10 years
- Slow economic growth and low interest rates mean market returns – beta – may also be low; this underscores the importance of taking enough risk to earn a sufficient return
- Many "safe" bonds offer zero or ultra-low returns – and now that most central banks have stopped raising rates, easy and attractive cash returns are hard to find
- Investors who "hunt for income" using riskier asset classes may be able to fight off inflation, stabilise returns and reduce overall portfolio volatility
- An active approach to income investing can help investors search for opportunities and manage a broad range of risks

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rate can reduce the value of an asset by nearly 20% in just 10 years. This is a clear example of why taking insufficient risk in low-return investments can put investors' goals at risk.

Even low levels of inflation can have a big effect over time

Year	Cost of 2% annual inflation	Asset value
0	–	100
1	2.00	98.00
2	1.96	96.04
3	1.92	94.12
4	1.88	92.24
5	1.84	90.39
6	1.81	88.58
7	1.77	86.83
8	1.74	85.08
9	1.70	83.37
10	1.67	**81.71**

Source: Allianz Global Investors.

While official inflation measurements like the consumer price index (CPI) may be low, they also have inherent limitations and fail to capture the real-world experience of many consumers. In many parts of the world, health-care expenses, education costs and real estate are climbing faster than the official 2% inflation target of most major central banks. Moreover, many governments are actively trying to push inflation even higher than 2% to help them pay down their debts. US Federal Reserve governors recently suggested that they might let inflation in the US "run hot".

Why it's important to hunt for income

To combat inflation, investors can use several approaches. Capital appreciation from equities and other real assets can be a good inflation-fighting tool, but those returns could take time to materialise. These assets can also be subject to rapid drawdowns similar to what the markets experienced in the fourth quarter of 2018.

A steady income stream, on the other hand, can be more tangible, helping to stabilise returns and make them more predictable. Moreover, the historically lower risk profile associated with income-generating investments might help reduce portfolio volatility in times of market and economic stress.

So where can investors hunt for income today? One option is government bonds – sometimes called sovereign debt – which are among the "safest" kind of income-generating securities available. But recent data by Bloomberg show nearly USD 10 trillion in negative-yielding bonds on the market, much of which is sovereign debt that we believe is unlikely to deliver a positive return.

Fortunately, there are other types of securities – including corporate bonds and equities – that may be able to generate higher levels of income in exchange for certain additional risks, and each one provides access to different parts of the corporate capital structure.

For example, the same company could theoretically issue corporate bonds, convertibles, stocks and high-yield bonds. The ability to choose where to invest along the capital structure lets investors choose which risks they are prepared to carry – while helping them target a desired level of income potential.

Income potential can be found throughout the capital structure

Risk/reward level	Type of income - producing investment
Generally lower risk with lower income potential	Sovereign bonds from developed countries
	Short-duration bonds and floating-rate notes
	US corporate bonds
	Convertible securities
	Dividend-paying equities
	High-yield bonds
Generally higher risk with higher income potential	Bonds from emerging-market countries

Source: Allianz Global Investors.

Using an active approach to help manage risks

Although there are many ways to generate income, there is no "one-size-fits-all" solution for any investment strategy. As the accompanying chart shows, it is impossible to predict which assets will outperform at any given time. Investors should diversify across asset classes to help capture opportunities. This is where an active and global approach can help, since active managers can dynamically research and analyse these complex issues.

Market returns turned broadly negative in 2018

Real annual returns of major asset classes (2008 to 1Q19)

Legend	<-20%	-20 to -5%	-5 to 0%	0 to +5%	+5 to +20%	>+20%

Rank	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	1Q 2019
1	US sov	Chi eq	Gold	UK sov	REITs	Jap eq	Chi eq	Jap eq	UK eq	EM eq	Ger sov	Chi eq
2	Ger sov	EM eq	REITs	US IL	EMU HY	US eq	REITs	EMU eq	US HY	Chi eq	Jap sov	Comm
3	UK sov	EMU HY	EM HY	Ger sov	Jap eq	EMU eq	EMU sov	Chi eq	EM HY	US eq	US cash	REITs
4	EMU sov	EM HY	EM eq	US sov	EM HY	UK eq	UK sov	EMU sov	EM eq	Jap eq	EMU sov	US eq
5	Gold	US HY	EM loc	Gold	EMU eq	EMU HY	US eq	Jap sov	Comm	EM loc	US sov	EMU eq
6	Jap sov	REITs	US HY	EM HC	EM HC	US HY	Ger sov	UK sov	UK sov	EMU eq	UK sov	EM eq
7	US cash	EMU eq	US eq	US IG	EM eq	REITs	EMU IG	EM IG	US eq	Gold	EMU cash	UK eq
8	EMU cash	EM HC	EMU HY	Jap sov	EM loc	EMU IG	Jap eq	EM HC	EM HC	REITs	EM IG	Jap eq
9	US IL	UK eq	EM HC	EM IG	US HY	EMU sov	US IG	EMU HY	EMU HY	UK eq	EMU IG	US HY
10	EMU IG	EM IG	EM IG	US HY	US eq	Jap sov	EM IG	EM HY	EM loc	EM HY	US IL	EM HC
11	EM loc	US eq	UK eq	EMU IG	EM IG	EM HY	EMU HY	US sov	Gold	EM HC	US IG	EM HY
12	US IG	Gold	US IG	EMU sov	EMU IG	EMU cash	US sov	Ger sov	US IG	EMU HY	US HY	EMU HY
13	EM HC	EM loc	Comm	US eq	EMU sov	US cash	EM HC	US eq	EM IG	US HY	Gold	US IG
14	EM IG	US IG	US IL	EMU cash	US IG	Comm	EMU eq	EMU cash	EMU IG	US IG	EM HY	EM IG
15	US HY	EMU IG	US sov	US cash	UK eq	EM IG	US IL	US cash	Jap sov	EM IG	EMU HY	UK sov
16	EM HY	Jap eq	Ger sov	Comm	US IL	US IG	Jap sov	REITs	EMU eq	Comm	EM HC	US IL
17	UK eq	Comm	UK sov	EM loc	Chi eq	Ger sov	US HY	EMU IG	Ger sov	US IL	REITs	EMU IG
18	EMU HY	US IL	EMU IG	EMU HY	Gold	EM eq	EMU cash	US IG	REITs	EMU IG	US eq	EM loc
19	US eq	EMU sov	Jap sov	UK eq	Ger sov	US sov	UK eq	UK eq	US IL	US sov	EM loc	EMU sov
20	Jap eq	Jap sov	Jap eq	EM HY	Jap sov	UK sov	EM HY	US IL	EMU sov	Jap sov	UK eq	US sov
21	EMU eq	Ger sov	EMU eq	REITs	US sov	EM HC	US cash	US HY	US sov	EMU sov	EMU eq	Ger sov
22	Comm	EMU cash	EMU sov	EMU eq	UK sov	Chi eq	EM eq	Gold	Jap eq	UK sov	Jap eq	Jap sov
23	REITs	US cash	US cash	Jap eq	US cash	EM loc	Gold	EM eq	EMU cash	US cash	Comm	Gold
24	EM eq	UK sov	EMU cash	EM eq	Comm	US IL	EM loc	EM loc	US cash	EMU cash	EM eq	US cash
25	Chi eq	US sov	Chi eq	Chi eq	EMU cash	Gold	Comm	Comm	Chi eq	Ger sov	Chi eq	EMU cash

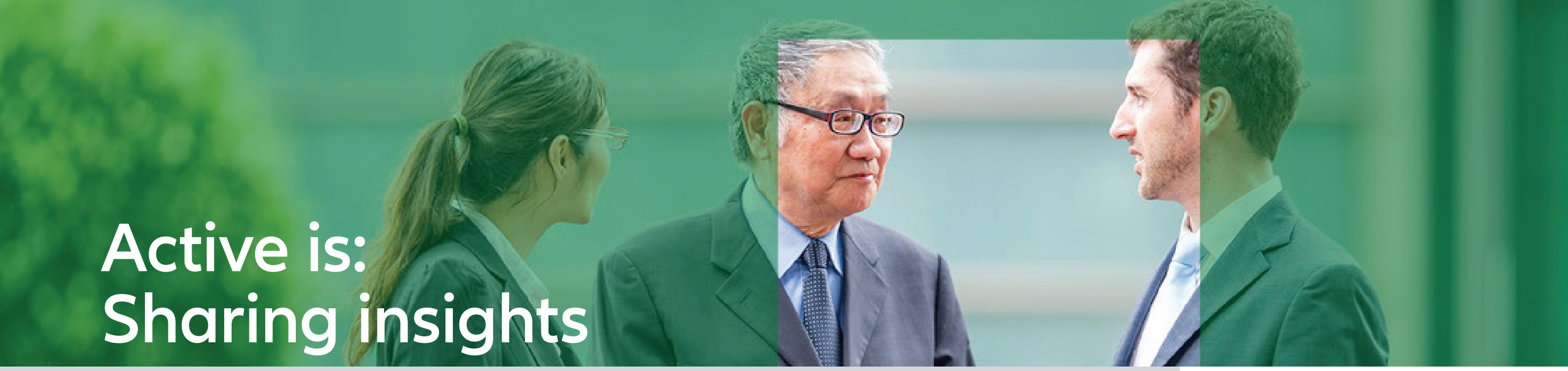
Source: Allianz Global Investors Global Economics & Strategy, Bloomberg, Datastream. Data as at 31 March 2019. US: United States, Chi: China, Ger: Germany, UK: United Kingdom, EMU: euro zone, EM: emerging markets, Jap: Japan, eq: equities, sov: government bonds, IL: index-linked bonds, IG: investment-grade, HY: high yield, Comm: commodities, HC: hard currency bonds, loc: local markets. All returns are calendar year except for 1Q 2019. Diversification does not ensure a profit or protect against a loss.

Similarly, just as all investing invites some degree of risk, there are certain risks that can affect income-generating securities, including:

- Interest-rate risk: when rates rise, a bond's value generally falls
- Credit risk: issuers could default on paying income or repaying principal
- Inflation risk: reduces purchasing power over time
- Liquidity risk: it could be hard to find a buyer or seller at the right time

Here too is where active management may be beneficial. At Allianz Global Investors, we take an exclusively active approach to the investment strategies we manage on behalf of our clients. At the core of our process are our global credit and equity research capabilities, which help us assess potential risks and returns across a company's capital structure. We also gain real-world insights into the issues affecting companies and consumers from our Grassroots® Research team – our proprietary in-house market research division.

With lower beta returns (what the broad market provides) likely for the next 10 years, we believe that investors should pursue alpha – or returns in excess of the market. Investors who successfully hunt for income can help protect their portfolios' purchasing power, seek acceptable returns and aim to reduce overall risk levels during uncertain times.



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Amid low returns from "safe" bonds, look to Asian risk assets

May 2019

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Thanks to positive macroeconomic news, China's resilient growth and room to cut rates in India and Indonesia, the outlook for Asia-Pacific risk assets is good. Corporate bonds, emerging-market debt and dividend-paying stocks can play a critical role for investors in search of income potential.

With traditionally "safe" bonds offering limited returns globally, we suggest investors actively hunt for income among "riskier" income generators such as corporate bonds, emerging-market debt and dividend-paying stocks. Asia-Pacific risk assets can play a critical role for investors, given the region's positive macroeconomic news, China's resilient growth and the potential for lower rates in India and Indonesia.

A favourable macro backdrop for Asia-Pacific

In 2018, the Asian market was dragged down by concerns over rate hikes by the Federal Reserve, rising tension in the US-China trade relationship and slowing growth in China. But since the beginning of 2019, these three key factors have become tailwinds that support Asian risk assets.

1. **The Fed is more patient.** Additional Fed rate hikes and further strength in the US dollar seem unlikely this year. This should help stem the outflow of capital to the developed markets from Asia and the emerging-market world.

Key takeaways

– "Riskier" assets in the Asia-Pacific region offer attractive income potential for investors dissatisfied with the returns of traditionally "safe" bonds
– After a tough 2018, Asian risk assets have been supported by Federal Reserve policy, easing US-China trade tensions and stabilising growth in China
– China's growth outlook is positive for Asia overall and should help the region's equity markets, including dividend-paying stocks
– India and Indonesia have room to cut their policy rates, which should help their bonds

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2. **A full-blown US-China trade war seems less likely.** Despite the recent escalation in tensions, we think the threat of weaker global trade and financial shocks will push the US and China to put aside their differences and eventually settle for a trade deal. Both sides remain engaged in negotiations despite the sabre-rattling rhetoric; market sentiment can shift drastically on sign of any positive development.
3. **China's growth looks more stable.** Proactive fiscal and monetary stimulus measures from the Chinese government seem likely to stabilise the country's growth this year. China's government has set 6%-6.5% as the official growth target for 2019, and we believe the authorities have the willingness and means to achieve it.

Resilient growth dynamic in China

Given the release of China's stronger-than-expected credit, growth and GDP data in the first quarter, we think the market will agree with our view that a sharp deceleration in Chinese growth is unlikely this year. This would be supportive for the Asia-Pacific region given how dependent regional economies are on trade with China. As the following table shows, China has become the most important export destination among many Asian economies – surpassing even the United States and the European Union. This gives us additional confidence in Asia's growth potential despite the risk of slowing demand in the developed world.

Another factor supporting our optimism on Asia is the expected bottoming-out of the tech cycle in mid-2019. We expect the global semiconductor sales cycle to benefit from a pickup in demand from major tech firms that plan to expand data centres, and from a pre-build in inventory by a key smartphone and 5G equipment manufacturer. This should help North Asian economies, which have a heavy tech focus in their export mix.

Asia's export economy depends on China

Export exposure in value-added terms by destination of final demand (% of GDP)

	China	Japan	ASEAN	US	EU	Rest of world
Taiwan	13.4	2.8	3.2	6.7	4.2	10.5
Hong Kong	9.6	1.3	2.6	3.0	4.3	8.3
Malaysia	9.6	4.2	6.8	6.1	4.9	16.1
Singapore	8.1	4.3	8.0	7.0	10.4	20.1
Korea	7.7	1.8	2.2	5.6	3.3	10.0
Thailand	7.2	3.6	5.1	6.1	4.9	16.0
Vietnam	6.2	4.2	3.5	9.4	5.7	14.4
Philippines	4.1	2.4	1.9	4.7	2.6	6.2
Japan	2.9	N.A.	1.4	3.2	1.7	5.1
Indonesia	2.7	1.8	1.8	2.4	1.8	7.4
India	1.1	0.5	0.9	4.1	2.7	5.9
China	N.A.	1.3	1.0	4.0	2.7	7.1

Source: OECD-WTO TiVA database, Allianz Global Investors Economics & Strategy. ASEAN: Association of Southeast Asian Nations. Data as at 2015.

Room for policy rate cuts

Central banks in domestic-demand-driven economies like India and Indonesia should also help support growth momentum in Asia. The accompanying chart shows the real policy-rate levels of key Asian countries; India, Indonesia and Malaysia are relatively high at 3% and above.

India and Indonesia have room to cut rates

Real policy rates (in %) of key Asia-Pacific central banks

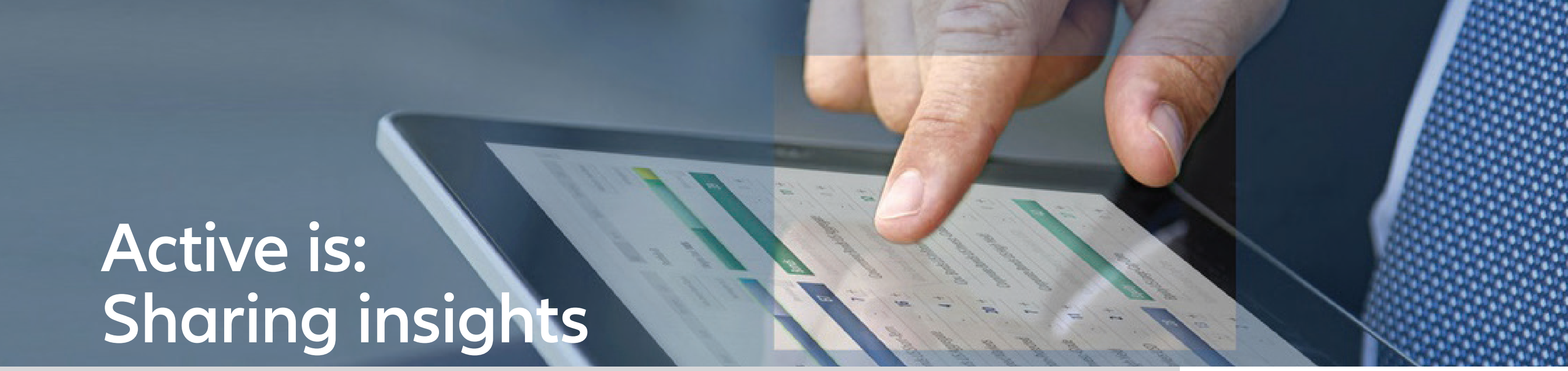
Source: CEIC, Allianz Global Investors Economics & Strategy. Data as at March 2019.

Given globally low inflation and a stable external environment thanks to an accommodative Fed, we think the central banks of India and Indonesia will cut policy rates to guide down their domestic interest-rate levels and support their economies. We expect the Reserve Bank of India to make a 25 basis-point cut in June, with the potential for more in late 2019, and we expect Bank Indonesia to start cutting rates in the second half of the year.

Infrastructure investments are also important for India and Indonesia's growth. We think it is important for these two economies to improve their basic infrastructure – such as power stations, roads, railroads, ports and airports – to solicit private investments and push forward the industrialisation process. India's Narendra Modi and Indonesia's Joko "Jokowi" Widodo agree, which is one of the reasons why they pledged to keep investing in infrastructure in their re-election campaigns. Of course, structural reforms are also needed to upgrade the legal and fiscal foundations and help the economies of these countries become more efficient and productive.

Investment implications

- Stable growth in China is positive for Asia, and it should help the region's equity markets and dividend-paying stocks.
- A turnaround in the tech cycle would be positive for North Asia's economies, benefiting the tech sector and supporting export growth.
- India and Indonesia, along with other economies such as Malaysia and the Philippines, have room to cut their policy rates, which should help their fixed-income securities.



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Low rates are back, so where do you turn in fixed income?

May 2019

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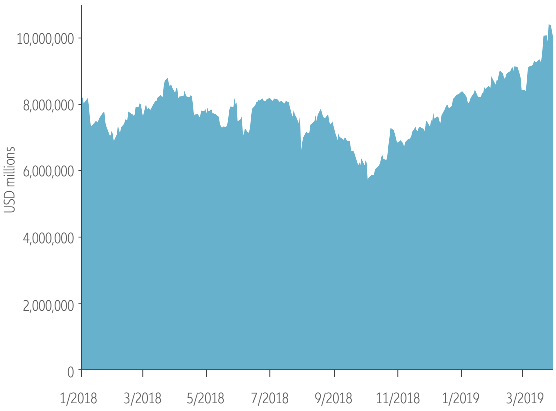
Investors who need income and return potential should consider an active, balanced, global approach. Consider pairing high-quality investment-grade corporates, Treasuries and select securitised assets with infrastructure debt and higher-quality US, European and Asian high-yield bonds.

With global growth slowing and inflation still low, most major central banks have paused their plans for raising rates – and in some cases have even begun cutting them. This has pushed bond yields lower around the world. In fact, the amount of negative-yielding US dollar-denominated debt has risen to more than USD 10 trillion globally, as the chart below shows.

A record amount of debt now has negative yields

Bloomberg Barclays Global Aggregate Bond Index negative-yielding debt



Source: Bloomberg. Data as at 31 March 2019.

Key takeaways

- Faced with low or even negative bond yields, many investors are looking to preserve income and return potential – and an active, holistic approach could help
- We see opportunities in the securitised fixed-income market and higher-quality corporate bonds, though investors should be cautious and selective with BBB exposure
- For additional income potential, look to higher-quality US high-yield bonds, select global high-yield bonds (particularly from Europe and Asia) and infrastructure debt
- Using these securities in a "barbell" approach can help investors take selective risks while providing the potential for favourable yields and returns

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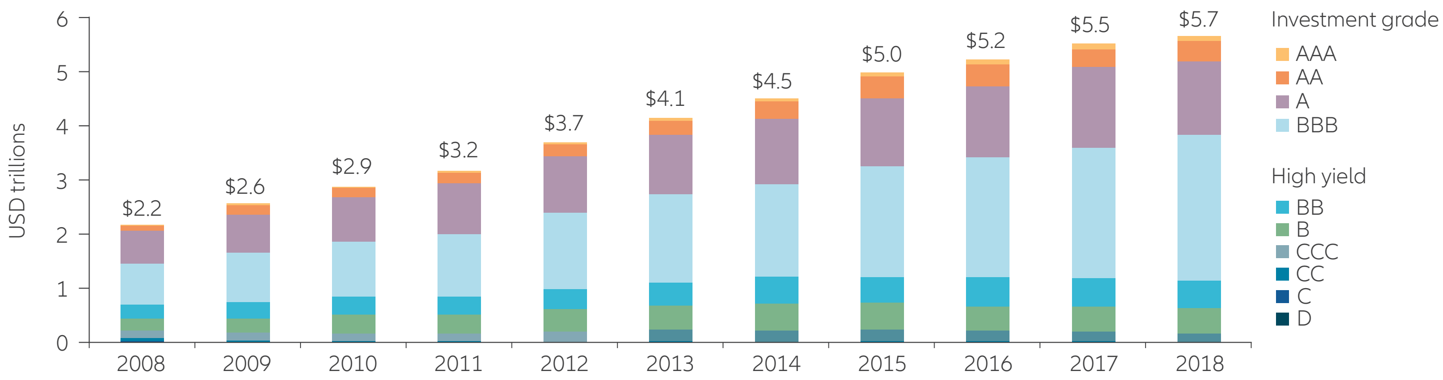
As a result, many investors once again are looking to preserve income and meet return expectations. We suggest taking a holistic, active approach to building fixed-income portfolios using a "barbell" approach – taking selective risks for higher income potential while using more defensive positions to balance overall risk. On one end of the barbell could be high-quality investment-grade corporates, Treasuries and select securitised assets. On the other could be BB rated US high-yield bonds, European and Asian high-yield bonds, and infrastructure debt.

In the investment-grade universe, look to higher-quality bonds

Among investment-grade securities, we see opportunities in higher-quality corporate bonds and the securitised fixed-income market.

More investment-grade bonds have lower BBB ratings

Ratings of the US non-financial corporate-debt market



Source: Bloomberg. Data as at 31 December 2018. Calculated using ICE (Intercontinental Exchange) investment-grade and high-yield bond indexes, excluding the issues of financial firms, as at 31 December for each year shown.

1. Look to higher-quality corporate bonds. The US investment-grade bond market has doubled in size since the 2008 financial crisis, but overall credit quality has deteriorated. The landscape is increasingly dominated by assets with BBB ratings, as shown above; these are on the low end of the range that qualifies as investment-grade. As US economic growth slows and corporate earnings moderate, we suggest repositioning towards higher-rated securities, such as bonds rated A.

Although there are specific areas of the BBB marketplace that look attractive, we believe investors should become increasingly selective and active in this space. The US economic cycle is now in a more mature phase, and low rates are once again tempting corporations to take on more debt. Consider focusing on issuers with:

- Credible plans to reduce their debt burdens (known as "de-leveraging").
- Consistent free cash-flow levels, which can often be found in monopoly-like businesses with the ability to take on debt.
- Attractive subordinated-debt issues, which are riskier but can offer more attractive terms; look for issues from high-quality banks and utilities.

2. Consider securitised fixed-income assets. One area of the investment-grade bond universe that offers attractive diversification opportunities is the securitised fixed-income market. These are pools of assets with cash flows that are divided and sold to investors, and they tend to be tied to what we view as more resilient economic sectors: consumers, residential housing and commercial real-estate. Among the more attractive opportunities are:

- High-quality asset-backed securities (ABS), such as AAA rated credit cards and prime auto, which tend to be liquid and can complement Treasury or cash holdings.
- More specialised areas of the ABS market such as franchise ABS, single-asset commercial mortgage-backed securities and non-agency mortgage bonds. These can help investors diversify their investment-grade bond holdings, and can be good alternatives to BBB rated corporate bonds.

For enhanced income potential, look for higher yields with higher quality

For investors in search of additional income and yield, we see opportunities in higher-quality US high-yield bonds, select global high-yield bonds and infrastructure debt.

1. Go higher quality in US high yield. Within what Moody's estimates to be a USD 1.2 trillion US high-yield marketplace, the highest-quality BB rated segment remains relatively attractive. These issuers have better credit profiles, tend to offer shorter-duration bonds and have higher yields than investment-grade securities. Our focus remains on companies with visible earnings streams and no imminent refinancing risks. As the economic cycle matures, US high-yield investors may have an opportunity to invest in "fallen angels" – BBB rated assets that have been downgraded to high-yield status. These corporations could improve their debt profiles and once again become investment-grade assets.

2. Explore high-yield issues in Europe and Asia. To diversify holdings and enhance yield potential, consider investing in global high-yield issues – particularly from Europe and Asia. Europe's substantial economic slowdown has made these bonds less expensive, and they are generally more conservatively positioned: nearly 73% of the market is BB rated versus 46% in the US, according to ICE. This has helped lower the default rates for European versus US high-yield issues, particularly during downturns. Asian high-yield bonds – especially US dollar-denominated ones – may also provide higher yields than their US counterparts. The Asian high-yield market is primarily dominated by Chinese companies, and we believe China's economic outlook is good thanks to its stabilising economy and the potential for a resolution to the US-China trade dispute.

3. Diversify with infrastructure debt. Infrastructure-debt investments – which are privately financed projects such as airports and water pipelines – are often highly regulated and can have predictable cash flows, longer maturities and lower loss rates than corporate bonds. While there may be liquidity constraints, their additional yield potential and lower correlations with equity and traditional fixed income can provide a valuable source of diversification. In addition, ESG (environmental, social and governance) investors can find synergies in infrastructure debt, since many of these projects focus on renewable energy, social infrastructure (such as universities, hospitals and schools), and conventional energy and utilities (such as waste- and water-treatment facilities).

Build your bond portfolio with a "barbell" approach

Although investors are facing low yields from government bonds globally, we see opportunities to invest actively across the fixed-income spectrum – particularly with a "barbell" approach that balances safer with riskier investments. On one end of the barbell could be high-quality investment-grade corporates, Treasuries and select securitised assets. On the other could be BB rated US high-yield bonds, European and Asian high-yield bonds, and infrastructure debt. Combined, this approach may be able to help investors take selective risks while providing the potential for favourable yields and returns.