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Active is:
Exploring new ideas

Allianz Global Investors Insights

Global view

Beware inflation: it lurks before it spikes

Neil Dwane
Global Strategist

Key takeaways

- Inflation may be temporarily gone, but it should not be forgotten: oil prices, currency volatility and trade wars could force up inflation unexpectedly
- The combination of inflationary factors and disinflationary structural forces raises the risk of a policy error by central banks
- When central banks see inflation, they will likely celebrate it rather than quash it
- Investors who want to prepare to fight inflation's detrimental effects should consider real assets, inflation-linked bonds and equities

Investors once knew to fear inflation, but it hasn't been much of a factor for almost four decades – neither in the global economy nor in many investors' strategies. This has led to a degree of happy complacency for consumers, who don't like inflation because it means higher prices, and for investors, who haven't felt the pressure to strive for higher real returns.

At the same time, central banks generally seek to maintain a certain level of inflation to keep their economies growing; recently, 2% per year has been their target rate. Yet in the post-financial-crisis era, central bankers have essentially printed money through policies of low rates and quantitative easing, and inflation has barely budged.

Post-crisis, central banks have essentially printed money and inflation has barely budged

Working against inflation are certain disinflationary structural forces – such as ageing demographics and a shrinking global workforce – that show no signs of abating. Increased competition and the rise of the digital economy are also making it more difficult for companies to raise prices. These are worrisome developments that raise the risk of a policy error by central banks as they attempt to meet their inflation mandates.

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Allianz Global Investors

Global view

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Why inflation could move higher

Even though inflation may be temporarily gone, it should not be forgotten. We believe there are a range of reasons to expect that inflation could move higher unexpectedly:

- The *price of oil* appears likely to continue hovering near USD 75 per barrel, which could be inflationary. An oil shock from the Middle East could drive prices up even more.
- Diverging monetary policy among major central banks is causing *currency-market volatility*. For trade-reliant countries, weaker currencies mean import inflation, which can undermine real consumer spending and investment.
- As China reforms its state-owned enterprises and the country begins exporting for profit rather than employment, *higher traded-goods prices* could help exporters but hurt consumers.
- *Trade wars* will hopefully be short-lived, but friction between the US and China or others is likely to deliver a small increase to global inflation.
- *Asset prices* have been boosted by "cheap" money and plenty of leverage, but the real-estate market could also cause problems if purchase and rental prices keep rising, consumer spending falls and economic inequality grows worse.
- Businesses are faced with *rising input costs* from higher wages and increasingly expensive raw materials. Eventually, they may be forced to choose between lifting prices and reducing their margins.

Rising input costs mean businesses may eventually be forced to lift prices or reduce their margins

Central banks are taking different approaches to inflation

The global economy made its way out of the 2007-2008 financial crisis by using record-low interest rates to pile on debt. A great deleveraging is overdue, yet much of the world's debt may not be reduced by the usual measures – repayment or default – but instead repaid with "default by inflation".

In this sense, central banks will likely celebrate inflation rather than try to quash it like they did decades ago. But since each economy faces a different set of threats and opportunities, investors should expect a variety of approaches from central banks managing diverging economies.

What investors can do to help fight inflation

Given the relative lack of inflation in recent years, too many investors may be neglecting to protect their portfolios. This is a mistake, given that even relatively low levels of inflation can significantly erode purchasing power over time.

Even low levels of inflation can significantly erode purchasing power over time

To combat inflation, consider real assets like commodities and real estate, which have traditionally held their real value better than financial assets like bonds and cash:

- While property has always been a good hedge, it is expensive in many regions, reducing its usefulness unless held for many years.
- Infrastructure assets often provide the potential for attractive long-term returns and help institutional investors with liability matching – albeit with now lower levels of yield.
- Gold can be a hedge against both inflation and policy errors by central banks.

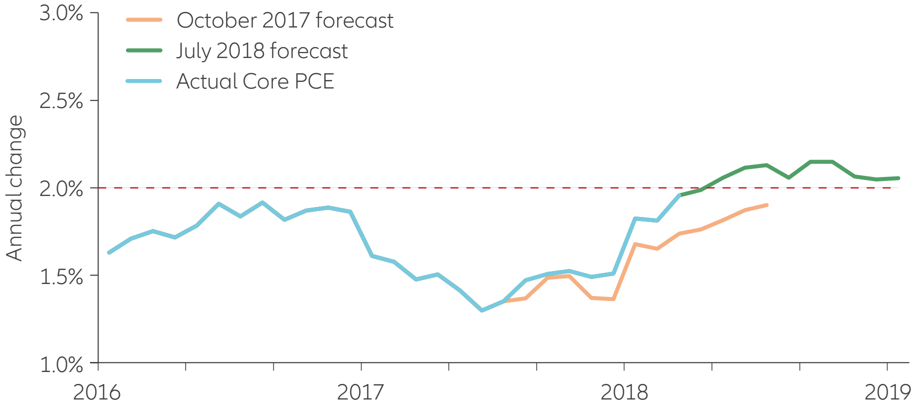
Aside from real assets, the two most common hedges against inflation are inflation-linked bonds (ILBs) and equities – though equities, like property, can be too volatile to be an effective inflation hedge in the short term.

- ILBs are markedly less liquid than many other fixed-income securities, and they can be expensive because large institutional investors buy and hold them to match their long-term liabilities.
- What makes ILBs attractive is that they adjust for changing levels of inflation, offer much lower volatility and can provide a well-diversified global opportunity set – qualities that are particularly useful given the inability of many traditional fixed-income investments today to offer attractive real returns.

Real assets, inflation-linked bonds and equities are the most common hedges against inflation

Core inflation may rise above the Fed's 2% goal

Core PCE forecasts (2016 to 2019)



Source: US Bureau of Economic Analysis; Allianz Global Investors calculations Data as at 25/7/2018.

Viewpoint

Water: an essential and investable asset

Andreas Fruschki, CFA
Director of Equity Research, Europe

Key takeaways

- After decades of warnings, many of the world's most critical investments in water infrastructure and technology still haven't been made
- The structural imbalance between water supply and demand – and the pressure to close the gap – make water particularly attractive for investors
- Water can be a defensive investment theme with prospects for high growth – a helpful combination under today's uncertain market conditions

Amid global concerns about rising temperatures and a changing climate, recent news headlines have featured a steady stream of stories about water worries:

- In South Africa, Cape Town has been fighting the rapid approach of "Day Zero" – a point when this drought-stricken city's taps could run dry.
- The US state of California is grappling with a multi-year drought that has fuelled a summer of devastating wildfires.
- London is experiencing lower-than-usual rainfall, forcing it to draw much of its water from key rivers and raising fears that the United Kingdom's capital could soon experience water-supply problems.

While clean water has always been an issue in developing nations, the fact that major cities and prosperous states are struggling to secure their water supplies illustrates the magnitude of the world's water infrastructure problem.

Tracing water issues to their source

For decades, experts have warned about the growing risk of water shortages even as scientists and engineers developed new solutions that connect water-rich with water-scarce regions, and that improve water-usage efficiency.

Experts have long warned of water shortages even as scientists developed new solutions to solve the problem

Urbanisation and population growth, the rising water intensity of industrial processes, high-output farming practices and consumer lifestyle changes are all stressing the water system. While these may be slow-moving individual factors, they have combined into a powerful overall trend – one that could result in severe disruptions to farming, industry and everyday life if left unaddressed.

So what is impeding investment? One issue is that fixing the world's water infrastructure is a costly long-term commitment, yet most parts of the water network are invisible to the average citizen. As long as water comes out of the tap, people are less inclined to worry about the hidden parts of the water cycle.

Politicians are also afraid to push for taxes or levies that could finance the construction or repair of waste-water treatment plants, or the implementation of new sewage-filtration technologies. As a result, upgrades to the water system can be all too easily pushed down the road.

Yet while this overall lack of investment is problematic, it makes water an under-appreciated and under-addressed theme that can be attractive for investors who know how to approach it.

How to invest in water

Investing in water is different from investing in other commodities, as water itself is not a tradeable asset. While rainfall is "free", clean water out of the tap is a commodity with high social value, and one that is extremely sensitive to environmental factors.

As a result, major investments along the entire water supply chain are needed to provide cities and farming regions with clean water – and this is where the value for investors can be generated. Collection wells, pumping stations, filtration solutions and the treatment of sewage are all critical parts of the complex system of fresh and waste water. Also critical are technologies that reduce water loss and further improve its quality in the delivery chain.

Major investments are needed along the water supply chain to provide cities and farms with clean water

Companies that offer these solutions stand to benefit from the growing need to improve the world's water infrastructure, and they will likely enjoy ongoing social and political support for their products and services.

A good way to approach water investing is with a concentrated, high-conviction portfolio of stocks of companies with the highest exposure to the most stable areas of the water

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Viewpoint

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industry. Integrating environmental, social and governance (ESG) factors into the investment process can also add the improved performance potential associated with socially responsible investing. In addition, actively picking stocks of water-related companies could help reduce cyclicality and volatility.

Integrating ESG factors into the water investment process can add the improved performance potential associated with SRI

The future of water investing

Only a few countries have achieved the level of sophistication where water is routinely safe to drink, or can be safely and easily released back into the environment. Yet securing a steady supply of clean water is a goal shared by every nation around the world, making water an investment theme worth pursuing.

Adding to the solid outlook for water investing is the fact that the societal need for water tends to provide protection from political uncertainty, and it can strengthen the regulatory support needed for continued investment.

Water-related investments are also less dependent than others on the broader economic cycle. Consolidated markets and the technological leadership shown by major water-market players allow for stronger pricing power and the potential for more stable profits.

Given this combination of drivers – including a supply/demand imbalance and protection against wider political and economic volatility – water can be a defensive investment theme with prospects for high growth. That could make water an even more attractive option for investors under today's uncertain market conditions.

Perspective on Europe

Are European equities overlooked?

Jörg de Vries-Hippen, CFA
CIO Equity Europe

Key takeaways

- Unlike the US market, which is dominated by tech, Europe has more "old" businesses such as industrials or financials – and Europe is attractively priced
- What's to love about Europe? GDP growth remains above-potential at 2%, and unemployment keeps declining: the latest euro-zone numbers are the lowest since December 2008
- As an active asset manager, we've uncovered many European firms that are financially sound, have full order books and even complain about a lack of capacity
- Consider a dividend-focused, value-based approach to Europe: financials and energy look attractive

European equity indices once again started to lag their US counterparts over the course of the summer, and investors have been steadily moving away from Europe for most of the year. Yet Europe is a region with solid growth, strong macroeconomic data and many healthy companies trading at a discount – which, in our view, makes worries about Europe appear overdone.

Recently, investors have preferred the US over Europe in large part because of the high-flying dominance of the US tech sector. Tech constituted more than 25% of the overall US market on 12 June, according to Bank of America Merrill Lynch, while the euro-zone market had a tech component of just under 10%. Europe has more balanced sector exposure, with the largest representation by "old" business such as industrials or financials.

But this is not necessarily a bad thing, particularly considering what happened during periods of excess sector concentration in the past – including the tech sector during the dot-com bubble, financials during the 2006 housing bubble and energy back in the 1970s.

Moreover, some portfolio manager surveys show that the most overbought area of the market is US tech, while European financials are among the most oversold. So while Brexit continues to weigh on investors' minds, it may be time to take another look at Europe.

The most overbought area of the market may be US tech, with European financials among the most oversold

Europe shouldn't be so unloved

Investors generally have an extremely poor view of Europe. Its equity markets recently registered their 24th consecutive week of outflows, effectively removing all inflows seen over the course of 2017.

However, although second-quarter economic growth hit a soft patch, primarily due to France and Italy, euro-zone GDP growth is expected to remain above-potential at around 2% this year. This should support local

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Perspective on Europe

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stock markets. In addition, the latest batch of macroeconomic data out of Europe contains many highlights:

- Industrial production and export activity have recovered from temporary low points.
- GDP growth in the UK recovered in the second quarter, supported by construction and industrial production.
- Unemployment continues to decline in the euro zone; the latest numbers are the lowest since December 2008.
- Overall employment is at a record high and wage growth has picked up notably; labour shortages can even be felt in the more buoyant countries, such as Germany.

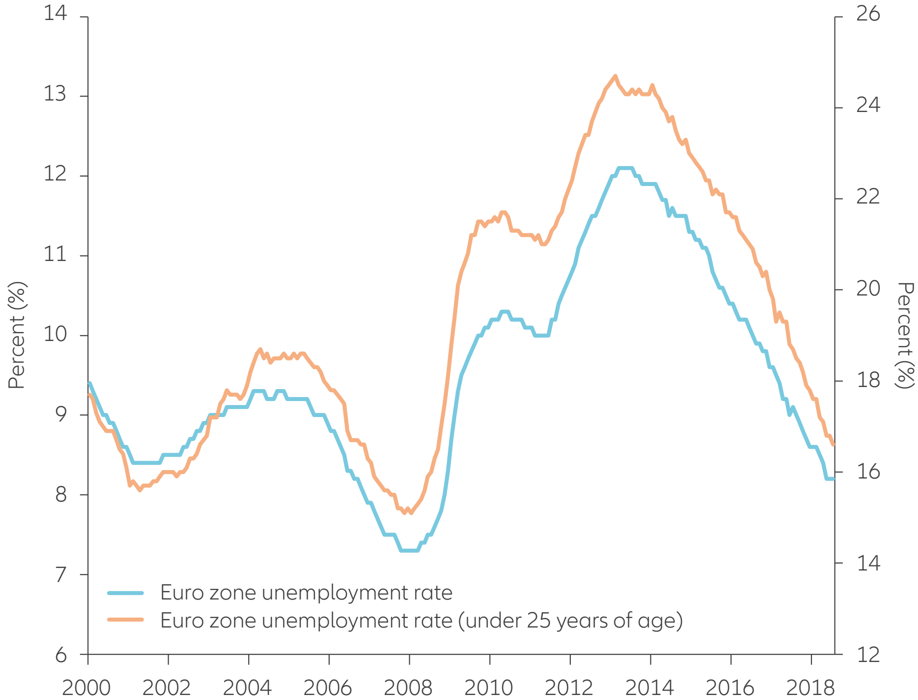
As a result, household consumption in the euro zone – which accounts for well above 50% of GDP – is set to remain a key driver of Europe's ongoing solid economic performance. Strong domestic demand has also shielded Europe from the impact of trade tensions so far.

Thanks to strong employment, household consumption will be a key driver of Europe's ongoing solid economic performance

An active approach to investing in Europe

Because Europe is a very open economy, the region and its stock markets get hit hard when investors worry about global trade or emerging-market issues. Yet some of the concerns around these issues appear overdone, with the market frequently deciding to shoot first and ask questions later. The Brexit vote on 23 June 2016 was a good example of this. After the initial panic and strong volatility, markets returned to focusing on the fundamentals, which were supportive. In fact, European markets have moved up more than 25% since the initial post-vote turmoil.

Despite a temporary GDP slowdown, unemployment is falling



Source: Eurostat, AllianzGI Global Economics & Strategy. Data as at 31/7/2018.

As an active asset manager, we focus on the fundamental facts. Panic moments often lead to mistakes, costing real money. We take a more considered approach, starting with frequent interactions with European companies. We've discovered numerous firms that are financially sound, have full order books and have even started to complain about a lack of capacity.

This leads us to emphasise a dividend-focused, value-based approach to European equities. Yields in Europe are high, confirming the discount applied to European stocks. In our view, there is an undue neglect of companies with well-supported dividend payments. Moreover, modestly rising interest rates and a continued, gentle economic expansion make the value side of Europe appealing. Such an environment typically translates into better earnings – for example, for financials, many of which are strong dividend-payers. In addition, ongoing restructuring efforts by European energy companies can translate into strong cash generation and dividends.

While large parts of the global stock markets trade on elevated valuations despite recent volatility, we believe Europe remains attractively priced. Investors should of course be prepared for even more noise and volatility in the run-up to the mid-term elections in the US. But buying good European companies at good prices may be able to shield investors from some of this impact. In a world driven by high-tech flash, consider using Europe's "substance and value" to balance an otherwise growth- and tech-biased portfolio.

With large parts of the global markets showing elevated valuations despite recent volatility, we believe Europe remains attractively priced

Grassroots® Research

High petrol prices are changing consumer spending habits

Phil Simon
Grassroots® Research Analyst

Key takeaways

- Higher petrol prices could spread beyond the energy industry to consumer discretionary; the restaurant and auto sectors could be particularly hard-hit
- 7 of every 10 US consumers in our new survey said higher pump prices are affecting how much they spend and save
- More than 60% of our survey respondents said paying higher petrol prices meant spending less on food and restaurants in the last three months

Petrol prices have been moving higher – and US consumers are feeling the strain. The average price in the US for a gallon of regular petrol was USD 2.83 in mid-August 2018, according to the American Automobile Association, up around 21% from a year ago.

Our investment professionals are watching to see if the extra money consumers must spend on petrol will cause shifts in overall consumer spending and offset the benefits of recent tax cuts, which initially increased the overall take-home pay of many US consumers.

Grassroots® Research findings illustrate the impact of petrol prices

To help understand where consumers are cutting back due to increased spending on petrol, Grassroots® Research – Allianz Global Investors' proprietary in-house research division – surveyed about 1,000 drivers throughout the country in May 2018.

The results show that:

- 84% of respondents noticed an increase in petrol prices in the past six months.
- 71% said higher prices are affecting how much they spend on other merchandise and their ability to save.
- Among the 84% who noticed higher prices, 68% are spending between USD 5 and USD 49 per week more to fill their tanks compared with one year ago. Approximately 20% are spending an extra USD 50 or more.

Restaurants are poised to lose the most

More than 60% of our survey respondents told us that spending more at the pump led to less spending on food and restaurants in the last three months, and the same percentage expects that to continue if prices remain high.

Jon Wolfenbarger, Senior Consumer Research Analyst at Allianz Global Investors, says higher gasoline prices are a particular headwind for restaurant spending among lower-income consumers. "The survey results could help explain why fast-food sales have been somewhat disappointing this year. However, tax cuts, solid employment and wage growth are offsetting higher gas prices for middle- and upper-income consumers, which has helped casual dining restaurant sales accelerate year-to-date."

Keep an eye on retail auto parts

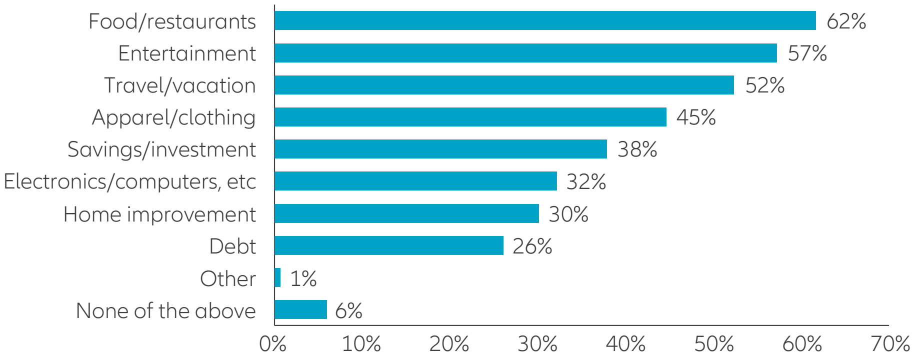
Historically, big increases in petrol prices have hurt sales performance in the retail auto parts industry. Courtney Sheldon, Consumer Research Analyst at Allianz Global Investors, says the key is the lower number of miles driven by consumers who are paying more at the pump. "The fewer miles driven by car, the less likely the vehicle is going to need some sort of repair, which has implications for auto parts retailers. We will monitor the impact rising gas prices have on this data point to see if it is becoming a concern."

Investment implication: high pump prices mean less spending in other areas

Given our Grassroots® Research team's findings, investors may want to keep a close eye on nonessential consumer spending – from fast food to entertainment – as well as spending on auto parts. Our survey results show that if petrol prices remain high or move higher, more than the energy industry could be affected.

High petrol prices will affect spending on restaurants, entertainment and leisure travel

Question: If petrol prices stay high, do you expect to spend less in any of the following categories in the next six months? (Select all that apply.)



Source: Grassroots® Research. Data as at May 2018.

Source: Allianz Global Investors Insights, Volume 10, Issue 9