

April 2017 Market Update

Key points

- Survey-based measures of the economy continue to look positive as consumer confidence rose to the highest level in 16 years.
- Political tensions, both domestically and abroad, continue to weigh on rates despite the Fed hiking rates in March.
- Recent Fedspeak indicates a high level of support from Fed members to continue hiking rates this year.
- Reduction in the Fed's \$4.5 trillion balance sheet has come more into focus as the committee debates the timing and mechanism for such a move.
- Recent political stumbles from the GOP indicate the timing for implementing tax reform has become less certain.

Outlook

GROWTH: Survey-based measures of the economy have been telling a positive story about the present situation in the U.S. Institute of Supply Management surveys are elevated and consumer confidence came in at the highest level in 16 years. On the other hand, quantitative measures of the economy have not been as robust as the surveys may suggest. Admittedly, economic measures such as personal spending, auto sales, and retail sales were below expectations during the first quarter, but we expect to see "soft" data converge with "hard" data at some point to resume the upward trend for growth in the coming quarters. Thus, we continue to maintain our outlook for growth for the foreseeable future.

2017 OUTLOOK FOR GROWTH	EXPECTATION
Real GDP (growth)	2.25% - 2.75%

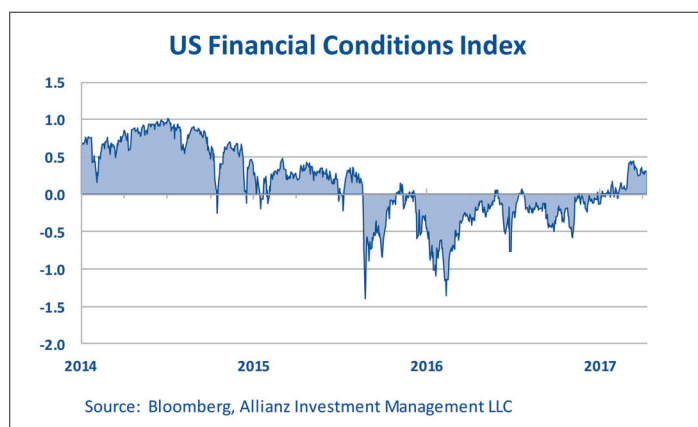
INTEREST RATES: Much to our surprise Treasury yields have failed to break out of their range between 2.30% and 2.60%, despite the Fed raising rates in March and signaling two additional hikes for this year. That being said, there appears to be some skepticism in the markets on whether that will happen. Much attention has been focused on Capitol Hill and the Trump administration's inability to retain enough votes to repeal and replace Obamacare, which has caused some market participants to question the timing of other large agendas like tax reform. Indeed, the short-term catalysts for bond markets have been dictated by the political stumbles of the GOP, but the larger narrative of central bank policy normalization remains intact. We still expect 10-year rates to break out of the current range to the upside of our target, but the timing for this to occur may be a bit longer than markets had originally expected.

FORECAST PERIOD	10-YEAR TREASURY YIELD
12 months	2.50%-3.00%

March 2017 recap and macro themes

The tug of war over the direction in bond yields persisted during the month of March as investors continue to reconcile the differences between “soft” and “hard” economic data points. Ten-year Treasury yields continued to trade in a range between 2.30% and 2.60%, as political tensions both domestically and abroad weighed on yields during the second half of March. The health care bill was the contentious issue under the spotlight, and some market participants viewed the inability to repeal and replace Obamacare as a large setback to the Trump administration. Our view has been that the runway to implement Trump’s complex agendas is longer than investors originally thought. Markets are catching up to this notion, as the uncertainty is having an effect on risk assets and putting pressure on rates. Ultimately, we still expect Trump’s agendas to move forward, but the timing and magnitude are being called into question.

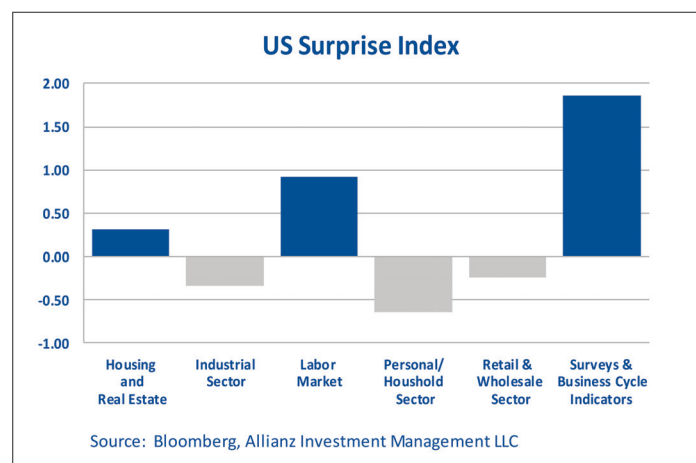
Despite the recent political stumbles and President Trump’s continued search for tweetable victories, it is important to remain cognizant of the larger thematic forces that are driving the direction of asset prices. Economic data for the most part was relatively solid, prompting the Fed to prepare markets for the rate hike in March with two more to follow in 2017. In our view, monetary policy driven by stronger economic data continues to drive the overall direction of rates. According to the latest minutes from the FOMC meeting, the committee appears very committed to three rate hikes this year. Despite the 50 basis point increase in policy rates over the past four months, financial conditions have not tightened very much, indicating the Fed has more work to do.



Regarding the Fed, minutes from the March FOMC meeting indicate a strong focus has been placed on its balance sheet. Many market participants are looking for clues to the timing and the mechanism for balance sheet reduction. The minutes suggest the FOMC’s desire to reduce the \$4.5 trillion balance sheet and that it is likely appropriate to do so at the end of this year. How that will be done continues to be debated among Fed officials.

In our view, this will be done by either ending reinvestments or gradually reducing reinvestments of maturing securities on the Fed’s balance sheet. Regarding the future path of policy rates, the minutes showed that most Fed officials believe “gradual increases in the federal funds rate would continue,” which is in line with recent Fed speak pointing to two more rate hikes this year. With regard to economic data, most FOMC members feel that the “economy was operating at or near maximum employment,” but there still seems to be a bifurcated view on inflation as some members believe it will take longer for core PCE to reach the 2% target. Indeed, the short-term catalysts for bond markets have been dictated by political stumbles and geopolitical risks, but attention should shift back toward monetary policy and potentially lift bond yields.

Economic data throughout the month of March tilted toward the positive side, with the survey and business cycle indicators driving the positive results. Consumer confidence measured by the Conference Board rose to the highest level in 16 years, and survey data from the Institute of Supply Management continued to remain elevated. In the labor market, although the headline payroll additions disappointed, the drop in the unemployment rate to 4.5% and the continued low level of jobless claims suggest a very healthy labor market. On the other hand, the household and retail sectors have failed to meet consensus expectations, putting some drag on the overall surprise index. Personal spending, although increasing, has been minimal, and auto sales were a huge disappointment in March. On balance, overall economic data continues to look healthy and with a robust labor market and relatively low energy prices, we expect consumption to pick up over the coming quarters and return to above-trend growth.



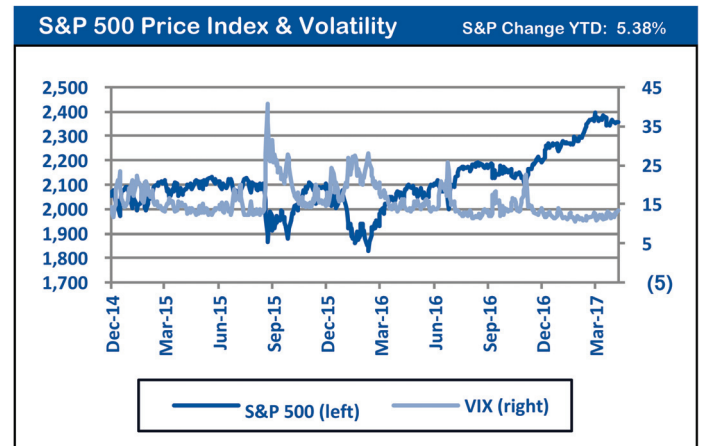
Market indicators (figure a)

- Despite uncertainty over Trump agendas and geopolitical risks, equities have remained impervious as the S&P 500® Index has gained over 5% year-to-date. However, comments from some Fed members in the latest minutes indicated equity prices were high. Additionally, with the runway for tax reform longer than originally expected, we expect some cautious sentiment toward the asset class in the coming months.
- The CBOE SPX Volatility Index (VIX) index, which measures future equity market volatility on the S&P 500® Index, has traded below 15 since last November, which is the longest streak in over 10 years. Persistent low levels of volatility have us inclined to believe that volatility should mean revert at some point, leaving us more cautious on equities going forward.
- U.S. Treasury rates continue to be range-bound despite the Fed recently hiking policy rates. With current 10-year rates near the lower end of the range, we think risk is tilted toward higher rates in the near term, and monetary policy action such as balance sheet reduction should be a driver of rates going forward.
- Oil prices dipped below \$50 per barrel for West Texas Intermediate, as supply levels continued to surprise to the upside. Prices have recovered over the second half of the month as talks of extended production cuts from OPEC and geopolitical risks in the Middle East region have elevated prices. Overall, oil prices should continue to drift higher as the market works on balance supply.

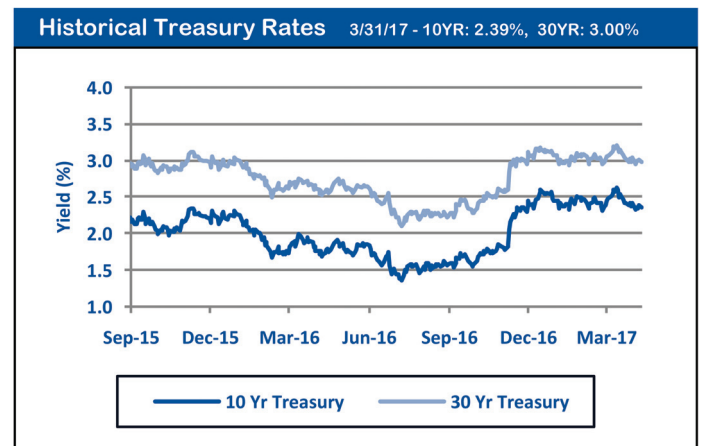
Economic indicators

- Consumer confidence, as measured from the Conference Board, rose to its highest level in 16 years as the index surged to 125.6 in March. Components of the index that drove the gains were the present situation and the expectations. We suspect that strong equity markets combined with low gasoline prices at the pump are boosting consumer confidence at the moment. Additionally, the final reading on the University of Michigan Consumer Sentiment rose to 96.9 in March from a prior-month reading of 96.3.

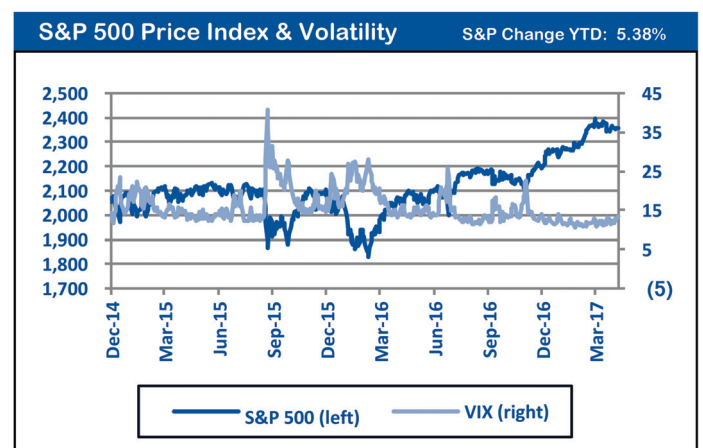
figure a



Sources: S&P, CBOE



Source: Bloomberg

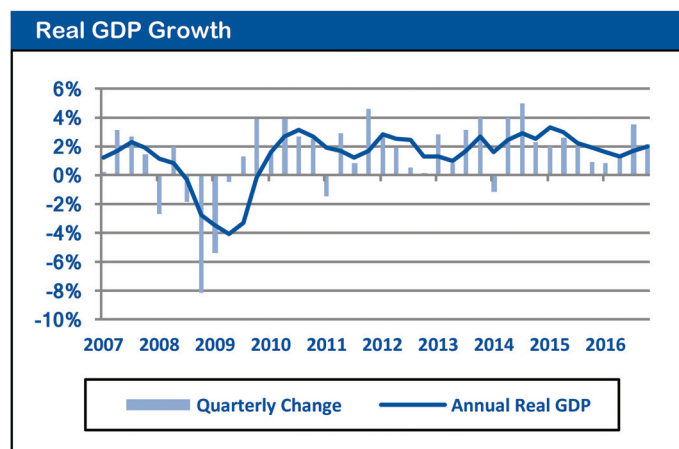


Source: Bloomberg

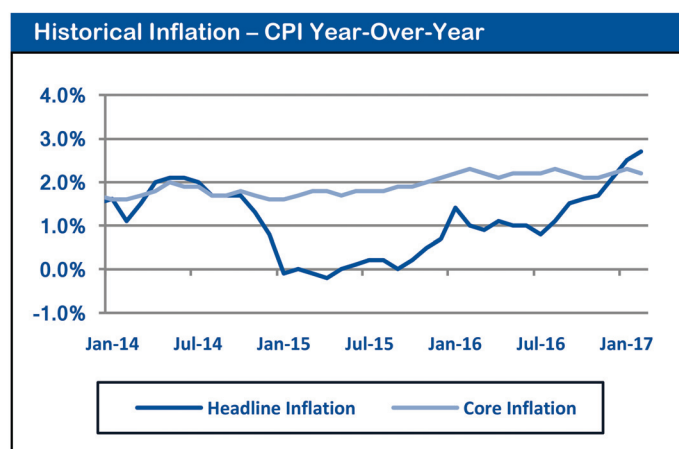
Economic indicators (continued) (figure b)

- The BEA lifted its third estimate on 4Q GDP from 1.9% to 2.1%, with the upward revision to personal consumption as the main factor. With almost half a million jobs added to the economy during the fourth quarter and wages rising modestly, we are not surprised to see the solid consumption data contributing to the total output of the economy.
- Core CPI, which removes the volatile food and energy index components, rose 2.2% over the last year, while the headline CPI figure, which includes the volatile component, came in at 2.7%. The energy index component was the primary catalyst behind the uptick in headline CPI, as it increased 15.2% over the last 12 months. Month-over-month headline CPI rose 0.1% compared to a consensus estimate of 0.0% in February, and was the smallest one-month positive movement since July 2016.
- Jobless claims for the last week of March surprisingly dropped by 25k to 234k. The continuously low level of claims provides a confident backdrop that labor markets continue to tighten. As a result, we expect some modest wage pressure to occur as businesses search for qualified workers in this environment.
- The U.S. dollar index, a measure of exchange rates between the U.S. and other major world currencies, declined during the month of March, as uncertainty around the timing of Trump's agendas pushed the index lower by 0.55%. There is some uncertainty as to whether the dollar will continue to strengthen, but we suspect this will largely be driven by global monetary policy.
- The latest reading on the ISM Manufacturing Index came in at 57.2, only slightly below the previous month's reading of 57.7. While the production component of the index slipped to 57.6, the silver lining continues to be the new orders component of the index. In addition, the employment index rose to its highest level since 2011 at 58.9.

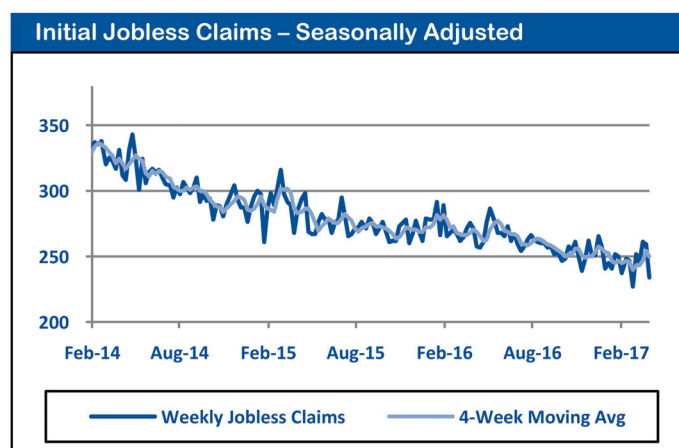
figure b



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

EVENT	Previous	Survey	Actual	Next
ISM Manufacturing Index	57.7	57.2	57.2	May 1 (Monday)
GDP annualized (third)	1.9%	2.0%	2.1%	April 28 (Friday)
Unemployment rate	4.7%	4.7%	4.5%	May 5 (Friday)
Retail sales	0.4%	0.1%	0.1%	April 14 (Friday)
Consumer Price Index (YoY)	2.5%	2.7%	2.7%	April 14 (Friday)
U. Mich. Consumer Sentiment	96.3	97.0	97.6	April 13 (Thursday)
Home Price Index (MoM)	0.93%	0.70%	0.86%	April 25 (Tuesday)

Definitions

Table columns

Previous – Observation as of the end of the prior month

Survey – Economist survey prediction for current month's observation

Actual – Actual observation as of the end of the current month

Next – Date of next period's observation

ISM Manufacturing Index

Based on a survey from the Institute for Supply Management, this index indicates a positive growth in the manufacturing sector when the figure is above 50 and a contraction of the sector when it is below 50. An increase in the figure indicates either slowing contraction or accelerating growth. The index represents underlying figures in employment, inventories, new orders, production levels, and deliveries. (Source: Bloomberg)

Unemployment rate

Based on a monthly survey of households, the unemployment rate is one of many figures in the Current Population Survey that move markets by indicating what portion of the population is at work, looking for work, what they are getting paid, and how many hours they work. The unemployment rate is the percentage of workers unable to find work who are actively seeking a job. The survey is conducted by the Bureau of Labor Statistics.

Retail sales

Retail sales measure the total amount of purchases by consumers in stores that sell merchandise, food, and other services to end consumers. This measure is a significant indicator of trends in consumer spending, which moves markets because consumer spending accounts for over ⅔ of U.S. economic output. Data is compiled by the U.S. Bureau of the Census.

Consumer Price Index (CPI)

The Consumer Price Index measures the prices of a fixed basket of goods that reflect an average consumer's cost of living. CPI is a popular indicator of inflation, driving prices on U.S. inflation-linked bonds and used to adjust tax brackets and Social Security payments. CPI is compiled by the Bureau of Labor Statistics monthly.

Home Price Index

The S&P CoreLogic Home Price Index is the seasonally adjusted average price of residential homes in 20 major cities in the U.S. Data is published with a two-month lag (numbers available in March reflect price changes from January). Housing prices affect consumer wealth and consumers' ability to borrow and spend, which in turn affects U.S. economic growth.

Gross domestic product (GDP)

Gross domestic product is the sum of the value of all goods and services produced in the economy. It is one of the most comprehensive benchmarks for economic performance. Real GDP measures economic productivity adjusted for inflation, which measures growth that is not due to goods getting more expensive. GDP is published by the Bureau of Economic Analysis.

University of Michigan Consumer Sentiment Index

The index is derived from surveys of 500 households by the University of Michigan on consumer finances and attitudes regarding the economy. The index is set to 100 as of 1966, reached a high of 107.3 in June of 1999 and a low of 56.4 in June of 2008. High consumer confidence levels lead to robust consumer spending, whereas low consumer confidence levels lead consumers to pull back on spending.

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