Income Webcast Series #3
The Economist View: Hunting for income in the second half of 2020

Transcription

Recorded on 30 June 2020

Presentation

00:00:01 Moderator
Good morning everyone and thank you for joining Allianz Global Investors "Hunt for Income" webcast series. My name is Eddy Kwong from Sales and Marketing, your moderator for today's webcast.

The financial markets reacted to the coronavirus with an unprecedented first-quarter drop, then turned around quickly in the second quarter. This appetite for risk in the face of the deepest recession since the 1930s is quite unusual. At this moment, how can investors, like yourself, navigate these turbulent times and generate the income that you require from your portfolios?

At Allianz Global Investors, we believe investors should be cautious and maintain a neutral allocation in the medium term – while remaining ready to take advantage of select opportunities.

Today, we have invited Christiaan Tuntono, Senior Economist, Asia Pacific to share Allianz Global Investors' mid-year outlook to help all of you to explore investment opportunities in the final six months of this dramatic year.

Christiaan is a member of the Global Economics & Strategy team at Allianz Global Investors. He is responsible for economics and strategy research and has had an extensive financial career as a macro specialist. Before, Christiaan worked for Credit Suisse, J.P. Morgan and Goldman Sachs in a variety of roles.

In today's webcast, Christiaan will share views on the global macro-economy, monetary policies and fiscal stimulus polices, as well as the investment implications for major global events, including the recovery from Covid-19, US-China tension and the US election for the first half of the hour. After the presentation, if you have any questions, please use the online QA column to raise them, and we will cover as many questions as we can in the QA session later.

Now, let's welcome Christiaan to share his views on the outlook for the second half of 2020.

00:02:16 Christiaan Tuntono
Thank you very much Eddy for your kind introduction. Good morning everyone, my name is Christiaan Tuntono. It is my great pleasure to talk with you everyone and share with you our view on the macro-economy and on the markets. So, if I may ask everyone to look at slide number 3, this is the key takeaway for our presentation.

This is how we look at the world right now. We think that, because of the outbreak of the Covid-19, the world economy has fallen into a deep recession and it is likely the deepest we have seen post-World War II. And then if you look at how the virus actually affects the economy, you may pan on the next slide. It actually hits on several fronts.

Number one is the demand effects that the virus prohibits people from gathering and that causes some consumer demand collapses and also hit on the supply side, that it reduces labor supply, by prohibiting people from going to work, and there's effects on loss of productivity. It also hits on the financial effect as equity markets, and our financial markets got impacted, and there’s disruptions in terms of the financial system.

Also, they're potentially causing capital flight away from countries where they suffer from some weak fundamentals, and also on the external effects that it reduces trade, travel, tourism, etc., and you can go back to previous slide.

All these are having impacts on dragging down economic growth. And also the effect of it, even though there is a lot of monetary and fiscal policy support, the end effect is likely to be a long term rise of public debt level. At this time, the market situation seems to have calmed because of the very, very strong stimulus responses from the governments and central banks, but we are still in an uncertain territory right now, because we don't really know the long term effects of all this on the economy and on the market, and there is still uncertainty on this.

At this time, we think that the rebound in equity prices is driven mainly by the market optimism about the strong monetary stimulus, even though right now we see that the economy is still sluggish, data are still very weak, there is an expectation that it should improve going forward when the pandemic gradually passes away.

Bond yields are still likely to remain low because of the very, very strong monetary stimulus from central banks, and this is likely to support the bond market for the time being.

If everyone turns to slide number 5, I think this is a very good chart to pan out across the world where’s every different countries actually have on this pandemic. I would like to point you to a very famous article called “The Hammer and the Dance”.

What this really means is that The “Hammer” is a metaphor for a phase where countries actually implement very, very strict control measures on trying to stop the spread of the pandemic; and the “Dance” is, after the very, very strong control measures, you still have to manage in terms of the social distancing, to have a very quick response in terms of testing, in order to prevent a renewed surge of the pandemic.

You can see various countries and regions are showing that in the very, very forefront, you can see Hong Kong and Taiwan, along with Korea, Japan and China, are more in the advanced stage of this pandemic- they are more in the “Dance” phase that they are implementing social distancing, trying to prevent a serious second outbreak. But there are some countries that are still in the “Hammer” phase, even though they probably have moderated a bit, such as the United States, France, and Germany. There are some countries that actually are picking up in terms of the spreading, like Sweden. So you can really see that everyone is going through this passage and we generally definitely see some countries that are more advanced in this pandemic will have better or faster recovery in their economy and on the market as well.

If you pan to the next slide on page 6, obviously the impact of the pandemic is severe on the economy. We take the US as an example. On the top left chart, the GDP (Gross Domestic Product) forecast for 2020, we are expecting US GDP growth to contract more than 5%. But at the same time, if you look forward, if we are assuming that there is no serious second wave outbreak, then we are expecting in 2021 growth should actually recover and pick-up because of the very low base and it will gradually moderate going forward in 2022. The unemployment forecast is we are expecting a surge to about over 10% in 2020. But it is likely to moderate going into 2021 and 2022, and the market economists’ expectations for an economic recovery actually has pulled forward.

And if you see economists that are expecting a 3Q 2020 recovery actually has picked up to about 66% in May, versus about only 44% in the previous month. These are some good signs that, despite the very weak economic situation right now, that we are still hopeful about a pick-up in growth going into the second half of this year, and also in 2021.

If you turn to slide 7, there we really see the latest data actually is showing some tentative signs of stabilisation. The global PMI survey, you will see that manufacturing and services have hit rock bottom and recovered, and also the global PMI is also showing that in the US, Japan and the Euro Zone that they have hit rock bottom and recovered as well.

If we pan on Asia and look at the next slide, slide number 8, is that what really drives the economic recovery in Asia. We think that there are four factors that are very important to look at.

Number one is that you have to look at the daily confirmed infection cases in Asia and this is the chart on the left. We really see that there are various different waves and China is the first wave, because the pandemic started in China and we really see a pick-up in the number of infections, but then it has moderated or plateaued up until now.

And then the second wave is coming in Korea, that really picked up and then actually has plateaued as well. And the third wave is around in Taiwan, Hong Kong, Thailand and Malaysia, and the fourth wave is in Singapore, India, Indonesia, and the Philippines. And therefore, various regions in Asia are going into the pandemic at various different phases and definitely from this we see that we are more favourable in terms of China, Korea, Taiwan and Hong Kong, and see that they are at the more advanced stage of the pandemic.

The second important thing is really the harshness of the containment measures that we've seen in various economies. This is a chart that is showing, at the bottom, the economies that actually are harshest in terms of really strict containment, and on the top side are those that are more lenient; doing more testing and social distancing. You can see China, Vietnam, Malaysia and India are more on the stringent side, they are more forceful in terms of institutional strength to try to control the spread of the pandemic. And Korea, Taiwan, and Hong Kong, they are doing more social distance things; less stringent in terms of trying to curb people's movement to try to contain it.

And then the third factor, if you turn to the next slide, is about when the pandemic really hit the economy, how much strength, on the fiscal side, actually various economies can provide. And the table on the left you can see the blue bar and also the grey bar. The blue bars, those are the actual fiscal stimulus, that means the spending the governments are going to do, or the tax reductions that are getting into the economy, and we see that as a more solid kind of support to the economy. You can see Hong Kong, Singapore, Thailand, as a percentage of their own GDP, are more forceful in terms of supporting. The grey bars are more the kind of measures that going through the soft loans, contingent measures, so we are putting less weight on it and we prefer to look more at the blue bar as the strength of support.

And the fourth factor is really how open is the economy. As we all know that the global economy are going through the pandemic, in the US and the EU demands are recovering but is still very low and therefore the more open an Asian economy is, actually the more drag that it would have in terms of recovering and getting the benefit of external demand support. We can see that Hong Kong and Singapore, again, are more open and they're likely to be dragged down by it.

So what does this all mean? When you're really putting all these four factors together. We are more favourable on China. We think that China is at the advanced stage of the pandemic, as I mentioned earlier, it shows strong institutional strength to contain the spread of the pandemic. It has good fiscal and monetary stimulus support to uphold the economy, and it is also a very territorial economy, that means, even though China is a very great trading nation, but as a percentage of GDP, actually the external sector is not as big. So, as long as the domestic economy recovers, we are expecting that the economy should recover sooner.

And following China, we are favourable for Korea and Taiwan. Same thing; is that they are more in the advanced stage of the pandemic, but they have less stringent control on the spread of disease, but in a way they are less likely as well because I think that the outbreak was not as serious as other places that we saw. And also these are more open economies, so they are more likely to be dragged down by the slow recovery that we saw in the US and Euro zones and other global economies.

And the more concerning areas within Asia that we have is more on India, and the ASEAN economies. The reason is that the pandemic is still going on, especially in India and also Indonesia, the institutional strengths that have been demonstrated by the ASEAN economies are actually various: some economies are actually showing stronger control, but then some are actually more relaxed, and therefore we think that they have various different stages of recovery and also the stimulus measures, even though there are, probably not enough to really give us full support in terms of a really swift recovery. So, we think that they may come back up or climb up out of this economic impact probably at a slower pace vis-a-vis China, Korea and Taiwan.

If you turn to the next slide, on slide 10, this is a table that is based on the OECD –WTO indicators to show what economies in Asia actually would be more benefited by the recovery of China demand, which is an important driver. As I mentioned earlier, China is going to recover earlier; it will start to consume, it will start to import, and many Asian countries can benefit from it. But who and how strong will they benefit from that?

If you look at the chart under China it really shows the domestic value-added embodied in China demand. Just take Taiwan as an example, which is listed as 13.4%. It means that China demand actually represents about 13.4% of Taiwan's GDP, roughly speaking. What that means is, assuming that there's a 10% rise in China demand, it actually implies that there will be about a 1.3 percentage point increase in Taiwan's GDP growth and so on and so forth.

And we really see that the economies like Taiwan, Hong Kong, Malaysia, Singapore, Korea, Thailand; they are the

ones that are likely to benefit more as China demand recovers.

If you turn to the next slide, on slide 11. We pan into the sections looking at the strength of the various fiscal supports, and we take the United States as an example. This is a full table - sorry about this, it's a little wordy - but I think you can read through and see the various different measures introduced by the Fed (Federal Reserve Board) and by the White House in terms of supporting the economy. And for the Fed, you can see that there are many measures coming up, like cutting interest rates by 100 basis points, the 700 billion quantitative easing programme, and also by Powell the "QE (quantitative easing)-unlimited" to be launched. And also from the White House, about a 2-trillion comprehensive stimulus package, which amounts to about 10% of GDP. And also for the IMF (International Monetary Fund), that they actually had pledged about a 1-trillion support package for countries that have financial needs. So, the responses are very, very strong.

And on the next slide, on slide 12, you can see, let's focus on the chart on the right hand side, the amounts of monetary stimulus from various central banks were very strong. And we project that the M0 as a percent of GDP is likely to really pick up going forward, and this would be a very strong support on the liquidity and the money supply in the world.

And on the next slide, on slide 13, we can see that this is a chart that's showing the movement of the S&P 500 and also the timing of various Fed stimulus launches. The most intensive period is around the March time. And you can see the Fed really launches various different programs to support the economy. And because of that, actually the market hit the bottom and started to recover coming from that.

And on page 14, the next slide, in terms of looking at the fiscal responses of Covid-19, this time around, the total extent of fiscal stimulus that was launched by the G20, including G7, actually it was already stronger than what we saw back in 2008 and 2010. It was spear-headed by the G7 economies, by the deep blue column on the left hand side, the amount of support was quite unprecedented.

Turning the topic to the US elections, if you turn to the next slide, on slide 15, we now see that actually President Trump faces quite formidable economic challenges during his re-election campaign. If you look at the chart on the left, we compare the unemployment rates Trump has, versus all the other incumbents that have lost or won their re-elections. We see that Trump, right now with the average unemployment rate about 13%, has actually superseded all those previous incumbents that have an unemployment rate, I think the average is about 7.5 or 7.7%, and right now the unemployment surging at 13% is not quite favourable for Trump himself.

Also if you look at the chart on the right hand side, if you compare the net approval rating, which means the approval percentage of the president minus the disapproval, on the Y-axis, and you look at the average GDP growth per capita on the X-axis, you can see that Trump actually is more disclosed as unfavourable because of the negative net approval ratings and also the slow growth that we have. This is indicating that the chance for Trump to succeed and be re-elected actually has declined from six months ago.

If you turn to the next slide, on slide 16. The latest poll shows that Biden is ahead in some of the critical states that Trump won back in 2016 and these include Michigan, Wisconsin, Pennsylvania, Florida, North Carolina and Arizona. And remember Trump actually won by very, very thin margins back in 2016. Right now, with the polls showing that Biden is leading in all these states, it is showing that this is a quite formidable challenge for Trump to get re-elected as well.

So if you turn to the next slide, on slide 17. The odds for expecting a Democratic win in this election actually has improved quite visibly. Back in February or so, expecting a Democratic candidate to win the election was only 43%, but right now it has increased to 55%. And if you look at the chart at the bottom, expecting the Democrat to win the presidency and also on the legislature actually has the highest percentage of 46% as of June.

This is a substantial increase from only 9% back in February. So, this is really tilting more favourable for a Democratic win. So what does all this mean?

If you turn to the next slide, on slide 18, a Biden win is likely to mean a restoration of the Obama legacy. So, we're expecting Biden policy to support the middle class more, the labor, green energy, healthcare, etc. I think the key difference is that Biden is likely to to restore the top individual tax rate from 37% back to 39.6% and also partly unwind the 2017 corporate tax cut, to raise it from, currently, 21% tax rate to 28%. This would have impact in terms of the expected earnings among the S&P 500 if this is to happen. So, in a way, this is likely to suggest that there could be some earnings impact for the market.

Panning a different topic, if you turn to the next slide, on slide 19, we look at how the US-China Phase 1 deal is getting on. Right now, it shows that there is some lagging in terms of China satisfying its purchase commitment. It is falling behind by about 60% or so. If you look at the chart on the left, as of

March, China only purchased about 14.4 billion of US exports and this is actually falling behind from the dotted blue line by quite a sharp margin. So, we are expecting that this is likely to be a potential risk, even though. right now, both the US and China still say they are committed to satisfying the contract. But we'll keep a very close eye on it and think that there's still risk that this issue may pop up, possibly later on the second half of the year, to cause some turbulence in the market but we will closely watch out for it.

In terms of US-China relations, there are actually a lot of US actions against China, and I think the slide 20 really helps summarise most of them. You can categorise them in different buckets on technology, financial, diplomatic and others. On technologies, obviously, there is tighter restrictions in terms of sales to Huawei and there's more scrutiny in terms of what kind of technologies that the US can sell to China. On financials, there are scrutiny in terms of potential de-listing of ADRs in the US, and also tighter requirements for US retirement funds investing in China. On the diplomatic front, obviously, what's going on in sanctions for China in disclosing Covid-19, and also on some movement in terms of tighter restrictions on China Visas are also the key. So, be watchful of all these geopolitical issues that they may probably cause some hiccups in the market as well.

On the next slide, on slide 21, this is a general overview in terms of how we think about the equity market, to make a brief summary of that, the key themes about the market is really about the dichotomy between what's going on in the economy and what's going in the market. There's no doubt that the Covid-19 has hampered growth and there is damage to businesses and consumers and the recovery may not be as fast as people expected. But at the same time monetary and fiscal stimulus support was very strong and it pre-empts a lot of concern about the market right now.

So, in a way, we actually think that maybe a defensive and high quality sector allocation is probably appropriate at this time. In a way, the market is supported but we still see potential risks at this time, because of the fundamental economy. So, taking some cautious but proactive approach in investing may be something that we think could be appropriate.

In terms of valuation right now, you turn to slide 22. This is showing various levels of valuation in different markets: S&P 500, MSCI World, MSCI Japan, MSCI EM, etc. The red arrow is about the valuation level in terms of the cyclically adjusted P/E ratio. And you can see that the S&P 500 actually was quite higher than the average; about 26.5 compare to historical. But at the same time, if you look at MSCI Japan and MSCI EM, actually valuation is quite low and at the low of the historical range.

If you look at the fixed income market on the next slide. Overall, the actions from various central banks was very, very strong, and we are expecting that this is likely to continue to support the government bond market. We think the government bond yields in the US, the Euro Zone and Japan and UK could continue to trade at quite a low level. At the same time, investment grade bonds are supported by central bank purchases as well.

So, if you look at the next slide, on slide 24, we think that a Barbell approach to deploying fixed income risk could be appropriate. The chart below is in terms of the various risk level: the lowest risk is definitely the US Treasury bonds, and you can probably look at stepping up in terms of risk sector going to US Dollar assets, or high quality investment grade bonds, and the more rewarding, or higher risk, is Asian high yield that probably would capture more of the return but obviously this is also stepping up in terms of the risk ladder that represents a more proactive approach in terms of fixed income investing.

Overall, in terms of asset allocation themes on slide 25, we would recommend a Barbell approach to investing. On the first hand, is that we think that investors should still stay defensive in terms of asset classes and therefore can consider assets like treasuries, gold, US dollar and high-quality investment grade bonds. But at the same time, we can look beyond and look at a world that is after the post Covid-19, and pay attention to some sectors like food delivery, online retails, technology sector, health care space. And also China as an asset class. I think the Chinese market shows quite low correlation with what's going on in the rest of the world and could be an asset class that would add to the stability of the overall portfolio.

And if you turn to the next slide, on slide 26. Considering the reopening cyclical sectors, we would look at the airlines, hotels, parts of energy complex (like renewable energy, natural gas companies, refineries), diversified financials, medical tech and biotech. These are some of the sectors that could be interesting in a post Covid-19 world.

On the following slide, in terms of technology, some sectors like the Wi-Fi and 5G services, virtual access, corporate IT and mobile payments could be some interesting areas as well. Also, on the next slide are some highlights of the healthcare sector.

So, overall, this concludes my 30-minute presentation to share our views on the macro and investment. I am very thankful for your listening and I'll just pass the mic over to

Q&A

00:28:51 Moderator

Thank you, Christiaan. So, let's quickly move into the Q&A right now. We have quite a number of questions on the US election. Whether it's Biden or Trump, what are some of the risks that are lying ahead for us, and how do you think it is going to impact our financial markets and especially around the implications of US and China relations.

00:29:33 Christiaan Tuntono

Okay. These are very good questions. As I mentioned earlier, if the election result shows up as what the poll currently is saying, and that means that there's a higher chance for Biden to become the next president, then the direct implication on the market is that there could be some impact in terms of corporate earnings because there's a plan to revise partly up the corporate tax rate from 21% to 28%. So this is something the market may be wary of and may cause some hiccups on that. So that’s the first point.

And in terms of the US-China relations, we are not really expecting too much of a change in terms of how the US is going to deal with China. I think, in a way that the policy stance that the United States is currently on China, on trade or in tax or in various issues, actually is quite bi-partisan. So, it actually has the support of both the Republicans and the Democrats. Therefore, changing the presidency to the Democrats may not change too much.

But what I think probably may really make a difference is the character of the president, as we saw over the past 4 years, Trump has his very unique style of negotiation and handling things. I think probably a Biden presidency will return to more of a normality that we're familiar with how the White House is going to deal with China. Probably more things will be dealt with behind closed door. There possibly will be less Twitter going out and shocking the market at any minute that would come out and things probably would be more strategic. So I'm actually expecting that, but I think the overall direction of US-China relationship would still be challenging.

There will still be competitions between the two largest economies in the world and there's still chance that there could be negative news coming on financials, on tech or on trade that may actually concern the market going forward.

00:31:28 Moderator

It seems that there are quite a number of questions around Covid-19 as well. I think recently we have seen a slight increase of Covid-19 cases in different parts of the world. Do you think there is a second wave coming, and if so, how do you think the market will react?

00:31:47 Christiaan Tuntono

Yes, that is definitely a risk of that. As you can see in the States, there are certain states that actually have re-opened, seeing new infection cases re-rising, and the market actually got spooked by it.

Let's see last week, there were several days that the market took some quite sharp corrections because of the news. This is always a concern, but the latest happening so far is still stability. I think in a way that, while the number of new cases rise up, there is a question of “Would it really stop, or reverse the pace of economic reopening?”

I think in a sense that some states will probably slow down, and probably postpone in terms of the re-opening up, but it's quite hard to think it would reverse and then the whole Unites States is going to close down again.

Therefore, I think there would be negative impact on the economy but at this moment, showing that probably may not be as severe as concern. And the latest data coming out are quite positive: there are some data that actually exceeded expectations. Therefore I think, overall in the world, growth is still coming back, even though the market has expectations that it will come back gradually, or with some twists and turns. Especially in Asia, there were some cases in terms of a second wave over in China, but things are actually getting better.

So, overall I'm still optimistic. I think that overall trends of macro recovery should be on, and with the very strong monetary and fiscal stimulus provided by global central banks and governments that it should be quite supportive.

00:33:40 Moderator

Okay, good to know. So, I guess we have time for maybe one last question. I know that we have some participants from the ASEAN region. What is your expectation for oil prices and also what is your view on the energy sectors?

00:33:58 Christiaan Tuntono

Okay. I'm generally quite sanguine over oil prices. Obviously, we all know that it went through quite a difficult time earlier and prices dropped to the negative zone. But, I think as the global economy is starting to recover, especially Asia, which is a very big importer of oil. Also, you look at OPEC (Organisation of the Petroleum Exporting Countries) and Russia, cutting back in terms of the supply, that we more or less see that supply and demand getting back to equilibrium. And I think it will take time, but gradually prices should be

supported. So I think probably, I would say the worst time for oil prices may have passed at this time. Overall, for the energy sector our view is quite supportive. I think that, no matter how bad this virus is going to cost demand and supply, one day it will pass as we humans have dealt with many pandemics in our history before. So, the overall tone is that I'm still sanguine and positive about the future.

00:36:06 Moderator

Good. Thank you for your time. And before finishing up today, I would like to once again thank Christiaan for his time and the sharing of his insights with us today.

To all of you, in the audience today, don't forget to use the online survey form and let us know your valuable feedback. The transcript of today's webcast will be provided to you over the course of the coming weeks. In the near future we will continue to host a series of live webcasts, bringing you forward-looking investment insights to help guide you through all these uncertain times.

Thank you again for joining today's live webcast. We wish you a safe and pleasant day. Thank you.

Q&A — Unanswered questions during the webcast

Q: Due to current condition that many stimulus from governments and central banks, which one is better between Asia Pacific market (bond/equity) or U.S/Canada market (bond/equity) considering risk appetite, liquidity and market potentials between them.

A: Over the coming quarters and given the huge uncertainty with respect to the virus and the economic outlook, we prefer to have, in general a balanced portfolio positioning. This holds true for the decision on bonds vs equities as well as for the intra-regional allocation. Longer term, i.e. on a multi-year horizon, AP x Japan assets are preferred over US assets on valuation grounds.

Q: What's your view on Europe/ Brexit?

A: There is significant risk of a no-trade-deal Brexit, with major negative repercussions, notably for UK but also, albeit to a much lesser extent, for EU. Due to coronavirus, this risk currently seems to be underestimated. We prefer to reflect the Brexit risk primarily via a short position in GBP.

Q: Any advice for the investors who focus on income investment theme this year?

A: We still have a moderate positive view on credit as central banks continue to directly intervene in this market, even though spreads are tight and valuations rich. With value equities having underperformed by so much post-GFC (post-global financial crisis), we recommend to stay invested in dividend strategies.

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