AUGUST 2018

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Global view

Trump turns the tables on trade

Neil Dwane
Global Strategist

Key takeaways

- Trade is a winning political issue for President Trump; expect to see a steady flow of headlines in the run-up to the November mid-term elections
- China's newly restricted access to US technology has been a wake-up call, but it could also cause Asian nations to forge closer trading ties with China
- With so much uncertainty around global trade, investors shouldn't be complacent: watch for currency volatility and keep an eye on shrinking corporate margins

What will President Trump do next?

President Donald Trump has been busy transforming the terms and tone of global trade, careful not to flout World Trade Organization rules while using national security to target what he says are unfair trade practices. Trade is a winning political issue for him, so as the November 2018 US mid-term elections approach, we expect to see a steady flow of trade-related headlines.

The Trump administration's approach to renegotiating trade agreements should result in more bilateral than multilateral deals. President Trump believes that by keeping trade agreements between two countries, he can win the largest discounts and most favourable terms for the US.

He has also brought forth a new and rather extraordinary trade weapon: focusing on companies rather than just individuals or states. Among his targets have been Russian aluminium producer Rusal and Chinese cell phone maker ZTE. Given the potentially profound market implications, many corporations will be keen to avoid catching his attention.

President Trump has brought forth an extraordinary trade weapon: focusing on companies rather than just individuals or states

Will the US-China battle heat up?

We expect President Trump to continue concentrating on China –

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particularly as it relates to the technology sector – as the trade war between the two countries continues to grow. Markets are laser-focused on this confrontation, particularly given the risk of one or both sides making a serious error with a USD 1 trillion trade relationship at stake.

In the US-China trade war, one or both sides could make a serious error – and a USD 1 trillion trade relationship is at stake

China will have a hard time addressing the enormous trade imbalance it has with the US. The US does not make much that it can sell to China, but the US's tough negotiating stance is hamstrung by the fact that China is fully integrated into the global supply chain of consumer and manufactured goods, of which the US consumer is the largest purchaser. As a result, President Trump will have to balance being aggressive towards China while not hurting the consumers who vote for him.

For China – as well as Russia and a few others – President Trump's new focus on restricting access to US technology has been a wake-up call. Chinese firms may now need to develop their own operating systems and source code to reduce further risk to their businesses. With the tech sector representing more than 25% of major US and Asian benchmarks, this may be seriously disruptive. Suppliers in Singapore, Taiwan and South Korea could even need to choose which nation they will supply: the US or China.

Could the trade war spread?

President Trump believes the world has taken advantage of the US for years. Could he next train his crosshairs on Germany, another major exporter? Or could China, the European Union (EU), Canada and others band together, using the Trans-Pacific Partnership or another preferential trade agreement to lower tariffs for each other while excluding the US? These scenarios may sound far-fetched, but they are worth preparing for.

At the same time, Europe and the UK face their own trade war in Brexit, with no guarantee that negotiations will end smoothly. Brexit has the potential to disrupt the EU's economic engine, which would hurt Germany, as the world's largest exporter, as well as the UK, Europe's largest consumer.

If the trade wars heat up, and retaliation rather than reciprocity becomes the order of the day, investors could face a host of new challenges. Retaliatory measures could be subject to the whims of politics, since industries, supply chains and consumers can be specifically targeted. Retaliation can also be difficult to price in and it can have the opposite effect. Consider autos and auto parts – the largest traded-goods sector, worth USD 1.3 trillion. Interference in the auto-supply chain may raise prices and reduce consumer demand, but it could also open up competitive opportunities along the supply chain.

If the trade wars cause more retaliation than reciprocity, investors could face a host of new challenges

China could retaliate by selling some of its USD 3 trillion worth of US Treasuries or by steeply devaluing its currency. We consider both scenarios to be unlikely, since China's clear economic goal is to open up its markets and gain international credibility – plus where else could the country park 3 trillion US dollars? However, China is not without weapons: it could target large US corporations that do business in China, as it did with South Korea a few years ago.

What should investors watch out for?

1. Prepare for the end of NAFTA

President Trump has been ramping up tensions with Mexico, and it is entirely possible that the US could pull out of the North American Free Trade Agreement, particularly given the United States' push for new bilateral agreements that bring greater benefits to the US. An end to NAFTA would affect not just goods but services: financials, tech, banks and insurance companies could all be hurt.

2. Keep an eye on non-tariff barriers

While news headlines are all about tariffs, the US and many other countries use other, non-tariff trade barriers to control foreign competition, including subsidies, state aid, tax relief, industry bailouts and elaborate "rules of origin". Investors should focus on these more granular details, which will affect corporate prospects.

3. Watch for currency volatility

For decades, the US dollar has been the world's reserve currency, but a growing number of countries have sought to diversify away from the dollar standard – and this may accelerate as trade wars evolve through retaliation. This process could create currency volatility, and the US could feel pressure fund its own deficits though higher savings and investments.

4. Mind the margins

Corporations around the world have been caught up in the trade-war maelstrom, and politics are winning over economic common sense. Margins could be affected as production is relocated away from the outsourcing partners that once made production cheaper and more efficient. Consider the global tech titans of the US: if they are no longer able to rely on labour and equipment from Asia, they may be forced to rebuild their manufacturing capabilities in the US or select from a dwindling list of allies.

5. Guard against complacency

For some time, US enthusiasm about President Trump's tax cuts and deregulatory efforts has made markets complacent. So while the markets are nervous of the changes in trade, they seem to be counting on common sense to prevail, which is making them relaxed about the eventual outcome. This is already undermining corporations and investment.

Viewpoint

Time to change the narrative on active

Andreas Utermann
CEO and Global CIO

Key takeaways

- While passive investment vehicles have been popular in the recent past, the market environment appears to be shifting in favour of active management
- In times of lower correlations and higher volatility, active managers' skills can play a powerful role in separating the winners from the losers
- Done right, active management is more than picking securities and measuring against a benchmark; it should be a broader partnership built around identifying clients' needs
- Active managers should provide fair value, so we've introduced a bold and innovative approach: our active "outperformance fee" model provides clients with attractive optionality

The asset management industry has grown used to saying that past performance is not an indicator of future success – while sometimes behaving as if it is. Procyclical advice can see investors moving into funds or strategies that performed well in the past, rather than those that may hold greatest potential in the future.

Similarly, while passive investment vehicles have grown popular against the backdrop of a prolonged bull market, they may not position investors well when conditions – and opportunities – change.

It's time to break that cycle, and we think active asset management is a critical part of the solution.

We're helped by a market environment that appears to be shifting in favour of active. High correlations between stocks are beginning to break down; volatility shows signs of increasing.

In this environment, active skills can play a powerful role in identifying the winners from the losers – across individual securities, sectors, economies or asset classes. And faced with a more muted return outlook over the next five to 10 years, investors will need ways to work their money harder.

A more muted return outlook over the next 5-10 years means investors will need to work their money harder

But we don't think a more challenging market outlook is enough to prove the case for active management. As an industry, we need to change the narrative.

Too often, active management is regarded solely as a job of security selection and measuring performance against a benchmark index. While that's a core part of what we do, we think active management involves a broader partnership built around identifying clients' needs.

We deploy a toolkit of strategies designed to meet those needs and make adjustments with clients over the long term. This toolkit should include expert capabilities within and across asset classes that help us guide clients in a way that is truly product-agnostic. To maximise this agility, we may agree on an overall framework with clients, within which the timing and size of asset allocation decisions is at the discretion of the manager.

This level of insight and dynamic skill will be critical to successful investing in the future, as disruption reshapes the world around us.

New technologies – artificial intelligence, blockchain, machine learning – are upturning industries and driving a wedge more keenly between the winners and losers.

Active managers seek to separate the signals from the noise – and facilitate the efficient allocation of capital to support the goals of our clients, other stakeholders and society as a whole.

Active managers can help facilitate the efficient allocation of capital to support the goals of our clients, other stakeholders and society as a whole

Amid these seismic changes, passive managers will, by contrast, be forced to play a passive role. Another problem with passive is that it may give the largest weighting to sectors that have already peaked. Procyclicality – the tendency to follow the herd or track the cycle – is potentially a huge destroyer of value.

By contrast, active managers seek to embrace the future with conviction. A good example is our approach to environmental, social and governance (ESG) factors. We are integrating ESG factors into our investment process to engage with companies to help drive improved performance and hold management teams to account.

Whatever the arguments for active, however, active managers need to show that they represent fair value. This includes being bold and innovative on pricing.

We have introduced a new approach to performance fees. Our new "outperformance fee" offerings charge a low base fee, comparable to a passive product. Clients pay an active performance fee only when we deliver attractive outperformance.

Already we've had very positive feedback. We're not arguing that the fixed-fee model is wrong: we

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simply want to provide optionality for clients, so they feel more empowered in the process.

And, while fixed fees incentivise growth in assets under management, a shift to more of a performance component encourages us to limit the capacity of the funds we offer. That way, we maximise the alpha potential of the fund and stay focused on sharing value with clients.

Our outperformance fee model helps us stay focused on sharing value with clients

Our goal is to come to a common understanding with clients of where and how we add value.

The asset management industry needs to win back the trust of its clients and stakeholders. Active managers can do that by sharing our clients' journeys for the long run, adding value in a cost-efficient way – including through innovative fee structures – and staying focused on where the next big opportunities are coming from.

Economic inequality

To reduce inequality, focus on inclusive growth

Neil Dwane
Global Strategist

Key takeaways

- Today's slow-growth environment is creating social problems, including resurgent populism and rising economic inequality.
- An "inclusive growth" approach – which includes higher pay for workers – might turn around the global economy while reducing inequality.
- As Henry Ford proved, higher pay can result in greater productivity, reduced turnover and higher profits – and it can help the middle class grow.
- A better-trained, better-paid workforce can make business models more profitable and sustainable – and could usher in a longer-term return to widespread growth

The global economy has been stuck in second gear since the financial crisis. Historically low interest rates and seemingly free-flowing credit have kept the economy from backsliding – and boosted corporate profits – but they have failed to reignite growth. Beyond the economic toll, we are seeing a host of social and political problems come to the fore, including a resurgence of populism and rising economic inequality.

It will take multiple approaches to fix the global economy and address growing societal frustration

There are no easy solutions to these problems; multiple approaches will be needed to truly fix the global economy and address growing levels of societal frustration. But one such approach may be encouraging governments and corporations to deliver "inclusive growth" – growth that is shared throughout society in a way that reduces economic inequality.

For an example of how this might work, consider the American automobile magnate Henry Ford. Although he is primarily remembered for his transformative success at using the assembly line to mass-produce the Model T, what is less widely known is how he used high wages to stabilise his workforce and improve productivity.

As the Model T's popularity grew, Ford realised that chronic employee absenteeism and high turnover were hurting his bottom line, so he decided to pay his workers a wage so competitive that they would be unwilling to risk leaving or losing their jobs.

Ford's strategy worked, and the payoff was significant: employee turnover decreased, workers became more skilled, production lines became increasingly efficient and profits soared. Beyond his factory walls, Ford's approach helped develop America's middle class, and helped create an economy that was increasingly driven by consumer demand.

In contrast to Ford's approach, what seems to drive many corporate management teams today is the pursuit of short-term profits by cutting costs – particularly the cost of labour. And instead of making wise capital expenditures, many companies conduct share buybacks that inflate their stock options, even though buybacks can actually diminish medium-term returns by starving investments that boost competitiveness. All too often, these boosts to profits and stock prices come at the expense of employees, the environment and sometimes the quality of a company's products.

Cost-cutting can boost short-term profits, but it can also hurt employees, the environment and product quality

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Economic inequality

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To be sure, most companies exist to generate profits. But companies form part of the social and ethical structures of their societies, and the pursuit of profit can be only one goal. Companies could be better off trying to make their business models more sustainable by managing long-term risks to their businesses, by focusing on productivity and innovation, and by finding ways to contribute to the societies they depend on for their prosperity.

Higher wages are part of the inclusive growth approach that society needs, but simply boosting payrolls will not instantly repair decades of increasing inequality and failing economic growth. There are too many other economic pressures at work, including the rise of artificial intelligence and robotics; according to a survey by Oxford University, 47% of US jobs could soon be lost to computerisation.

So if corporations want to make their business models profitable and sustainable, they need to focus on raising the skill levels of their employees, not just pay levels. And if governments truly want to reduce some of the longer-lasting effects of inequality, they must implement policies that help workers evolve into new roles.

There may be downsides to this inclusive-growth approach –profits and investment performance may take a short-term hit – but the medium- to longer-term payoff could be a widespread return to growth. This is surely more in line with what society needs: a rising tide of economic prosperity that lifts all boats and carries us towards a more sustainable future.

There may be short-term downsides to an inclusive-growth approach, but the longer-term payoff is more in line with what society needs.

Paying down debt in a low-growth world

Inclusive growth could be a more palatable solution to the slow-growth environment that is preventing economies from reducing their debt levels, especially since some of the alternatives are a lot less appetising:

1. **Enforced austerity.** This approach would require economies to go on a severe diet by becoming more efficient and repaying excessive debts, without counting on debt forgiveness. This could foster more economic inequality and add to the appeal of populist politics.
2. **Debt default.** This could deliver a devastating blow to the financial system and impose severe economic conditions for years to come, and it might transform the political system in untold ways. Just look at Argentina, which has yet to recover from a century of defaults.
3. **Default through inflation.** This solution is arguably just as pernicious as direct default, since inflation hurts society's poorest citizens more than its richest. Many central banks have a target inflation rate of around 2% per year, but even relatively low levels of inflation can significantly erode purchasing power over time.
4. **Default through hyperinflation.** History shows that this option causes not only economic collapse but also social collapse, as seen in the Weimar Republic of Germany in the 1920s and in Zimbabwe and Venezuela today.

Further reading

Visit allianzgi.com to read more of Neil Dwane's thoughts on these topics, including "How to repair economic inequality" and "Let's resolve to build a new business model".

About Allianz Global Investors

Allianz Global Investors is a leading active asset manager with over 700 investment professionals in 25 offices worldwide and managing around EUR 525 billion in assets for individuals, families and institutions.

Active is the most important word in our vocabulary. Active is how we create and share value with clients. We believe in solving, not selling, and in adding value beyond pure economic gain. We invest for the long term, employing our innovative investment expertise and global resources. Our goal is to ensure a superior experience for our clients, wherever they are based and whatever their investment needs.

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Data as at 30 June 2018. (Number of investment professionals as at 31 December 2017.)

Volume 10, Issue 8 | 565858 | INSIGHTS_AUG18 | 03285