Allianz Global Investors

Revenue Growth and Corporate Profitability Should be Strong as Economy Continues to Grow

OVERVIEW

The three asset classes – U.S. equities, convertible securities, and high-yield bonds – utilized in the Income and Growth strategy advanced in the second quarter. The Russell 1000® Growth Index returned 11.9%. The ICE BofA U.S. Convertibles Index and ICE BofA U.S. High Yield Index returned 3.9% and 2.8%, respectively. By way of comparison, the 10-year U.S. Treasury returned 3.2% and the S&P 500® Index gained 8.6%.

Investors weighed stronger-than-expected first-quarter earnings results, positive second-quarter guidance, and a robust economic recovery against rising inflation and the timing of future monetary policy adjustments.

First-quarter financial results for S&P 500 companies exceeded estimates due to stronger-than-expected earnings and revenues. Earnings surpassed estimates by more than 22%, with 86% of the companies beating their projections, according to FactSet. Additionally, second-quarter 2021 earnings growth estimates strengthened over the period with a record-high number of S&P 500 companies issuing positive EPS and sales guidance.

The economy continued to rapidly recover during the period. The unemployment rate declined, jobless claims hit a pandemic-era low, housing industry statistics were constructive, and surveys of manufacturing and service sector activity remained robust. Conversely, inflation gauges increased.

The Federal Reserve left its benchmark rate and monthly asset purchases unchanged. Fed Chair Jerome Powell acknowledged that taper discussions had begun but reinforced the message that the rise in inflation is transitory. The Fed's new dot plot forecast incorporated 50 basis points of tightening in 2023, reflecting a faster recovery in economic activity and higher inflation expectations.

Against this backdrop the U.S. Treasury yield curve flattened with short-dated yields rising and long-dated yields falling. The 3-month, 2-year, 5-year and 10-year yields finished at 0.05%, 0.25%, 0.88%, and 1.44%, respectively.

EQUITY AND OPTION MARKET ENVIRONMENT

U.S. equities rallied, with the S&P 500 Index and the Nasdaq Composite closing the quarter at record highs.

Equity market leadership shifted compared to the prior quarter. Longer duration stocks led, and GDP-sensitive stocks lagged alongside a declining 10-year U.S. Treasury yield. In this environment, large-cap growth companies outperformed their value counterparts by nearly 7% in the quarter with most of the return differential occurring in June as the cyclical rotation reversed.

Within the Russell 1000 Growth Index, all sectors produced a positive return. Energy, communication services, and real estate led, followed by information technology. Conversely, the materials, consumer staples, consumer discretionary, and utilities sectors lagged.

Equity volatility spiked higher in May and again in June, but its overall trend was lower concurrent with stock market strength. The VIX Index started the period at 19.4 and finished at 15.8.

CONVERTIBLE MARKET ENVIRONMENT

Convertible securities primarily benefited from positive underlying equity performance.

The reversal of the cyclical rotation in the equity market during the quarter was also evident in the convertible market. As a result, energy, telecom, media, and technology were the top-performing sectors, while transportation, industrials, utilities, and consumer discretionary were the laggards.

Below-investment grade issuers outperformed investment grade issuers. Equity-sensitive structures outperformed total return (balanced) and yield alternative (busted).

Primary market activity steadied in the quarter with 32 new deals priced for $15.3 billion in proceeds. The year's total stood at $55.9 billion – on pace to exceed 2020's near record volume of $105.8 billion.

HIGH YIELD MARKET ENVIRONMENT

High-yield bond prices increased, and spreads compressed for the quarter.

Performance dispersion among credit quality categories tightened compared to the previous quarter. BB-rated issues recovered sharply concurrent with a decline in interest rates, but CCC-rated issues continued to outperform higher-quality high yield.

The top-performing industries were theaters & entertainment, energy, and consumer goods. The bottom-performing industries were healthcare, utilities, and packaging.

Primary market activity remained robust in the quarter with new high-yield issuance totaling $140.5 billion across 212 issues. Year-to-date new issuance of $299.1 billion is on track to surpass 2020's record of $449.9 billion. Refinancing remained the greatest use of proceeds at 60% of the quarter's total. Fund flows were -$4.1 billion.

The credit ratings upgrade cycle accelerated, and default rates declined sharply quarter over quarter. The trailing 12-month default rates on an issuer-weighted basis and a dollar-weighted basis fell to 3.02% and 1.63%, respectively.

OUTLOOK

The U.S. economy and corporate earnings are projected to grow significantly in 2021. These conditions should benefit risk assets.

Expansion in the United States is expected to continue as the post-COVID reopening accelerates. Additional supporting factors include an increase in business spending and investment, pent-up consumer demand, excess household savings, ongoing and potentially new U.S. fiscal stimulus, and a further recovery in the labor market.

Revenue growth and corporate profitability should be strong. U.S. companies are well positioned to benefit from operating leverage as strengthening top-line growth is met with productivity gains, driving margin expansion and bottom-line growth.

Potential risks include higher interest rates due to faster-than-expected economic growth or a sustained rise in inflation as well as a potentially less accommodative Fed.

In the second quarter, much of the growth in inflation appeared transitory, driven by reopening-sensitive categories and supply chain bottlenecks that should ease into year-end. Wage and rental inflation require closer monitoring as the year progresses.

A less accommodative Fed is possible given the central bank's most recent commentary and dot plot forecast. While a policy adjustment could be interpreted as hawkish, the Fed remains very flexible, with the anticipated timing of the first hike approximately a year and half away. An upper bound federal funds target rate of 75 bps still resides well below the last cycle's peak (250 bps). Furthermore, the 10-year Treasury yield at 1.44% (as of June) remains very low in absolute and relative terms. Lastly, the labor market – one of the Fed's mandates – has yet to fully recover.

The takeaway: U.S. equities have the potential to move higher during the second half of the year supported by better-than-expected quarterly earnings reports and faster-than-anticipated economic expansion. Notably, over the past four rate hike cycles ('94, '99, '04, '15) the S&P 500 Index gained 9.5% in the 12 months prior to the first hike, and 26.0% over the subsequent three years, according to Credit Suisse.

U.S. convertible securities should benefit from continued equity market strength in 2021. The asset class has the potential to produce a return in line with broad equity markets. Given robust first-half volume market strategist projections for annual new issuance have been revised higher to ~$85 billion from ~$55 billion at the start of the year. Primary market activity should help to broaden and balance the overall convertible market which remains well positioned to participate in the upside and provide downside protection.

A coupon-like return is possible for the U.S. high-yield bond market in 2021. Although there is limited opportunity for significant spread tightening, spread widening is not anticipated given a positive fundamental outlook for the asset class. Credit metrics, default rates and ratings trends should continue to improve into year-end. Along those lines, many market strategists have reduced their default rate expectations for 2021.

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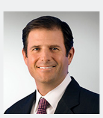

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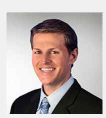

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The **Russell 1000® Growth Index** is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **ICE BofA US Convertibles Inde**x tracks the performance of publicly issued U.S. dollar denominated convertible securities of U.S. companies. The index is calculated on a total return basis. The **ICE BofA US High Yield Index** tracks the performance of below investment grade U.S. dollar denominated corporate bonds publicly issued in the U.S. domestic market and includes issues with a credit rating of BBB or below. The index is calculated on a total return basis. The **S&P 500® Inde**x is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **CBOE Volatility Index**, known by its ticker symbol VIX, is a popular measure of the stock market's expectation of volatility implied by S&P 500 index options. The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.