

Global Market Update

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Global Investors



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In brief:

- Strong data from China and other EM have to be considered separately from developed economies
- Headwinds remaining for US economy: GM and Chrysler bankruptcies may cause further damage
- Rising commodities prices will benefit Brazil and Russia
- 'Green shoots' not yet completely convincing
- Recent rally has already priced in many good news, cautious short-term forecast

The following are highlights of a conference call hosted by Neil Dwane on Tuesday, 2 June 2009

The market rally

Many investors have not fully participated in the market rally, neither in terms of asset allocation nor in terms of performance - if they've been in the markets. However, the bulls will argue that the market has been consolidating after a strong rally and that it's just gaining its momentum for another move ahead, which we saw in parts yesterday from Wall Street, despite the bad news of General Motors going into Chapter 11.

In any case, it is safer at this moment to try and give an estimate of where this rally could be going: As mentioned in a previous call, somewhere between 940 and 950 on the S&P is a technically important ceiling for the market rally, and now we're at 943. This is the point where the market needs to press on. If the market makes no further headway from here, many technical analysts will say that it has retraced a lot of its 'oversoldness' seen in January and February, and that the direction from here will be lower.

To declare the next bull market we will have to see the S&P get through 1010. I believe the market itself has reached the point it wanted to get investors to, which is the point of maximum pain. We're at the point where serious questions would be asked about your ability to invest if you weren't in the market because you would have missed a very strong rally.

With regards to positive data from China and the US, we would differentiate: we continue to see very strong data from China, which we believe will broaden out, and we are beginning to see other emerging markets like Brazil beginning to pick up through their own self-confidence and powerful dynamic.

The US economy

We don't see the US data as particularly compelling. The ISM survey data bouncing from 42 to 44 is still showing the US in deep recession, and so it is still in the 'less bad' category rather than in growth.

Looking ahead, particularly in the US, with the S&P being at 17x to 18x earnings, we have to believe that things are not just getting less bad but actually better to justify valuations in the US, and it's not necessary that we're actually getting growth in the next three to six months. There is a growing central case that the first sign of positive growth may fall in Q4 2009 or Q1 2010. We continue to think that the economic data is still in the less bad camp rather than getting better but certainly the psychology in markets has turned dramatically in the last three months. The power of this psychology, while it has worked to an advantage in the equity markets in the shorter term, has also surprised many investors with its endurance and its ability to continue.

But: the headwinds in the USA remain very strong, industrial production continues to be at a relatively low level, the destocking of inventory levels is still a strong point of arguments amongst economists and investors, as only

some industries persuasively suggest a major economic turn. Given the slack in the economy, we are continuing to expect disinflation -not necessarily deflation- which is probably good news at the balance, and we are expecting to see the bond market to remain under pressure.

US Treasuries

The bond markets have been the biggest story since the last conference call, other than General Motors and Chrysler. We believe we will begin to see, initially in the US but fanning out to other countries, the fear of the amount of money being printed or borrowed by the governments and then self-funded by the central banks. The Fed is currently acquiring approximately half of the issuance from the US Treasury, and rather worryingly, the duration of that debt has fallen from six years to four years over the last six months. So it's not just the shorter-term financing at this stage that worries the market, but the funding of the longer term debt of America.

The bond market has had some wobbles, which is seen as a positive sign by some who say that economic growth is appearing and therefore the yield curve is steepening. Others, like us, would argue that the bond market difficulties and the steepening of the yield curve would suggest that quantitative easing (QE) is not working and that markets are beginning to struggle significantly with the quantum of supply.

This is also causing a weakness of the dollar (having fallen 6% on a trade-weighted basis across all currencies last week alone), which has fed through to commodities. Commodities have been rising almost consistently because of the weakness of the dollar and are now being used as a dollar hedge.

A combination of these moves is not necessarily indicative of the world having become a space of growth and optimism, but it does say that investors are beginning to worry about their exposure to the US dollar. Some of this is justified: the US is running smaller trade deficits, and therefore the requirement for the world to hold dollars is falling. We are seeing growing pressure on the US dollar which we expect to cause problems over the year, and the dollar can go even weaker, especially if US economic policy is seen to stall. We would then expect Bernanke to do more extraordinary 'heavy-lifting', which would undermine the dollar completely.

Investing now

We have reduced our tactical overweight on equities as we feel that markets are reaching the crunch point and as we don't want to threaten what may lead the market higher.

When it comes to staying invested in this rally it is important to consider two things: the things that have moved in this rally have been the financials, materials and mining stocks. There have been many lower quality companies that were highly leveraged and exposed to damaged prospects due to the crunch in the financial sector.

Looking at what may sustain or even take leadership in this rally, it is not likely to be the stocks that have led this market much higher. Even this morning we've seen a massive placing by the Abu Dhabi Investment Authority of their stake in Barclays which they bought a year ago at a significantly lower price. This has had a huge impact on the share price of Barclays, which was down over 15% today.

Many people who initially thought they may have helped to solve this problem may now see very little value in financials. This is valuable insight from sophisticated investors into valuations of banks. A helpful rule of thumb with respect to banks may be: if it is trading above its tangible book value, then the return on equity can probably be in excess of 10% or 11%. Given the regulation, and that is becoming increasingly apparent in terms of holding capital and core capital, and in terms of having to hold capital against OTC and other positions on their balance sheets, we are struggling to see how many conventional banks will be able to earn those amounts of capital. Therefore many banks are trading at levels above which they are no longer attractive.

We think one has to look for stocks that have not performed well in this rally. There are numerous high quality stocks that have not performed well, because they have been used as a source of funds to play the lower quality rally that has transpired. Many areas of the well-performing market have not reflected the income-generating capacities of their companies, which is why many high-yielding companies with well-covered dividends have gone through the crisis well but have not performed too well.

The dilemma of investing in this market is twofold: in mature markets investors would have to play big, safe, high-yielding strategies. In more aggressive markets, such as emerging and thematic markets, they should seek exposure to economies with strong current account surpluses, which are able to fund their countries' economic activity through this difficult period.

US bankruptcies

Looking at themes like GM and Chrysler, although it may well be only a three to four-month process, it may well cause a lot of damage throughout the US economy. In addition to manufacturers, many dealers, employing much more people than manufacturers, will start to lose their

jobs, and it is a very political issue. During summer we expect some the green shoots to turn out not be quite as positive as they initially looked.

The underlying prospect for US housing remains troubled, we are beginning to see, in certain states, that clearing prices for standard homes are now being found. With the availability of credit still relatively tight and with bond yields going up, the marginal buyer of these properties is still not easy to be found, until unemployment starts to fall. Some of our economists think that US unemployment will continue to rise until next year.

Around the rest of the world, rising commodity prices will be beneficial for countries like Brazil and Russia. This might also be beneficial for most of Europe, as with the current strength of the Euro, the real price of many commodities is actually in decline at the moment. Although the price itself is going up, the price we're paying is not changing, and therefore the level of our economic activity may well be influenced by the buoyancy of economies in Latin America and Russia, which will more than offset the sluggish activity in the UK and the US.

Looking into 2010

The challenge of 2010 is that many don't know yet what it will look like. It will probably look better than 2008 and 2009, reflationary policy will continue to work. A much greater insight into 2010 at the corporate level will be possible during the results season in September and October. The favoured outlook by many is to see that as the year progresses it will possibly get stronger. Investors after this market rally have to work out their own view of when the risk opportunity of inflation and reflation becomes more prominent in their minds than the risk opportunity of deflation and depression. It seems to be fairly certain at this moment that we've now missed the deflation/depression. Policymakers seem to have staved off what seemed to be a very clear prospect at the beginning of this year. However, I am not totally convinced we are seeing the green shoots of a V-shaped recovery, as the market would want to have it. I think the recovery will be drawn out longer than that.

Certainly by the second half of 2010, many underlying fundamentals of the world will have begun to reassert themselves powerfully, growth in emerging markets will be clearer, and deleveraging as well as the increase of levels of savings in many OECD countries will have happened more convincingly. I believe the outlook for 2010 is that it will continue to improve. However on the back of the recent rally I'd be more cautious about the next three to six months, given that we've already made a lot of progress and that a good amount of further progress has already been discounted.

Questions

What is your view on the shape of the recovery? What is your cyclical picture?

I think the V/W/U/L/shaped debate is interesting but to some degree futile. We will get a much longer-term recovery in the OECD. I don't believe a V or W actually reflects the type of recovery we're facing. I do believe however that countries like Brazil or China may have a V-shaped recovery, where the ability to offset global headwinds remains in their hands. Countries with big current account surpluses will be able to offset headwinds more convincingly than those that will have to continue to borrow to uphold their economic activity.

I think the lesson of this rally was that many people had been wrong-footed in January of this year, with everybody expecting a fall in the markets. So when the rally came it was quite sharp and oversold. Many people tried to trade out of the market when there were first signs of stalling momentum showed and found that the market has continued to grind higher against them. It is still a bear market, only from 1010 it will be possible to declare a new bull market. The underlying economy and the reflation policies being put in place by policymakers will declare how bad the underlying economy is now set to become. The lesson is that many people were far too defensively positioned.

Was this rally too optimistic and may the correction be very sharp?

The initial bounce surprised nobody because many shared the opinion that at the beginning of March the market had been sharply oversold. The sustainability of the rally however had many people flummoxed, particularly because of fairly unconvincing economic news particularly from the US. What has been hardest to call was how the psychology of the market has moved from very negative to positive. Few equity managers will be very happy because it has been hard to find stocks that can be held convincingly in this market.

The nature of a market downturn is that you have to find signals of what the market is not necessarily prepared for. We've tried swine flu, difficulties in the Middle East, rising oil prices, a weak dollar, Chapter 11 of GM and Chrysler: it is not obvious yet what will change the psychology of investors. It still seems to me that many are still structurally short, wanting to buy into the market ten or twenty percent lower down, but for as long as this psychology prevails, the market will not come down to meet them.

What will be the nature of the next bull market?

I believe the next bull market will be founded on emerging market growth and the changes to the world caused by this. I don't think we've had a bull market in commodities, only a taster of it up until last summer. If I had a crystal ball I think we'll see emerging markets, commodities, and some of the more prevalent structural themes, such as infrastructure and eco trends as foundations of the next bull market.

Regarding currencies, I think we're in the middle of a major shift. Many people are thinking that the dollar is run for the benefit of the Americans and therefore will be trying to diversify away from the dollar.

In the next five years I think we will see a tradeable renminbi, which will have significant implications particularly for intra-regional trade in Asia. Because of the pairing of the renminbi and the dollar we may see the US dollar, sterling and possibly even the Swiss franc weaken, because these governments actively use QE, the Euro will remain relatively strong, because many European economies are not in the dire situation of the US and the UK.

In emerging markets, China's and Brazil's currencies look set to remain the most strong. India needs to get its financial act in gear, it's still a relatively prudently managed country but still doesn't have the international firepower of Brazil and China. Over the medium term, India however has much improved prospects and after the election attracts much foreign direct investment.

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