JULY 2018

Active is: Exploring new ideas

Allianz Global Investors Insights

Global View

Why we must repair economic inequality

Neil Dwane
Global Strategist

Key takeaways

- Economic inequality may be at its highest level since the Industrial Revolution; in the US alone, the top 1% owned more than 38% of total wealth in 2016
- The social safety net is weakening as fewer people can afford basic living expenses, quality health care or retirement savings
- Those who invested in the financial markets since the 1980s have done extremely well, but the many people who don't – or can't – invest in risk assets have fallen further behind
- Governments, corporations and investors all have roles to play in fixing the inequality problem. Allianz Global Investors constantly strives to add value beyond pure economic gain by aligning our interests with those of our clients and our communities

Even though extreme poverty has fallen in recent years, economic inequality has become one of the most pressing social and economic issues facing the world today. In addition to taking a human toll, it drags down economic growth and destabilises social systems, and it stresses government spending and revenue streams. Yet although there's no easy fix, policy makers, corporations and investors can help narrow the inequality gap.

Inequality is one of the most pressing social and economic issues facing the world today

How pervasive is economic inequality?

According to the United Nations, the top 1% of the US population owned more than 38% of the country's total wealth in 2016. But as the chart on the next page shows, this is not just a US problem.

Several factors are driving inequality higher. Globalisation has hollowed out manufacturing industries in developed countries, and the rise of robotics, automation and artificial intelligence threatens future jobs. With fewer work opportunities to support populations, income and wealth inequality will grow worse. The deregulation of financial markets has also played a role by helping those who have wealth

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Global View

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to increase it – particularly since the 1980s. By contrast, the large number of people who don't or can't invest in risk assets have found themselves left increasingly behind. Enabling more people to participate in the "risk premium" of financial assets is clearly part of the solution.

A clear and present danger

In the emerging world, wealth inequality is a major issue; not enough people own their own homes or have sufficient savings. In developed markets, a decreasing number of wealthy individuals are shouldering more of the tax burden while the social safety net grows strained; fewer people can afford basic living expenses, quality medical care or retirement savings. Worldwide, economic inequality is a destabilising force that creates distrust, and today's world of ultimate openness – aided by social media – prompts many people to perceive they have fallen behind. This can boost populist politics and make people more stressed, less healthy and more inclined to make risky decisions as they try to catch up.

Economic inequality is a destabilising force that increases the appeal of factional politics

How to repair economic inequality

Allianz Global Investors believes that all societal stakeholders can play a role in addressing rising inequality – even as we ensure that poverty levels continue to fall.

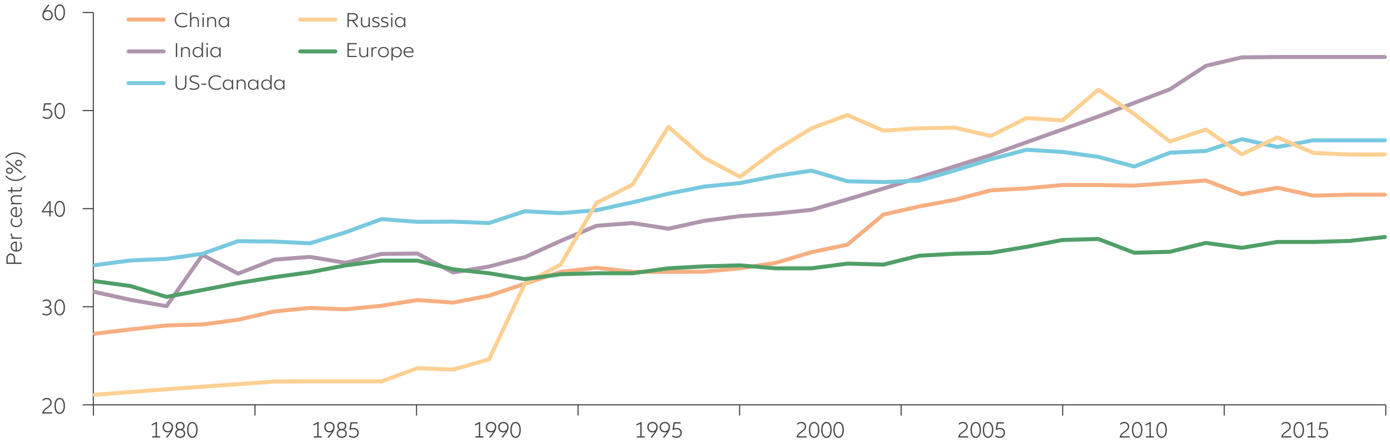
1. To raise the level of personal savings and investment, governments should expand policies that educate their citizens about financial markets and encourage investment.
2. The financial industry can improve financial inclusion by promoting wider access to financial services in a sustainable, responsible way.
3. Financial literacy must be enhanced to enable larger portions of the population – particularly younger generations – to raise their economic standing.
4. Regulation and tax reform need to become more fair and less politicized – and central banks must be allowed to focus on the longer-term interests of their economies, free of short-term political considerations.
5. More-progressive tax policies can redistribute wealth in helpful ways, since lower-paid workers spend a greater proportion of their earnings than their higher-paid counterparts.
6. Governments must improve the social safety net, using ubiquitous new technologies to make it more efficient, less prone to abuse and better at revenue collection.
7. Education systems should be modernised to boost workers' skill sets, and student-loan systems may need to be overhauled – particularly if they reprice education in a way that benefits the supplier, not the student.
8. Workforces need training, investment and support, and management teams should move into a more cooperative approach towards managing and retaining employees. Successful companies tend to pay more than less successful ones; better people and better remuneration deliver better productivity.
9. With lower taxation and smarter regulation, financial services companies and banks should be able to reduce and better align their fees. This may help address accusations of profiteering.
10. Investors can pressure management teams and boards to focus on environmental, social and governance (ESG) factors – particularly executive pay – that can help reduce inequality.

Investors can pressure boards to focus on ESG factors – particularly executive pay – that can help reduce inequality

At Allianz Global Investors, we constantly work towards applying the power of active management to real-world issues – from the challenges and opportunities presented by robotics and artificial intelligence, to the perils of low productivity and rising economic inequality, to the ESG factors that help companies and shareholders succeed. As such, we will continue to strive to add value beyond pure economic gain by aligning our interests with those of our clients and our communities – directing capital into initiatives that are likely to promote future growth in a more sustainable and equitable way.

Income inequality is rising almost everywhere

Income shares of the top 10% of populations (1980-2016)



Source: World Inequality Database, World Inequality Report 2018. Data as at 2016.

Viewpoint

From TPP to USA: 7 stages of economic integration

Hans-Peter Rathjens, PhD
Analyst

Key takeaways

- International trade has become a key component of global GDP in the last 30 years, thanks in large part to falling tariffs – yet fears of a trade war are growing
- To boost their economies, countries can enter into trade agreements that place them into one of seven categories of economic integration
- TPP and NAFTA are two examples of trade pacts that lower or eliminate tariffs, but they are low on the economic-integration spectrum
- The euro zone and the United States both offer the free movement of goods, capital, services and labour – but only the US can boast complete economic integration

Trade tensions are at the top of the global economic agenda, with financial markets showing concern that a major trade war among large countries could hit the global economy. Over the last 30 years, falling tariffs have helped increase international trade's share of global GDP, and rising tariffs could slow or even reverse this trend.

Yet the debate over trade – and whether closer trading ties must involve deeper economic integration – tends to overlook a more nuanced picture. To make this debate a more informed one, and with a nod to Hungarian economist Béla Balassa, here are the seven stages of global economic integration – from least to most integrated.

The debate over whether closer trading ties require deeper economic integration overlooks a more nuanced picture

1. Preferential trade area (PTA)

Example: Trans-Pacific Partnership (TPP)

Countries that sign this type of trade pact enjoy lower tariffs for certain products than the countries that don't. Some types of PTAs can lead to trade creation, which occurs when high-cost domestic production is replaced by low-cost imports from other members; this is beneficial for the living standards of all countries involved. Other types of PTAs can lead to trade diversion as trade moves from a more efficient supplier *outside* of the PTA towards a less efficient one *within* the PTA. Ideally, a PTA would result in more trade creation than diversion.

2. Free-trade area (FTA)

Example: North American Free Trade Agreement (NAFTA)

With an FTA, member countries agree to eliminate tariffs between themselves but maintain their own external tariffs on imports from the rest of the world. Because there are many kinds of external tariffs, FTAs generally develop elaborate "rules of origin". These rules are designed to prevent goods from being imported into the FTA member

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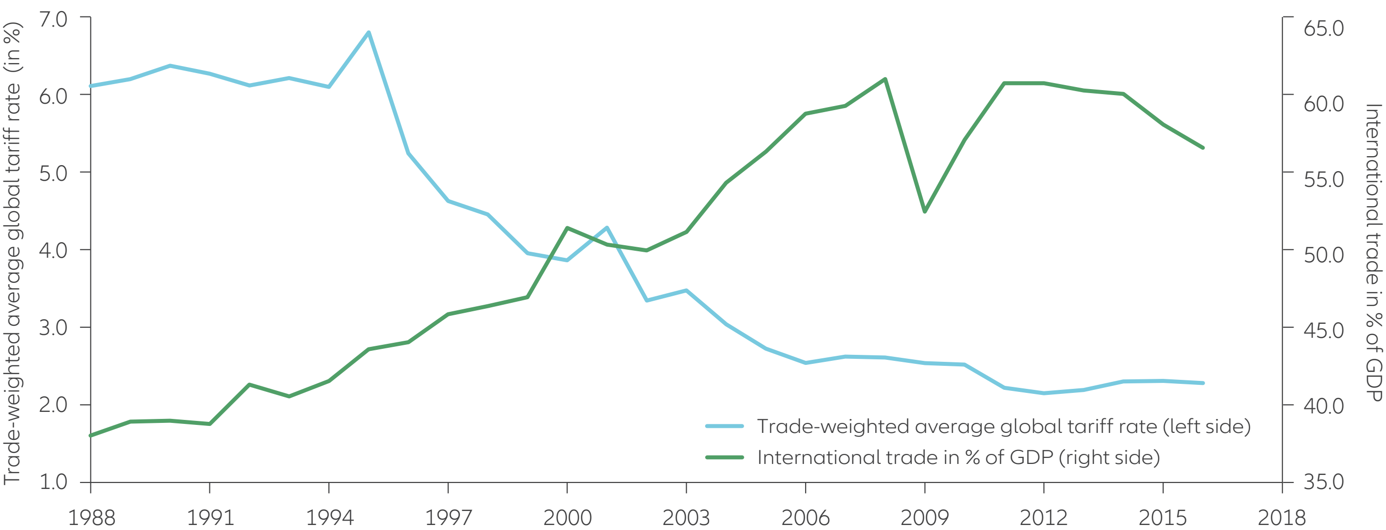
As tariffs fall, international trade grows

International trade's share of global GDP has generally increased in the last 30 years, thanks in large part to falling tariffs



Source: Datastream. Data as at 20 June 2018.

Viewpoint

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country with the lowest tariff and then trans-shipped to the country with higher tariffs.

3. Customs union

Example: European Union (EU)

When a group of countries agrees to form a customs union – eliminating tariffs between themselves and setting a common external tariff on imports from the rest of the world – their standard of living increases. Yet while a customs union avoids the problem of developing complicated rules of origin, it introduces the new problem of policy coordination: tariff rates across a range of import industries must be agreed upon by all members. This type of economic integration is a key question in negotiations about the UK's impending exit from the EU: will the UK remain in some kind of customs arrangement with the EU after Brexit occurs in 2019?

A customs union like the EU eliminates tariffs between member countries while setting a common external tariff on imports

4. Common market

Example: European Single Market

A common market agreement establishes free trade in goods and services, sets common external tariffs among members and allows for the means of production to be easily moved between countries. The European Single Market agreement between the EU and (with certain limitations) Iceland, Lichtenstein, Norway and Switzerland guarantees the free movement of goods, capital, services and labour. (Turkey can only access the free movement of goods.) Because a common market increases competition and specialisation, it makes the allocation of resources more efficient within its member states. At the same time, common markets can have a downside. The Brexit vote in the UK shows how this level of integration can be perceived as a loss of national identity, spurring a desire to "take back control" of borders.

5. Economic union

Example: The EU's Common Agriculture Policy (CAP)

This is a type of common market that adds some fiscal-spending responsibilities. For example, the EU aims to support farmers, who supply a critical good (food) yet have unique economic challenges. The EU's CAP supports farmers via direct income payments and market interventions, and by addressing the specific needs of rural areas.

6. Economic and monetary union

Example: The European Monetary Union (the "euro zone")

In this type of agreement, members use a common currency and a central monetary authority to determine monetary policy. Goods, capital, services and labour can move freely across borders. The euro zone with its 19 members is a prime example. However, as the global financial crisis made clear, there are limitations to such an arrangement, including a small margin for error for economic policy. There is also a lack of flexibility that comes with using a common currency with a fixed exchange rate and shared interest rate in a region that has broad economic differences.

The euro zone demonstrates the limitations to an economic and monetary union, including a small margin for error for economic policy

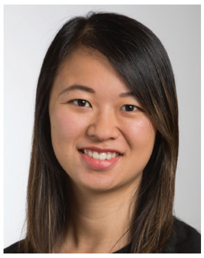
7. Complete economic integration

Example: The United States of America

In the US, which provides perhaps the best-known example of complete economic integration, each state has its own government that sets policies and laws for its own residents. At the same time, each state cedes control over certain areas – foreign policy, agricultural policy, major welfare programs and monetary policy – to the federal government. While there is some loss of independence with this arrangement, the primary economic benefit is that the free movement of goods, services, labour and capital is guaranteed.

Grassroots® Research

Emerging-market consumers show growing optimism



Aggie Wong
Grassroots® Research Analyst

Key takeaways

- With household consumption representing around 60% of global GDP, consumer sentiment is a factor investors should incorporate into their decision making
- More than 70% of emerging-market consumers plan to buy property and vehicles in the next five years, according to a new Grassroots® Research study
- More than 8 out of 10 consumers in emerging-market countries said name brands are important when purchasing a consumer product, food or cosmetics
- Chinese consumers we polled said positive economic growth is the reason they expect to travel more in the next 12 months

Consumers have long been the engine that powers the global economy. As global growth returned to solid levels in the years since the financial crisis, household consumption rose to around 60% of global GDP, according to the World Bank, making consumer sentiment a factor investors can't afford to ignore.

A new study from Grassroots® Research – Allianz Global Investors' proprietary in-house research division – reached 1,000 consumers in China, Brazil, Mexico and Germany to get their views on planned spending, financial priorities, travel and more.

Emerging-market consumers plan big purchases

The study revealed that more than 8 out of 10 respondents in emerging-market nations – China, Brazil and Mexico – plan to purchase a vehicle in the next five years. Meanwhile, almost three-quarters plan to buy furniture or appliances in the next 12 months, and more than 71% plan to purchase property in the next five years.

8 out of 10 respondents in China, Brazil and Mexico plan to buy a vehicle in the next five years

The picture was different in Germany, highlighting the cultural and socioeconomic differences between Germany and the emerging-market countries we surveyed. Just under one-third of German respondents hoped to buy property in the same five-year time frame, while around the same number said they considered property ownership unimportant. This is in line with statistics showing that Germany has one of the lowest homeownership rates among developed nations, according to the OECD. Consumers in Germany also showed a lower intention to buy a vehicle, furniture or appliances compared with their counterparts in emerging-market countries.

Aspirations for trading up are strong in emerging markets

Emerging-market consumers also showed clearly positive sentiment around smaller-ticket items, according to our survey, and people in Brazil, China and Mexico were much more drawn to name-brand products than were value-conscious German consumers.

Emerging-market consumers were more drawn to name-brand products than value-conscious Germans

For example, in Germany, price was by far the most important factor cited when considering purchasing a consumer product, food or cosmetics, and a mere 46% were concerned

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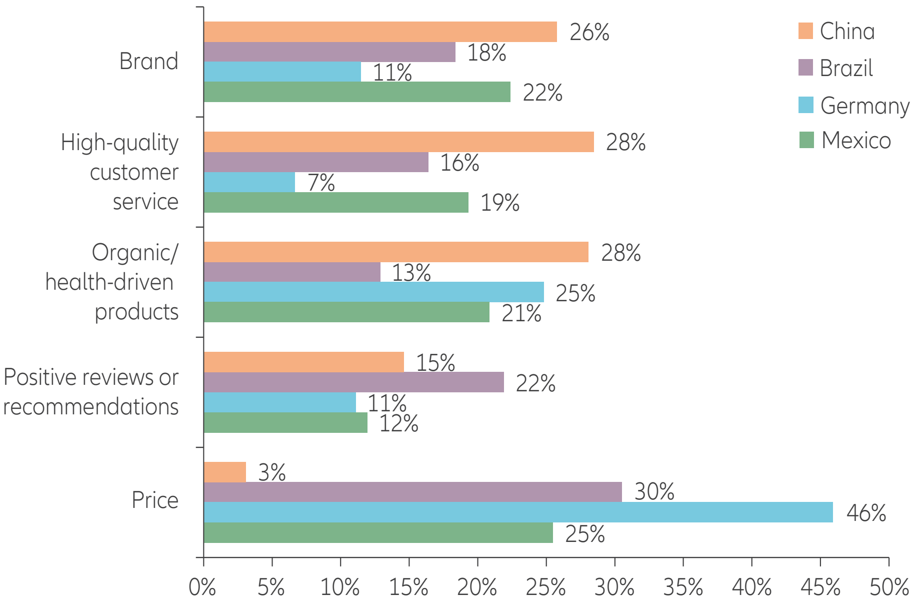
Value is paramount for consumers in Germany

Question: Which attribute/factor do you consider most when making a purchasing decision about a consumer product/food/cosmetics, assuming product quality is acceptable?



Source: Grassroots® Research. Data as at May 2018.

Grassroots® Research

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with name brands. Meanwhile, 83% or more of emerging-market respondents rated name-brand items somewhat to extremely important when making such purchases.

When asked to identify their top financial priorities, life experiences – dining/entertainment, travel and social activities – dominated in all four countries. However, Chinese consumers showed a very low preference (3%) for paying down debt and a very high preference (50%) for putting money to work on life experiences. Spending on life experiences also ranked highest among Brazilian consumers, even though respondents there were also focused on paying down debt.

Brazil and Mexico, despite their high levels of aspirational spending, also stood out for wanting to be able to spend a little more on everyday items, suggesting some potentially pent-up demand for consumer staples.

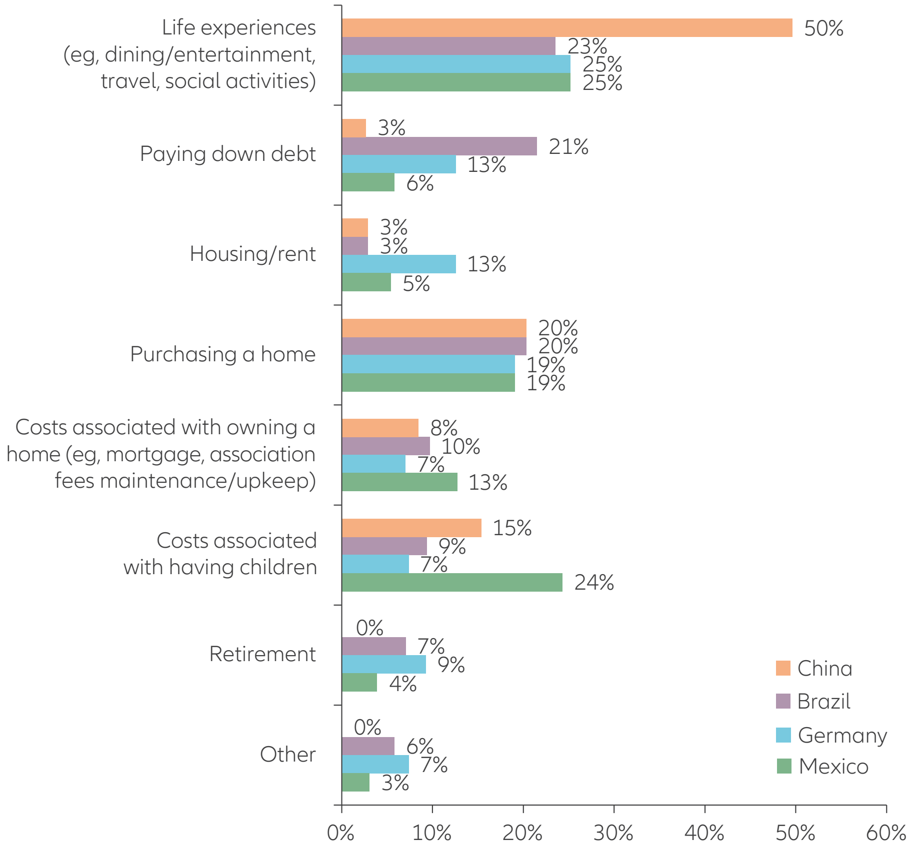
Travel outlook is positive but influenced by cultural factors

Travel intentions also seemed to reflect the ambitions and optimism of the emerging-market consumer, with 81% of respondents in China citing a positive economic outlook as the reason they expect to travel more in the next 12 months.

Alec Patterson, Sector Head of the US Consumer Research team at Allianz Global Investors, found it notable that a lower number of Germans (40%) than emerging-market respondents (57%) travel multiple times per year.

Half of respondents in China value life experiences the most

Question: What is your current top financial priority?



Source: Grassroots® Research. Data as at May 2018.

"This was somewhat surprising, as was the fact that a majority of Germans seem to want to maintain the status quo. Meanwhile, consumers in Brazil, China and Mexico showed a high desire to travel more frequently."

57% of emerging-market respondents travel multiple times per year

Still, conclusions about consumer sentiment cannot be based on travel results alone, since travel is often influence by tradition and culture. Research Analyst Bianca Schnieder, who specializes in European consumers, noted that Germans still generally scored high in terms of their overall desire to travel. "This needs to be seen in the context that Germans – in particular, German families – often take a long summer holiday of two or more weeks," said Schnieder. "Chinese consumers tend to prefer shorter-duration holidays, and they can increasingly afford to travel multiple times per year."

Summer reading

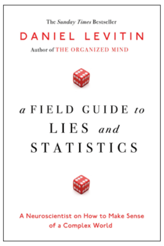
Six books you should read this summer

Neil Dwane
Global Strategist

The ability to separate the insight from the noise – the real news from the fake – is an increasingly critical one, particularly for investors. These books show us how to question prevailing narratives and take a fresh look at the world around us.

A Field Guide to Lies and Statistics: A Neuroscientist on How to Make Sense of a Complex World

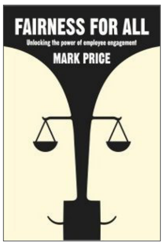
By Daniel Levitin



In a time when "post-truth" and "fake news" have entered the popular lexicon, it's becoming increasingly difficult to navigate a world where information is everywhere, but not all of it is relevant or truthful. Learning how to understand statistics can make us better citizens and better investors.

Fairness for All: Unlocking the Power of Employee Engagement

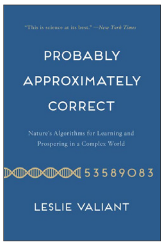
By Mark Price



The relentless pursuit of profit is not the only way to generate returns to share-holders, customers and employees. This book explores the idea of "inclusive capitalism" and the six principles that the John Lewis Partnership – a well-regarded UK retailer – uses to put its people first.

Probably Approximately Correct: Nature's Algorithms for Learning and Prospering in a Complex World

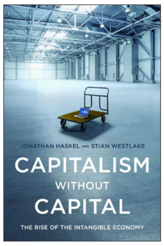
By Leslie Valiant



Nature is mind-bogglingly complex and ever-changing, yet life has nevertheless thrived without an instruction manual. We do it by combining experience with learning, intuition and teamwork – essentially using our own natural algorithms to determine effective behaviours.

Capitalism without Capital: The Rise of the Intangible Economy

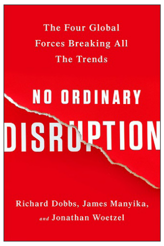
By Jonathan Haskel and Stian Westlake



Corporations are increasingly relying less on tangible assets than on intangible ones – such as software code, brands and algorithms. This shift gives rise to disruptive new business models, reducing barriers to entry across markets and changing the very nature of investing.

No Ordinary Disruption: The Four Global Forces Breaking All the Trends

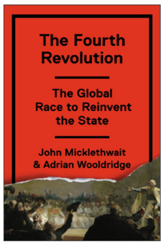
By Richard Dobbs, James Manyika and Jonathan Woetzel



The directors of the McKinsey Global Institute detail how emerging markets, rapid technological change, shifting demographics and greater global connectivity are reshaping the future. Business leaders must reset their assumptions if they want their companies to succeed.

The Fourth Revolution: The Global Race to Reinvent the State

By John Micklethwait and Adrian Wooldridge



Strong institutions or small government? More state support or more promises that cannot be honoured? The West has been grappling with these issues for years, but most of their models are dysfunctional. Perhaps we need to reform how government works and the role it plays in society.

Source: Allianz Global Investors Insights, Volume 10, Issue 7