# What should investors make of the strong first half?


The first half of 2017 has seen a strong run-up in risk assets. But as the rally tapers off, what should investors expect in the second half of the year?

In this edition of Monthly Macro View, Geoff Lewis, Senior Asia Strategist thinks that in the near term, investors should not be surprised to see a healthy correction. Although a summer correction is in the cards, over a longer 12- to 18-month horizon the conditions for stocks to further outperform bonds remain in place.

## Markets in June: A flat end to a stupendous first half[1]

The first half of 2017 has been kind to investors, to say the least; equity returns have far exceeded the modest expectations they held in January.

But after the strong run up, the rally looks like it is running out of steam, and markets now seem to have a hard act to follow. Last month, the MSCI World in US dollars rose a slim 0.42%, marking the eighth consecutive month of positive returns. Such a long rally in stocks has not been seen since the vigorous 2003/2004 global upswing. So, where to from here?

Indeed, the rally has been largely driven by falling bond yields, in line with the consensus expectation at the start of the year. With frequent central bank mutterings about policy tightening, what worked well in the first half may not work well in the second; even a gradual upward trend in bond yields may prove enough to pressure highly-valued equities.

The anticipated 'summer doldrums' correction may well have begun; in early July, we have seen some rotation out of growth and yield stocks, back into the earlier reflation themes of small caps and financials.

While a little seasonal weakness is no real cause for alarm among investors, and a pause for market consolidation is plausible in the near term, we should expect a fair bit of volatility.

Still, over a longer 12- to 18-month horizon, we think the conditions for stocks to further outperform bonds remain in place. We are therefore advocating a mid-year switch to a more defensive strategy, and are retaining our preference for the Eurozone and Asia ex-Japan within global equity portfolios.

Meanwhile, bonds have also surprisingly fared better than expected, despite a sell-off towards the end of June.

[1] Factset, Bloomberg, Manulife Asset Management, as of 30 June 2017. Calculated by total returns in US dollar.

With few exceptions, government bonds in developed markets will be increasingly vulnerable to a loss of fundamental support. Economic and policy conditions in the second half are more likely to elicit higher than lower developed market bond yields, with potential downside increasing with the investment horizon.

## Signs of policy stirrings at central banks

Investors have, in recent months, been surprised by signs of shifts in monetary policy among central banks globally. Besides the US, the Eurozone, the UK, and Canada have announced that they were looking to withdraw some of their post-Global Financial Crisis support.

Last month, the US Federal Reserve raised its policy target rate by 25 basis points, and provided details on the winding down of its balance sheet. Both steps were widely anticipated, and September has become the consensus starting date for reducing the balance sheet, and one more rate hike is projected in December this year[2].

The European Central Bank has indicated that its monthly bond purchase programme will continue until December, as it cuts its inflation forecast, simultaneously removing the stated bias towards even lower rates in the near-term[3].

In the UK, despite political uncertainty, the Monetary Policy Committee appears to be considering withdrawing the emergency policy accommodation introduced after the initial shock of Brexit last July[4].

The Bank of Japan, meanwhile, admitted that it is still far away from meeting its inflation goal. While it is least likely to tighten rates soon, we note it has been buying fewer bonds recently. Domestically, it is also facing growing calls regarding how it intends to handle the exit.

Against this backdrop, the global yield curve has flattened in June. What all these mean is that investors will now have to factor in the impact of less-accommodative global liquidity on their portfolios.

## China's financial markets come of age

In our view, the most important events in the financial markets recently were those concerning China - the inclusion of China’s A-shares in its MSCI Emerging Market Index and MSCI AC World Index on 20 June, and announcement of the “Bond Connect” scheme on 1 July.

We believe MSCI's decision has major implications for China’s equity markets, their place in the international financial system, and the way global equity money is managed over the

[2] Minutes of the Federal Open Market Committee, 13-14 June 2017. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate, 14 June 2017; Federal Reserve Bank of St. Louis, 15 June 2017.
[3] Speech given by Mario Draghi at the ECB conference in Sintra, Portugal, 27 June 2017.
[4] Financial Times, Reuters, 21 June 2017.

medium to long term. The move should also raise the country's profile with global investors, and encourage the domestic market to meet international standards.

Meanwhile, China's domestic bond market, which has grown over the past decade to become the world's third largest, may see more rapid progress. Currently, foreign investor ownership is only 2.7% of a market equivalent in size to US$243 billion[5], and there is room to grow.

The Bond Connect Scheme underscores Beijing’s wish to give the renminbi bond markets a much bigger role and to reduce China's overdependence on bank lending as a source of finance. Encouraging higher foreign investor participation may help to achieve the goals.

## Cautious optimism ahead

In sum, we expect returns from equity and fixed income to remain structurally low for an extended period, with a greater risk of correction in the US equities market within the next 3 to 12 months. We also believe global emerging market equities will have some of the best returns over the next five years.

For global stock markets, we anticipate low- to mid-single digit (annual) returns over 2017 to 2021.

While this range of returns may appear relatively compressed by historical standards, we would stress that the uncertainties attached to such projections are great, given the uncharted waters of central bank policies and the likelihood of a withdrawal of policy support in the not-too-distant future.

[5]Manulife Asset Management, June 2017.

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