Manulife Asset Management

Monthly Macro View

September 2017

For retail use, September 2017

Stock markets struggle but stay afloat

It's been a challenging month defined by political tensions (with North Korea and within the US), and concerns around issues like potential quantitative easing tapering in Europe and a possible debt ceiling crisis in the US. But it's not all been bad. The global economy remains strong with all 45 OECD-tracked countries set to grow this year. The US financial sector looks especially promising. Many in the media are negative on China, but perhaps irrationally so – the data points to the worries being overblown, with solid opportunities remaining if you know where to look.

In this edition of Monthly Macro View, Manulife Asset Management's Senior Asia Strategist Geoff Lewis shows you where your focus should be and why.

Monthly performance at a glance [1]

- The MSCI All Country World returned 0.4% in August, the 10th consecutive month of gains, and longest positive run since 1969.
- Emerging markets remained in the lead with a 2.3% return. Europe and Japan were flat over the month.
- The outperformance of growth over value continued (+1.8% vs -1.2%, Russell 1000 indices).
- Sector performances were mixed – Energy fell 3.3% as Materials gained 2.0%. Telecoms and Financials both posted negative returns (-1.75% and -1.9% respectively).
- In the commodity space, the DJCI's +0.65% gain concealed large monthly gains in metals and gold offset by falls in crude oil and agricultural commodities.
- Investors enjoyed another month of positive returns from bonds, as fears of earlier tightening by central banks faded. Citi's World Government Bond index returned 1.2% in August.
- Despite a couple of brief spikes, the VIX index ended the month at just 10.60.

Equities and fixed income[1]

Asian equity funds experienced a second consecutive month of equity outflows (US$3.7 billion in total). Most of this was from India (US$1.5 billion) and South Korea (US$1.2 billion), in keeping with the weak tone of global stock markets. This still left Asia with an inflow of US$22.5 billion year-to-date.

[1] "Portfolio Allocation Trends – August 2017", Institute of International Finance. Factset, Manulife Asset Management, as of 31 August 2017, total returns in US dollar.

Some further outflows from Asia and emerging markets (EM) are possible this month if markets remain unsettled. But we would regard this as temporary and not a change of trend, since the fundamentals for EM in aggregate have not changed and remain strong.

In the fixed income space, the "hunt for yield" by global investors continues and will survive the current bout of market nerves. Inflows into emerging market debt (EMD) from mid-July to mid-August were strong, taking EMD's allocation within global bonds to 11.3%, the highest share since 2014.

Generally, EM currencies – the potential Achilles' heel for global investors in EMD – hold up better during broad global expansions. The mechanistic view that EM debt flows are closely linked to short term interest rate differentials with the US isn't accurate. With inflation low but positive in many EM economies, we see more potential for rate cuts and other monetary policy easing actions within the EM universe than for rate hikes. India, Indonesia, South Korea and Turkey fit into this category.

US dollar path is key to EM market direction

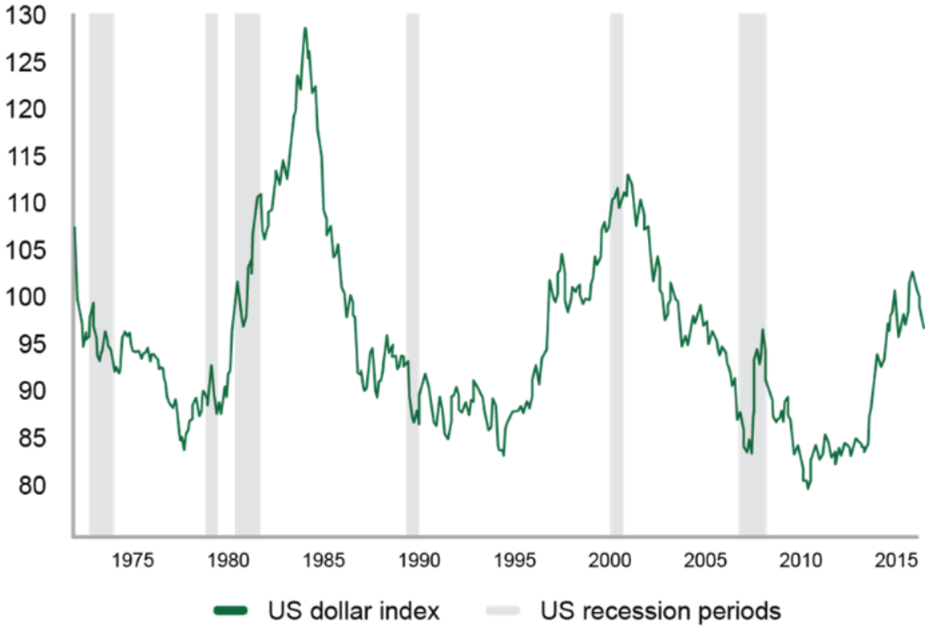
The trend in the US trade-weighted dollar index will also have a strong bearing on stock market direction, as it has done thus far in 2017. Note that a broader, stronger global economic expansion in the past was usually accompanied by a weaker rather than a stronger dollar (Figure 1).

US politics could further weaken the dollar in summer, which sets up for a counter-trend rebound ahead of an expected Fed rate hike in December. Many FX analysts think the greenback is due for a technical rally. After some consolidation, the dollar could resume its downward trend, though the lack of firm underpinnings means this is not a strong conviction view.

A return to a strong dollar is not in line with the current US administration's interests (given their goal to raise US GDP growth and reduce external deficit). If US competitiveness is boosted by a weaker dollar, it may reduce the perceived need for stronger administrative action on foreign trade, such as increasing import tariffs (a potentially risky move). While the White House may well pay lip service to a strong currency, we think this Administration would probably welcome a reversal of the dollar's 21% real appreciation from August 2011 to December 2016, as implied in remarks by Steve Mnuchin at the end of last month[2].

[2] See "Mnuchin shrugs at weaker dollar, sending currency lower", Market Watch, 31 August 2017. US dollar appreciation measured by Fed's broad real effective exchange rate, inflation adjusted.

Figure 1: US dollar real trade-weighted-index critical for global market direction[3]



Despite geopolitics, global confidence is high

For the first time in a decade, the world's major economies are growing in sync. All 45 countries tracked by the OECD are on track to grow this year, with 33 poised to accelerate from a year ago. This is the first time since 2007 that they are all are growing simultaneously, and the most countries in acceleration since 2010, during the post-global financial crisis (GFC) rebound phase. A Wall Street Journal lead article last month covered the trend towards more global optimism.

There are grounds for more optimism over the global economy, but we would counsel against getting too positive. The International Monetary Fund (IMF) in its World Economic Outlook update in July made only small upward revisions to the April numbers. Following 3.2% growth in 2016, global output is forecast to grow 3.5% this year and 3.6% in 2018, so the IMF expects little upward momentum going into 2018.

Distribution of growth in this expansion remains highly skewed. Of the world's top 20 economies, only Indonesia joins China and India with a GDP growth rate above 4% in 2017 and 2018 – this is why for many countries, 2017 still feels more like a 2% plus expansion than a 3% plus one.

In the past 50 years, simultaneous growth among all the OECD-tracked countries has been rare. In addition to 2007, it has only happened in the late 1980s, and for a few years before the 1973 oil crisis. This could be undone in 2018 if synchronised growth were to be accompanied by overheating. History suggests that soaring global stock prices and property markets could quickly return to earth. That is not our base case, however, as global inflation fortunately remains subdued. Nor is it the view of the central banks, who could also derail the upturn if they withdraw financial stimulus too aggressively.

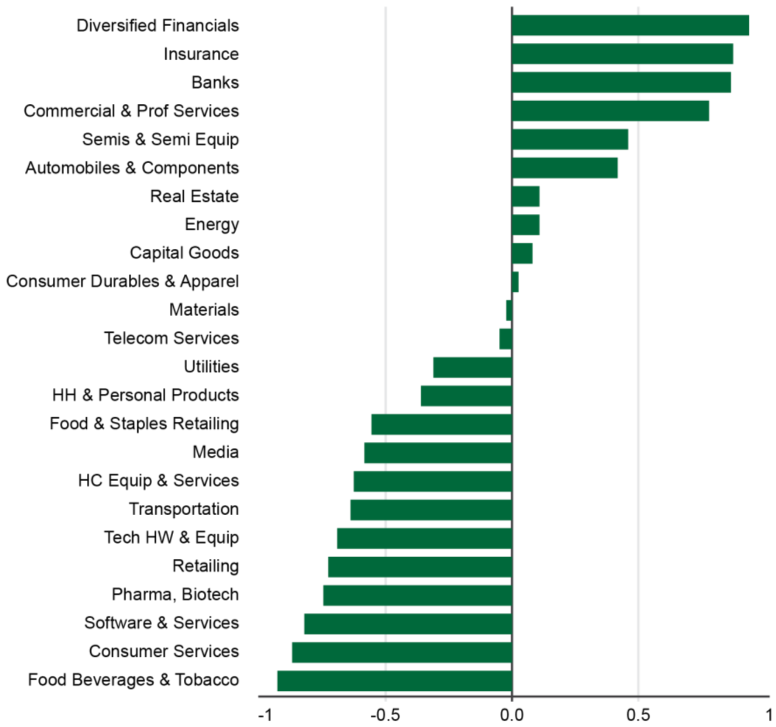
[3] http://www.macrotrends.net/1329/us-dollar-index-historical-chart, January 1973 to August 2017

Good opportunities in the US financial sector

As QE unwinds, some investors fear the withdrawal of unconventional monetary policy support could harm economies and markets. However, we think that if the Fed continues to raise rates very gradually, US banks would face an improving medium-term outlook that should more than compensate for any marginal negatives arising from monetary policy normalisation. Banks often benefit in an environment of gradually rising interest rates (see Figure 2), as their net interest margins (NIM) widen.

US banks have done more to improve their balance sheets after the GFC than many of their peers in other regions, and consequently have performed well in recent stress tests. US regulators were quick to introduce new macro prudential regulations that have acted to strengthen bank balance sheets, reducing the risk of repeat of the financial crisis of 2007/2008.

Figure 2: Large cap industry group correlations to 10-year yield shows financials benefits from rising yields[4]



Still positive on China

Despite media fears, we see little risk of more than a slight deceleration in store for the Chinese economy. After some mixed data in July, August releases rebounded strongly, indicating that the short-term outlook for China remains good. The August Caixin Manufacturing Purchasing Managers' Index (PMI) at 51.6 is the second highest this year, with June new export orders posting a 7-year high[5].

The property sector also does not appear to constitute a major recessionary threat at this point. Mainland property developers have been bidding aggressively in 2017 to reload their land banks, while Tier 3

[4] Credit Suisse May 2017, TIS Group, June 2017. Correlations calculated since 2004.
[5] Bloomberg, as of August 2017.

residential inventories have fallen to low levels. The conditions for a Chinese property crash aren't there. While we are more focused on "New China", there can still be good investment opportunities in the "Old China" industries where valuations are cheap, after taking industry restructuring and consolidation plans into account. For example, the stabilisation of the economy in 2016 was enough to boost mainland bank earnings, a sector long out of favour with overseas investors.

According to EPFR data, the share of Chinese equities in EM funds has not increased from 2016 levels, despite the clear improvement in the economy. This probably reflects lingering fears of a hard landing on the part of overseas investors. They may also be applying a higher ex-ante risk premium to China, as their China weighting peaked in mid-2015 just ahead of the sharp fall in an overheated A-share market.