Manulife Asset Management

Monthly Macro View

November 2017

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October – Positive economic data sets stage for 2018

Global economic data continues to impress: US consumer confidence and German business sentiment have hit new highs. China's economy has stabilised, and after the successful 19th Party Congress and visit by US President Donald Trump, the country is focusing on upgrading the economy.

The positive economic data sets the stage for 2018. In this edition of Monthly Macro View, Geoff Lewis summarises the factors underpinning global synchronised growth, and why the global portfolio is overweight equities and underweight bonds going into 2018.

Economic data continues to impress

- **US market shows high consumer confidence and strong GDP growth**[1]

Recent US activity data has been better than expected. US GDP growth in the third quarter beat expectations at 3.0% (seasonally adjusted annual rate), with trade and inventories together contributing over 1.0% to growth. Consumer confidence is close to a 17-year high[2]. The buoyant labour market and prospect of tax cuts next year should support consumer demand in the near term, though we have reservations over long-term demand in view of the low household savings rate.

- **Eurozone strong with German business sentiment at all-time highs**[3]

In the eurozone, GDP growth rose to 2.5% year-on-year, beating expectations and recording the fastest pace since 2011. Germany's IFO business climate index in October rose to an all-time high[4], led by the future expectations component. Despite stronger activity in Europe, there are currently few signs of inflation pressures. The opposite is the case as in October, core inflation (excluding food and energy prices) unexpectedly dipped below 1.0% year on year, with headline inflation also easing to 1.4%.

- **Mixed results in China with continued growth momentum but weaker PMIs**[5]

In China, the official manufacturing and services Purchasing Manager Indexes (PMI) both eased back in October, though the SME and export-oriented Caixin manufacturing PMI held up better. That said, with business confidence high and demand and price indicators holding up, we feel growth momentum is unlikely to fall sharply in the fourth quarter. The Chinese property sector is expected to weaken and act

[1] US Department of Commerce, Reuters, 27 October 2017.
[2] Conference Board, 31 October 2017.
[3] Eurostat, 31 October 2017.
[4] The CESifo Group, as of October 2017.
[5] National Bureau of Statistics of China, 31 October 2017. Markit Economics, 1 November 2017.

as a drag on growth, but the new policy initiatives unveiled at the party congress last month should be sufficient to support growth of 6% plus in 2018.

Outlook for 2018

While the macro data has clearly been positive, it remains our view that buoyant survey readings are probably running "rich" relative to reality. Nevertheless, outside of Europe, economists have been slow to revise up their 2018 GDP forecasts and there may still be some upside risk to forecasts.

Many investors will know that a good macro outlook for 2018 need not necessarily mean strong market returns as in 2017, though a favourable economic backdrop certainly helps. We think equity valuations are unlikely to mean revert unless bond yields rise sharply. But with global inflation subdued and monetary accommodation being withdrawn only gradually, yields are expected to remain well behaved in 2018. Our global portfolios remain overweight equities and underweight bonds.

Within equities we prefer the US, Japan and Asia over Europe, the UK and EM outside Asia. Within fixed income, we are quite cautious in the short term after the recent sell off in High Yield and appreciation of the trade-weighted dollar. But we expect that the quest for yield will still be there as a theme for fixed income investors in 2018.

Trump visit and China after the Communist Party Congress (CPC)

President Trump's visit to China "a resounding success"[6]

China and the US signed trade deals totalling US$253 billion (for comparison, the entire 2016 bilateral trade deficit with China was US$254 billion[7]), covering everything from agriculture and auto parts to energy. The deals are mostly with large Chinese state-owned enterprises (SOE), so Beijing will be better positioned to follow through. On 10 November 2017, the day after President Trump's visit, Vice Finance Minister Zhu Guangyao announced a major financial reform – the opening of China's domestic financial markets to foreign banks, brokerage houses and insurance companies.

At the 19th Party Congress in Beijing in mid-October, President Xi Jinping consolidated his grip on power, becoming only the third leader after Mao and Deng to have his political "Thought" enshrined in the Chinese Constitution[8]. Xi's China is likely to play a more active role in world affairs. This could benefit the west through increased cooperation, but can pose challenges if China's interests are to be accommodated.

Key themes for investing in China going forward

We expect to see further efforts to improve the performance of China's SOEs. This will include a greater role for public-private partnership (PPP, SOE managers can learn from China's successful private sector

[6] South China Morning Post, 9 November 2017. Reuters, 10 November 2017.
[7] Research Report on China-US Economic and Trade Relations, Ministry of Commerce of the People's Republic of China, 25 May 2017.
[8] See "China's 19th Communist Party Congress – Onward and upward!' Manulife Asset Management", 7 November 2017.

entrepreneurs). Other key economic themes include cleaning up the environment ("Beautiful China"), reducing excess capacity in heavy industry (Supply Side Reform), and financial de-leveraging (Macro Prudential Framework). There will be more focus on the sustainability and quality of growth, with a strong commitment to eradicating poverty and reducing income inequality.

China's "New Economy" and related opportunities

President Xi also announced at the CPC that China should become a world leader in innovation by 2035. China's "New Economy" – IT, the internet of things, electric vehicles, green energy, etc. – can expect to receive strong government support. Beijing regards new industries like electric vehicles as a chance to "leapfrog" as opposed to merely "catch up" with western technology. R&D spending is growing rapidly in China, as is tertiary education in science, mathematics, computing and technology.

US Tax Reform

There appears to be a reasonable chance of some kind of US tax reform package being approved by Congress. There are significant differences between the House and Senate tax bills and tough negotiations lie ahead. Agreement on a reconciliation bill is likely to be delayed until the first quarter of 2018. The basic features have not changed much from President Trump's original plan.

All that said, to focus on the macro or GDP impact of the US tax package is to largely miss the point, however. It is the microeconomic effects that matter most. The majority of US firms stand to benefit from lower corporate tax rates. Banks are one of the highest tax-paying industries in the US and the sector stands to benefit significantly. A second potential benefit for many firms is the current expensing of investment spending. This is likely to trigger an increase in investment in capital projects and hence loan growth and demand, which will also be beneficial to banks. Other sectors with high effective tax rates include consumer staples, consumer discretionary, utilities and industrials.

To sum up, there is still considerable uncertainty as to whether Congress can agree on tax reform in the first quarter of 2018 and as such it is not priced into markets. But if it does go ahead, the tax cuts would give a strong boost not just to the S&P500 (potentially a 7% addition to EPS in 2018)[9], but to business confidence and stock markets globally.

[9] "Key Macro Themes," D Rissmiller, www.stratgasrp.com, 8 November 2017.

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