Manulife Asset Management

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The Year of the Pig - Will it Fly?

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2018 began with a wave of optimism over synchronised global growth. As the year progressed, however, divergent trends came to the fore, and increased geopolitical and economic uncertainties weighed ever more heavily on financial markets. Looking ahead, Geoff Lewis, Senior Strategist, Asia, Manulife Asset Management, expects markets to potentially perform rather better in 2019 even as the global economy slows as the long post-Global Financial Crisis (GFC) business cycle enters its latter stages.

Some of the headwinds that have battered equity markets in 2018 are likely to subside, and in some cases turn into tailwinds:

1. The Federal Reserve (Fed) after its "dovish" December rate hike looks to be closer to ending policy tightening, while oil prices have receded and the US dollar may be close to a peak;
2. The US economy is slated for slower growth in 2019, but we do not think that it will tip over into recession;
3. Emerging markets (EM) bore the brunt of the global equity correction in 2018 and may be poised for a rebound as the growth differential between DM and EM moves back in their favour;
4. The G20 trade truce between the US and China is a hopeful sign that the biggest geopolitical restraint on 2018 markets will fade, for three months at least;
5. As for the US dollar, we think it is close to a peak. It should begin its descent in 2019, providing an important tailwind for EM.

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Chart 1: The fourth quarter of 2018 and year-to-date returns[1]

MSCI equity indices	Total Return in US dollar (%)	
	Fourth quarter to date (as of 20 December 2018)	Year-to-date 2018
All Country World Index (ACWI)	-13.66	-9.97
US	-15.10	-6.07
Europe, Australasia, Far East (EAFE)	-12.90	-13.76
Europe	-13.07	-14.71
Japan	-15.78	-13.04
Emerging Markets	-8.21	-15.00
Asia Pacific ex-Japan	-9.30	-14.77
Lat Am	-1.36	-7.94

Currencies/Currency indices	Price return (%)	
	Fourth quarter to date (as of 20 December 2018)	Year-to-date 2018
US dollar index (DXY)	1.20	4.51
JP Morgan Asia dollar index (ADXY)	0.05	-4.49
EUR/USD	-1.36	-4.66
GBP/USD	-2.88	-6.34
JPY/USD	2.16	1.26
CNY/USD	-0.23	-5.42
SGD/USD	-0.40	-2.58

Bond indices	Total Return in US dollar (%)	
	Fourth quarter to date (as of 20 December 2018)	Year-to-date 2018
FTSE World Government Bond Index	1.15	-1.43
Barclays Global Aggregate	0.65	-1.74
Barclays Global High Yield	-3.57	-4.15
Barclays EM USD Aggregate	-0.32	-2.60

Commodities	Price return (%)	
	Fourth quarter to date (as of 20 December 2018)	Year-to-date 2018
Brent crude	-34.30	-18.72
Reuters/CoreCommodity CRB commodity total return index	-11.05	-9.22
Gold Futures	6.05	-3.49
Copper Futures	-3.67	-18.13

01 Market review: The fourth quarter of 2018

Fourth quarter correction deeper and more prolonged than in February

The US finally joined the global equity correction in October. At first, investors hoped that strong US fundamentals would mean only a short dip was in store. That hope soon proved false. It seemed as if weak non-US markets had combined to overwhelm the S&P 500. A growing number of markets – including "problem" EMs like Turkey and Argentina – were in bear market territory, with share prices down 15% to 20% from their January peaks. US equities looked stretched, with return divergences versus other regions above the 90th percentile. Key S&P500 chart levels succumbed, resulting in a longer and deeper US correction than in February[2]. An obvious trigger was the market's belief that the Fed would see strong data as a reason to keep raising rates "until something broke". In other words, there would be no "Powell put" to protect investors from falling markets.

S&P 500 constituents delivered another quarter of strong earnings in the third quarter, but tech share prices saw sharp fall as the sector lost its leadership position because of growing regulatory and data-privacy concerns, as well as earnings misses by several large cap names.
The US economy is showing signs of slower growth in some areas, as US households and firms adjust with a lag to past rate hikes, and the earnings revisions ratio has declined.

The US correction in the fourth quarter we think was mainly about valuations, as there was no big change in fundamentals. There was nowhere for investors to hide, as real returns were negative across all major asset classes, a rare situation that reflected the pressures imposed on global bond markets by the end of quantitative easing (QE). Investor sentiment globally remained poor in November and December. With few positive catalysts, equities remained in "risk off" mode with tight correlations across markets. The long awaited G20 Xi-Trump meeting at the end of November provided markets with only a brief respite, as the surprise arrest of Huawei CFO Sabrina Meng soured sentiment, denting market hopes of a US-China trade deal.

[1] Source: Bloomberg and Manulife Asset Management, as of 20 December 2018. Total returns in US dollar, all currencies returns are versus US dollar. Past performance is not indicative of future results.
[2] Source: CNBC, 31 October 2018: On 26 October, the S&P 500 fell below its 200-day moving average and dropped more than 10% from its intraday high hit on 21 September 2018; Bloomberg, 12 October 2018: The 200-day moving average on the S&P 500 has been pierced for the first time since the beginning of 2016.

We expect a more dovish Fed in 2019

Following December's "dovish" FOMC, we think there is a chance the Fed may call it a day in 2019 after just two more 25 basis points (bps) rate hikes. This is significant as until recently investors viewed "monetary overkill" as the number one recession risk for 2019. Supporting a more dovish stance from the Fed, we think headline consumer price index (CPI) is likely to slow to 1.5% year-on-year in the first quarter of 2019, down from 2.5% in October 2018 and a peak of 2.8% in July 2018[3], based on the gasoline price decline and "easier" year-ago comparisons. Market expectations in 2019 will switch from "fears of tightening" to "anticipation of easing" in 2020. This should provide support to stock markets while also removing significant further appreciation pressure on the US dollar which we think is currently close to its peak and will begin a structural descent some time in 2019, providing a welcome tailwind for emerging markets.

We do not think we are currently close to entering the next US recession even if the odds are rising for a 2020–2021 tailing off in growth. This matters for equity markets in 2019: since 1990, when the US has been in a recession the average correction in the MSCI World Index been more than 31% and lasted nearly a year. However, when the US is not in a recession, global equity declines have been much shallower at roughly 15%, lasting just 85 days and recovering in about five months[4].

Chances of a US-China trade deal in 2019 have increased

The G20 agreement between President Trump and President Xi was more than just a truce – it paves the way for more substantive talks in the first quarter of 2019 that may lead to an interim deal and a significant reduction in trade friction between the world's two largest economies. We see the burden of meeting expectations being mainly on China, which has been remarkably conciliatory in the face of President Trump's aggressive import tariffs. A long-term solution will still depend on some fundamental reforms from China in areas that, aside from trade and tariffs, include industrial policy, security threats, and external influence.

The Trump administration, Congress and US business are all united on the key issues that China needs to address and the US negotiating team will insist on meaningful targets, dates, and verification for what is agreed in the next three months. China is prepared to put quite a lot on the table immediately – and with mounting pressures from a slowing economy – is anxious to bring the trade war to a close. A trade deal would be an obvious catalyst for a rally in global equities in the first quarter of 2019. The potential support is greatest for China equities, whose valuations could recover significantly if domestic investor sentiment improves. Chinese stocks have fallen around 20% in 2018[5], to a large extent due to valuation compression from the twin headwinds of financial deleveraging and the trade friction.

[3] Source: Manulife Asset Management estimates, December 2018.
[4] Source: HSBC Global Research, 2018.
[5] Source: Bloomberg, CSI 300 index declined 23% in local currencies, year-to-date to as of 20 December 2018.

02 More economic uncertainty in 2019

Having begun on a wave of optimism over the prospects for another year of synchronised global growth, 2018 instead developed into a year of divergent trends and de-synchronised growth. Increased geopolitical and economic uncertainties like US-China trade frictions, Iran oil sanctions, crises in several emerging market economies, and much else besides came to weigh ever more heavily on financial markets.

Our view: US entering late cycle, no immediate threat of recession

The current majority consensus is that we are in the mature (or late) stage of this business cycle. A record 85% of fund managers say the global economy is in the late cycle[6], 11% above the previous all-time high in December 2007. Yet most recession gauges are not even flashing amber.

Despite the current media preoccupation with recession, we still think it is too early to worry about the end of this cycle. The term "late-cycle" really should describe a particular state or condition of the economy, not to a period of calendar time. It can easily last for a number of years, and in the past has delivered lower but still positive real returns to investors[7]. It has taken the US 10 years to catch up with the losses from the Global Financial Crisis (GFC). Thus, we view the US as only just entering the "late cycle" phase, which itself poses no immediate threat to investors.

Of the seven recession signals that we follow in our US Recession Dashboard (chart 2), three are neutral and four are green. According to a study by the US economics team at Bank of America Merrill Lynch, five monthly economic indicators that have been closely linked with US recessions (initial claims, auto sales, industrial production, Philadelphia Fed survey, and aggregate hours worked) suggests that no thresholds were about to be breached[8].

Chart 2: US recession dashboard [9]

[6] Source: BoAML, October 2018.
[7] Source: National Bank of Canada Financial Markets, August 2018.
[8] Source: BoAML, November 2018, study period from 1969 to 2018.
[9] Source: Manulife Asset Management, December 2018.

Normally, the late-cycle inflation is cost-push, rather than demand-pull. The giveaway is that profit margins almost always shrink late in an expansion. While history reveals it is possible to experience an "earnings recession" without an economic recession, there has never been an economic recession when earnings were still growing strongly. In the late cycle, labour is almost always the major source of cost pressure.

So the question of recession timing brings us back to the perennial debate: When will labour market tightness lead to a material acceleration in labour costs? That leads to questions about the NAIRU (non-accelerating inflation rate of unemployment) – a theoretical construct that has eluded measurement in practice and therefore has been of little value to policymakers. Unemployment is now at multi-decade lows in DM economies, and below most economists' estimates of NAIRU[10]. Estimates of the natural unemployment rate were clearly much too high in the mid-stages of this business cycle and have been repeatedly revised lower ever since. Will this process reverse in 2019? That is probably still the most difficult question facing investors over a horizon of 12-months or greater.

Falling oil prices a tailwind

Some investors are worried that the recent plunge in the crude oil price implies a sharp slowdown in the world economy is underway. But should investors really be worrying about oil just now? Oil prices as a guide to global demand have occasionally sent investors some very misleading signals. For example, in the mid-2000s the world crude price weakened and global growth remained resilient, then the oil price surged in 2008 just before the onset of the Global Financial Crisis (GFC). Later, during the post-GFC recovery, oil prices tumbled in 2014, but global growth only decelerated a little.

We think the reason for these misleading signals from oil prices is rather obvious; there have been frequent shocks to both global oil supply as well as demand. That is not the case today. The recent sharp 20% decline in November reflects an unanticipated glut in supply, not a collapse in demand, so cheaper oil is thus a tailwind that should help to support growth. It raises household disposable income and hence consumption in oil-consuming economies.

We think only if oil price falls and remains below US$50pbl is there likely to be a significant negative impact on US shale oil investment and a headwind to global growth. In fact, over a six to 12-month horizon we are bullish on crude oil as we expect OPEC to curtail output and the recent inventory rebuild to run off quite quickly.

Low expectations create scope for a surprise in 2019

Every bear market starts off with a dip, but not every dip goes on to trigger a bear market. So how can investors distinguish between the two cases? Should the fourth quarter 2018 correction be sold on further dips, or bought aggressively?

Of these two choices, our strong preference is for the latter. While 2018 was the year when politics dominated stock markets, 2019 could be the year that brings renewed focus on the economy. Some geopolitical concerns have been mulled over for so long that they have lost the power to shock. And the global economy faces a moderation in growth at the margin, not a meltdown that the media talks so much about.

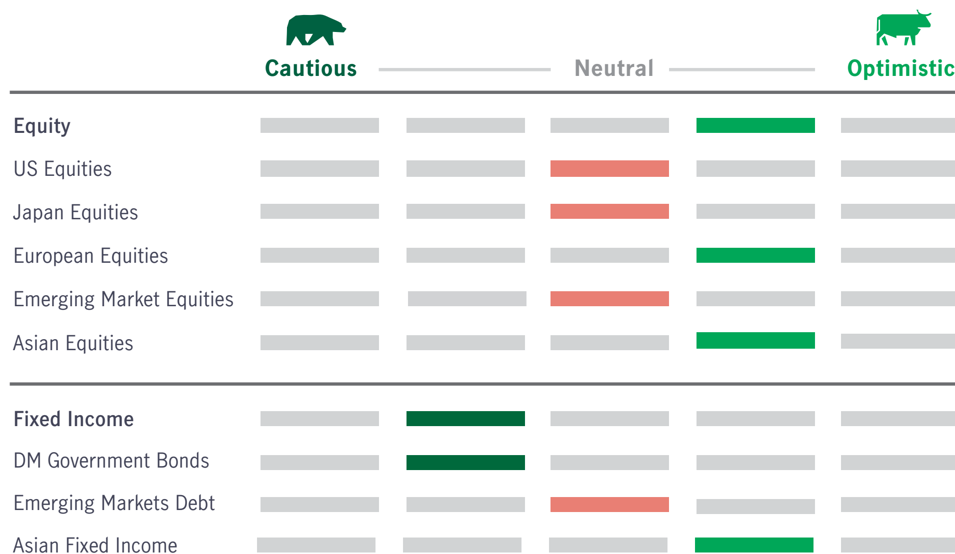
We are struck by how many of the sell-side 2019 outlooks that have landed on our desk are at best cautious or negative in tone. Is it time to take the other side of the trade? Looking to Main Street rather than Wall Street, guidance from management on earnings remains positive

[10] Source: International Monetary Fund, as of October 2018.

while forward multiples are back close to their historic averages. For example, the MSCI AC World forward price-to-earnings ratio (P/E) has de-rated to a below average 13.6 times[11]. Stocks appear inexpensive relative to growth, cash flow, and bonds. Meanwhile, positioning is light and sentiment depressed. Moreover, in those few cases historically where a strong global economy was accompanied by flat or negative stock-market returns, the following year has always seen a strong rebound[12].

03 Where to invest in 2019

Chart 3: Asset allocation for Asian investors in 2019 [13]



Developed markets

Among DM in recent years, one of the recurring themes in equities has been the large performance gap between the S&P 500 and MSCI Europe. On a rolling annual return basis, MSCI Europe has only outperformed the US 23% of the time during the last 10 years, compared with 66% in the 10 years prior to the GFC[14].

This strong US outperformance has also been broad-based, with 36 out of 39 US sectors substantially outperforming their European equivalents over the last 10 and five years (food producers, household products and mining being the only European outperformers)[15]. So, it hasn't all been about the US tech giants, by any means.

While Europe has certainly appeared "cheap", there's been a good reason for that. Judged by the ratio of trailing 12-months relative sales[16], Europe's underperformance appears warranted. A similar picture emerges if one looks at relative net margins[16]. As such, relative underperformance by European equities in recent years can largely be explained by divergent trends in sales and profit margins.

If we see a reversion in relative US/Europe margins in 2019, then one should also expect some tactical outperformance from Europe. Otherwise, US companies are better placed structurally with higher returns on equity (ROE), and are likely to retain their leadership.

[11] Source: Goldman Sachs Global Investment Research, 3 December 2018.
[12] Source: Strategas 2017.
[13] Source: Manulife Asset Management, December 2018. Projections or other forward-looking statements regarding future events, targets, management discipline or other expectations are only current as of the date indicated. There is no assurance that such events will occur, and if they were to occur, the result may be significantly different than that shown here.
[14] Source: HSBC Global Research, as of November 2018.
[15] Source: Societe Generale, Global Equity Market Arithmetic, 3 December, 2018.
[16] Source: Manulife Asset Management, Bloomberg November 2018.

Emerging markets

For a sustainable recovery in EM equities relative to the US and DM, we are probably going to need to see: (a) evidence of slower US growth and lower earnings, and (b) stabilisation in China and signs of recovery in those EM countries that stumbled earlier this year. While this may not become apparent much before mid-year – with (a) the more likely driver than (b) –we are fairly confident the EM-DM growth differential will widen in EM's favour in 2019, although not dramatically so.

There are a number of other positives that could see investors warm to EM equities in 2019. First, the sharp depreciation in the currencies of a number of "problem" EMs this year has the potential to improve current-account deficits significantly in 2019, cutting those of Turkey and Argentina by 50% or possibly more. Second, EM sentiment and valuations have fallen to low levels that in the past have been followed by significant market rebounds. Third, with the Fed close to pausing, oil prices down, and global growth moderating, the balance of risks is shifting towards cuts rather than increases in EM interest rates.

Manulife Asset Management's views on Asian Equities and Asian Fixed Income are as follows[17]:

Asian Equities: Overall, Asia should be better positioned globally in 2019 despite ongoing trade tensions. As the key drivers of the US markets begin to fade in 2019, Asia's strong economic fundamentals, supportive domestic policies, and accommodative monetary policy should be attractive to investors. We believe that these factors, coupled with historically low equity valuations in Asia, should drive capital flows back into the region. In particular, we are constructive on markets and sectors that leverage on the region's positive domestic-driven story.

Asian Fixed Income: A raft of macroeconomic headwinds, including rising Fed rates, a stronger US dollar, and deteriorating US-China trade relations have challenged bond markets in 2018. Heading into 2019, market re-pricing is expected to reach an end and Asian bond markets should have priced in slower growth prospects. This divergence in economic expectations between markets should provide ample opportunities in the areas of rates, credits, and currencies.

Conclusion

Looking ahead, we expect the following top-line outlook for 2019:

- Moderate and more balanced global growth, which will reduce worries over inflation and interest rates, and put less pressure on bond markets.
- Central banks will not tighten much as long as inflation remains well-behaved.
- The US dollar is peaking and could begin its descent in 2019, which will provide a tailwind for emerging markets.

After a volatile 2018, 2019 will likely see continued uncertainty, but more focused on economics and the fate of the US economy. Indeed, the Fed's interest rate trajectory will take centre stage next year in the late-cycle environment, with the global and US economy likely to continue moderate expansion with a low chance of recession in 2019. Against this macro backdrop, we remain somewhat optimistic on equities: European equities may fare well due to attractive valuations, while we are optimistic on Asian equities due to historically low valuations and domestically-driven economic growth prospects. Finally, although we are pessimistic on government bonds in developed markets, Asian fixed income may be a potential bright spot in 2019, as the rate hikes and volatility that punctuated 2018 should subside and potentially reverse into tailwinds next year.

[17] Source: Ronald Chan, Chief Investment Officer, Equities (Asia ex-Japan), Manulife Asset Management; Endre Pedersen, Chief Investment Officer, Fixed Income (Asia ex-Japan), Manulife Asset Management.

04 Key events to watch in 2019

Source: Bloomberg, Citi Research, December 2018.

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