Manulife Asset Management

MONTHLY MACRO VIEW

Making Sense of the Market Rebound

THE ASSET ALLOCATION TEAM

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The start of this year saw the return of risk-on sentiment as investors welcomed a newly dovish Fed and signs the Chinese economy is over the worst – but geopolitical tensions and the growth outlook are lingering concerns. Will strengthened stimulus from China and a solid economic growth in the US economy be enough to stabilise global markets? Frances Donald, Head of Macroeconomic Strategy within the Asset Allocation Team at Manulife Asset Management, examines the market fundamentals and economic issues underpinning the market's rebound in early 2019.

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01 Four Important Global Market Reactions Since The Start of 2019

Two significant macro events have supported a return to risk-on behavior, partly erasing the weakness seen in late 2018. First, China strengthened stimulus measures and markets began to adopt a view that the worst of China's most recent cyclical slowdown was probably left behind in 2018. Second, in early January, the tone of the Federal Reserve's (Fed's) communication appeared to take a dovish turn, suggesting fewer (if any) rate hikes ahead and more flexibility with respect to the Fed's balance-sheet tightening. Minutes of the FOMC's 19th December 2018 meeting released on 9th January [1] – coupled with a very dovish statement and press conference [2] following the FOMC's January 30th rate decision – reinforced that view.

These macro developments, combined with some oversold conditions in equities, generated four important global market reactions [3]:

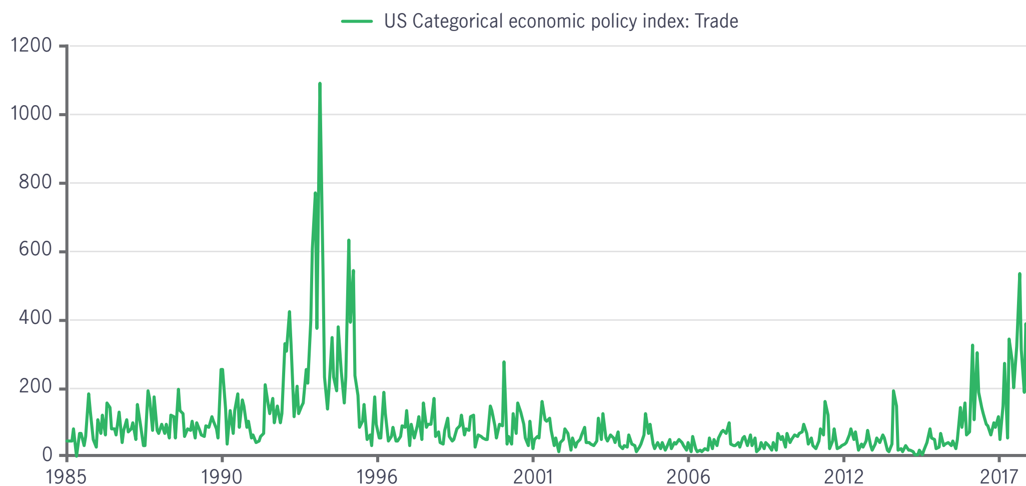
1. A broad risk-on tone has supported US and global equities; the S&P500 has recouped about two-thirds of its losses from the September peak. Critically, this strength has been found globally, with every major equity market in the world posting gains year-to-date.
2. Global central bank dovishness has kept most developed market bond yields well behaved and largely range bound after markets spent December 2018 pricing out further rate hikes. Crucially, this change in policy rhetoric has supported a stabilisation in the yield curve, which had aggressively flattened last December, triggering concerns about an impending recession. While the US yield curve remains extremely flat, it does not appear in immediate danger of inverting.
3. Interestingly, despite a more dovish Fed and ongoing concerns about the US's growing twin deficits, the US dollar has not materially weakened but instead remained flat. Still, a flat US dollar is more welcome to emerging markets (EM) (and US multinationals) than a rising one, providing further support to global market sentiment.
4. Weaker bond yields, a stable US dollar and enthusiasm over Chinese stimulus have bolstered the EM narrative along with EM asset outperformance after a very difficult 2018.

Meanwhile, geopolitical developments continue to produce headline risks that whipsaw global markets. These risks are challenging for market participants, in large part because they are difficult to quantify, model, or forecast, and yet they can significantly alter the economic outlook for several key countries. The US Economy Policy Uncertainty Index measuring trade uncertainty, for example, is at its highest level in almost 30 years [4]. This uncertainty continues, in our view, to encourage investors to seek safe havens more than might seem typical.

From the Asset Allocator's perspective, this continues to be a very tactical market in which we should expect persistent volatility. Even as Chinese and US policy makers have alleviated some near-term concerns, markets will be carefully assessing the global growth profile outlook, which continues to appear soft and worsening. We should expect heightened reactions to headlines, economic data, and central bank policy over the coming months.

[1] Minutes of the FOMC, 18-19 December 2018.
[2] FOMC press conference, 30 January 2019; Federal Reserve press release, 30 January 2019.
[3] Manulife Asset Management, Bloomberg, as of 12 February 2019.
[4] Bloomberg, Manulife Asset Management. As of 12 February 2019.

Chart 1: US trade policy uncertainty level spikes on increased geopolitical tensions



Source: Bloomberg, Manulife Asset Management. As of 12 February 2019.

02 China's Policy Inflection Point – Questions and Answers

At the end of December, it became clear to us and to markets that China was moving from piecemeal, reactionary forms of monetary policy towards proactive, broad stimulus. This has provided a key support to EM, which relies heavily on Chinese growth and trade expectations.

The inflection point in Chinese policy has also supported global risk sentiment as expectations of a Chinese economic stabilisation feed through into an improved global growth outlook, at least at the margin.

What has China done so far?

The People's Bank of China (PBoC) has recently been deemphasizing the "neutral" component of its prior "prudent and neutral" monetary policy refrain and is now placing an emphasis on forward-looking flexibility. Indeed, three moves from the PBoC in the past two months indicate it is now in full-blown "easing" mode:

- On 19th December 2018, the PBoC lowered funding costs for commercial banks for the first time since 16th February 2018 in a new Targeted Medium-Term Lending Facility (TMLF)[5]. By itself, this measure was not significant enough to bolster broad growth but it did signal accommodative monetary policy and suggested broader easing ahead.
- On 4th January, the PBoC cut the reserve requirement ratio (RRR) by 100 bps[6]. While there were four targeted RRR cuts in 2017, this marked the first broad and unconditional rate cut and signaled a substantial shift in monetary easing.
- On 24th January, the PBoC announced a new Central Bank Bills Swap (CBS) tool that allows investors to use holdings of bank-issued perpetual bonds to swap for PBoC bills[7]. Critically, it does appear the tool's primary purpose is to stabilise credit expansion and economic growth.

[5] People's Bank of China press release: PBC launches TMLF to spur lending to small and private businesses, 21 December 2019. TMLF offers rates 15 basis points (bps) lower than the existing Medium-Term Lending Facility (MLF).

[6] People's Bank of China press release: PBC decides to lower required reserve ratio for financial institutions to replace certain medium-term lending facilities (MLF), 4 January 2019.

[7] People's Bank of China press release: PBC Launches Central Bank Bills Swap to Support Liquidity of Banks' Perpetual Bonds, 24 January 2019. The tool was widely compared with "quantitative easing" because it's an open-ended facility that could achieve considerable size. However, the tool is not currently buying fixed-income securities outright like other central bank QE programmes.

What's next from policy?

We expect 2-3 additional RRR cuts in 2019, but perhaps more importantly, a complementary fiscal package that could include value added tax cuts and enterprise income tax cuts (to be finalised at the upcoming People's Congress in March) and additional local government bond issuance.

However, the timing and size of these additional forms of stimulus likely depends on: (i) US-China trade talk outcomes, (ii) Fed policy, (iii) the global growth outlook and (iv) Chinese corporate earnings. In our view, Beijing is not keen to undo its de-leveraging and de-risking efforts of 2017-18 and will likely err on the side of the least stimulus necessary to provide growth stabilisation, particularly with respect to property and credit markets. Premier Li's comments at the State Council's 14th January meeting that China will not utilise an approach that will "flood" stimulus into the economy[8] reinforces that view.

Will this stimulus be enough to support Chinese growth and markets?

In our view, the stimulus injected so far can be sufficient to provide temporary 12-18 month stabilisation in the Chinese economy, mostly via improved investor confidence, Chinese market sentiment and the expectations of further easing ahead. There are, however, two important caveats. First, stabilisation isn't likely to materialise in economic data for several more months as stimulus tends to have lagged effects on growth. Second, while stabilisation is on the cards, we are not expecting a meaningful rebound or upswing in growth. In order to witness a sizeable rebound, we believe major infrastructure or property stimulus would be needed, which seems unlikely to us.

In addition, we think it's worth highlighting that there were already some green shoots of stabilisation visible in the economy in the last quarter of 2018, including industrial activity, corporate credit and a recent acceleration in leading South Korean economic data points that should support a less aggressive decline in first-quarter growth statistics before a more solid stabilisation appears later this year.

All else equal, this growth stabilisation combined with additional rate cuts and corporate tax cuts should continue to be supportive of both Chinese bonds and equities.

Can Chinese stimulus and growth provide a tailwind to EM assets and/or global growth?

Once China's economic data does stabilise, we expect the global economy to feel the improvement with a three-to-four quarter lag. This means that the rest of the world's real economy is only likely to benefit late in 2019/early 2020, even if markets, such as China-tied copper prices, have priced in the improvement earlier in the year. For Europe, and Germany in particular, Chinese stabilisation is good news and mildly improves our outlook for European growth in the medium-term.

What does stimulus mean for your currency view?

Near-term resolutions or even improvements in US-China trade talks will provide short-term support to the renminbi and we expect policymakers are keen for the USD/CNY exchange rate to remain below 7.0 until there is more clarity on the trade and global growth outlook. However, narrowing bond yield spreads between China and the US and a shrinking current-account surplus are structural trends that are difficult to ignore. While we expect the USD/CNY exchange rate to breach 7.0 in 2019, it seems more likely that this will occur in the later part of the year rather than in the near term.

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[8] Reuters: China seeks good start to year to help hit economic targets, 14 January 2019.

Chart 2: Improving copper prices reflect improving Chinese growth story

Source: Bloomberg, Manulife Asset Management. As of 12 February 2019

03 US Growth Remains Solid; Don't Discount the US Consumer Just Yet

We are generally sympathetic to the idea that a sizable growth slowdown could occur in 2020. The negative impact on growth created by tighter monetary and fiscal policy and the impact of tariffs already in the system are important. It's also clear that the US economy is in a late-cycle stage and that high non-financial corporate debt could produce additional headwinds to growth. However, the amount of "known unknowns" remains too large for us to feel comfortable calling a recession that far into the future. Plus, mitigating factors include how the Fed and other central banks respond to a weaker growth outlook, the evolution of Sino-US talks, and the potential for further global fiscal stimulus measures, particularly from Europe and China.

Right now, however, there are some important tailwinds in the US economy in the next six months that we believe are underappreciated. Most of these centre on the US consumer:

1. Broad-based wage gains: US jobs data remain extremely strong as job openings, initial jobless claims, nonfarm payrolls, and other data points continue to accelerate. The result of this tight labour market is ongoing wage gains across almost every measure.
2. Sizable tax refunds: US households will soon receive their second year of sizeable tax refunds. We expect some of this refund to filter through into the broad economy and continue to support consumer confidence, which remains at elevated levels.
3. Lower gas prices: Gasoline prices are down 22% since their October peak, which will provide some relief at the pump for US households who spent an increasingly large share of their incomes on gasoline throughout 2017-18[9].
4. Falling mortgage rates: As bond markets price out rate hikes and yields fall, the US mortgage rate (along with other interest rates on consumer debt) has fallen rapidly. In our view, this should provide a temporary reprieve to the US housing market.

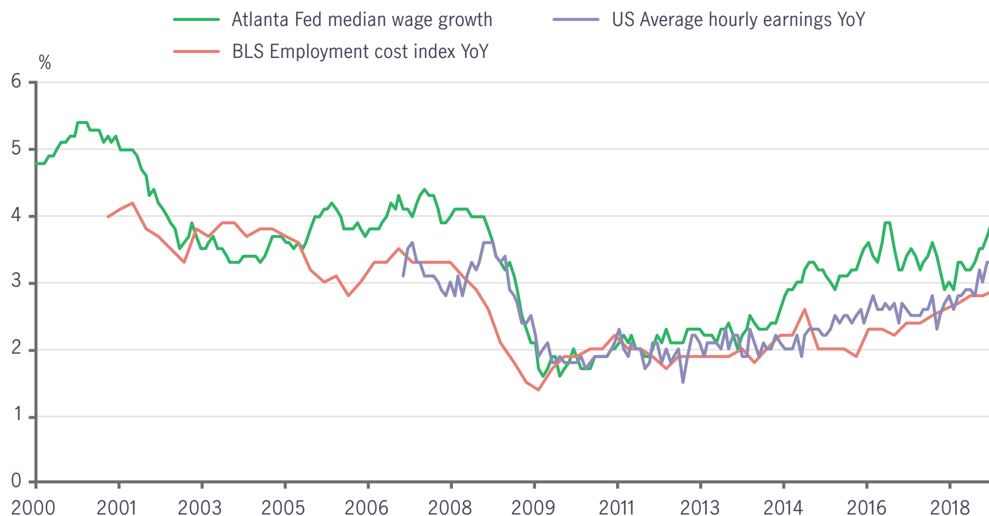
These potential upside surprises for growth are important because they will, in our view, pave the way for an additional rate hike from the Fed mid-year. Markets are clearly underpriced for this outcome, especially following very poor December retail sales data, with future markets pricing in less than a 10% probability of a rate hike by even the September 2019 meeting[10].

[9] Manulife Asset Management, Bloomberg, as of 12 February 2019.
[10] Manulife Asset Management, Bloomberg, as of 12 February 2019.

If we are correct, bond yields will need to re-adjust and likely the front-end of the yield curve should make one last push higher in this cycle. That move will be larger if wage inflation is viewed as creating broader core inflationary pressures in the economy.

However, higher rates may also create some volatility around equities, particularly if the 10-year Treasury yield climbs back towards 3%.

Chart 3: Americans continue to see healthy wage gains



Source: Bloomberg, Manulife Asset Management. As of 12 February 2019.

04 This month's FAQs

1. Is the outlook for EM still as favorable? At the margin, EM remains an attractive asset class, though slightly less than three months ago. In the fourth quarter, EM benefited from a more stable US dollar, diminished expectations for US and global rate hikes, and welcome stimulus from China. Looking ahead, we may see a short period of higher bond yields and a tactically stronger US dollar. However, overall, EM will continue to benefit from a reduction in geopolitical tensions and a more stable Chinese economy so it is too early to turn away from the asset class just yet.

2. Is there any good news out of Europe? European economic data continues to disappoint, just as it did throughout 2018. But before we become too pessimistic on the trajectory of Europe, it's worth remembering there are some mild upsides that should help the continent see a bottom in growth later this year. They include: a more stable China that supports European trade, mild fiscal stimulus, and nascent evidence of rising wages. We will want to see a stabilisation and improvement in Purchasing Managers' Indices (PMIs) before we get more excited about Europe but we also think it would be a mistake to dismiss the region entirely.

3. How do US government shutdowns affect the economy? Historically, government shutdowns haven't significantly altered economic outlooks in the US because any fall in employment or spending data rebounded in subsequent periods, leaving no material impact. That implies the economic data could actually see an artificial boost in the coming months as shutdown impacts from January are "unwound". Economists will likely attempt to parcel out those rebounding effects, but it isn't always straight forward. For example, the most recent US government shutdown may have depressed business and consumer confidence in a way that is difficult to measure, so the multiplier effects may, at the margin, still be slightly negative on balance for growth.

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