Manulife Asset Management

Monthly Macro View

October 2016

Looking for green shoots in a pro-growth Asian equity strategy

Over the past few issues, we examined potential investment opportunities in emerging markets (EM) and Asia from factors like valuations, earnings forecasts and revisions, portfolio inflows, economic surprise indices. We find that emerging Asia's economic data generally looks better today than it did six months ago, although for now improvements for the most part remain tentative rather than solid.

In this Monthly Macro View, Manulife Asset Management's Senior Asia Strategist Geoff Lewis notes that Asia's renaissance owes something to relatively benign global financial market conditions, reflected in the rush of foreign portfolio capital into local bond and equity markets. Partly, of course, the surge in portfolio flows to emerging markets reflects the quest for yield as many fixed income investors in developed markets find their own government bond yields are too low to meet their needs. Some, though not all of these bond flows to emerging market debts (EMD) may reverse once government bond yields rise significantly in the developed markets (DM), though this does not appear to be a big short term risk.

Geoff further explains why although Asia's long term growth prospects are good, the near-term economic outlook is less certain. Geoff believes that it will take more than just a gradual improvement in the global economy plus buoyant consumer demand for IT items to justify a major upgrade of Asia ex-Japan within a global equity or multi asset portfolio. It would take improved developed economy investment spending. Developed market economies' investment spending tends to have a higher import content than consumer demand, often including IT and semiconductors that favour Asian manufacturers.

September and third quarter market review[1]

Financial markets remain concerned about the waning efficacy of monetary policy. With the U.S. Federal Reserve (Fed) leaving key rates on hold in September, and the Bank of Japan (BoJ) announcing the introduction of "quantitative and qualitative monetary easing (QQE) with yield curve control" at its last meeting, On balance, equities barely moved in September. Government bond yields rose around the middle of the month, but soon softened. Oil prices made a significant gain of close to 8% (West Texas Intermediate (WTI)).

[1] Bloomberg, Manulife Asset Management, as of 30 September 2016. MSCI World & MSCI All Country (in US dollar term, price returns) recorded less than 1% gain in September.

Overall, global equities had a surprisingly strong third quarter, with developed markets rallying around 3 to 4 ½ per cent in US dollar terms, while emerging markets outperformed handsomely with a dollar return of 8.5%. Laggard Japan surprised investors with a 6.6% third quarter in Topix in US dollar. This came after Governor Kuroda promised to review Japan's monetary policies in September, creating expectations of further monetary easing just in time to support Abe's latest fiscal package.

Among fixed income markets, US Treasuries and Japanese JGBs both posted low negative returns in the quarter. Most bond markets, however, were able to deliver strong absolute returns that compared well with equities, as investors continued to move up the credit curve in search for yield. For example, US High Yield bonds returned 5.1%, European High Yield 3.0%, and Emerging Market government bonds 3.2% (Bloomberg indices in US dollars).

New OECD leading indicators point to an improving economy[2]

According to the latest figures from the OECD, global GDP growth is projected to remain flat around 3% in 2016 with only a modest improvement projected in 2017. The good news is this forecast is largely unchanged since June 2016 with weaker conditions in advanced economies, including the effects of Brexit, offset by a gradual improvement in major emerging market commodity producers.

The newly released and recalibrated OECD composite leading economic indicators (CLIs) point to an improving global economy in mid-2016. The prolonged period of sluggish world growth after the global financial crisis may finally be coming to an end:

- Stable growth momentum is anticipated in the OECD area as a whole, including the United States, Japan and the Eurozone, including Germany
- Amongst major emerging economies, the CLIs continue to indicate that growth is picking up in China, Russia and Brazil, while the CLIs for India continues to point to firming growth.

[2] Source: OECD, 21 September 2016.

Figure 1: CLIs continue to point to stable growth momentum in OECD area[3]

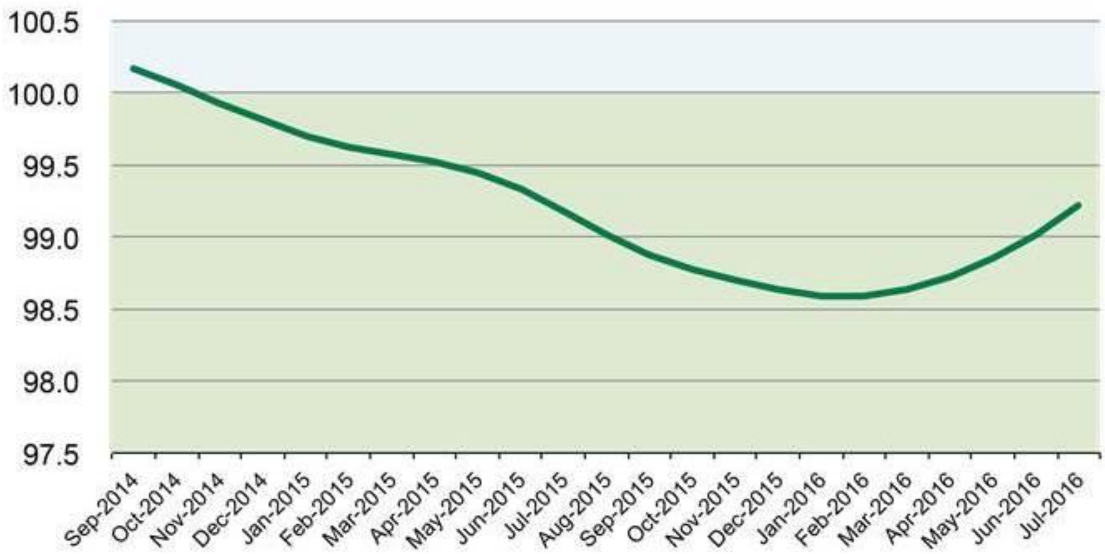


Figure 2: CLIs for China[3]

[3] Source: OECD Composite Leading Indicators News Release , 8 September 2016.

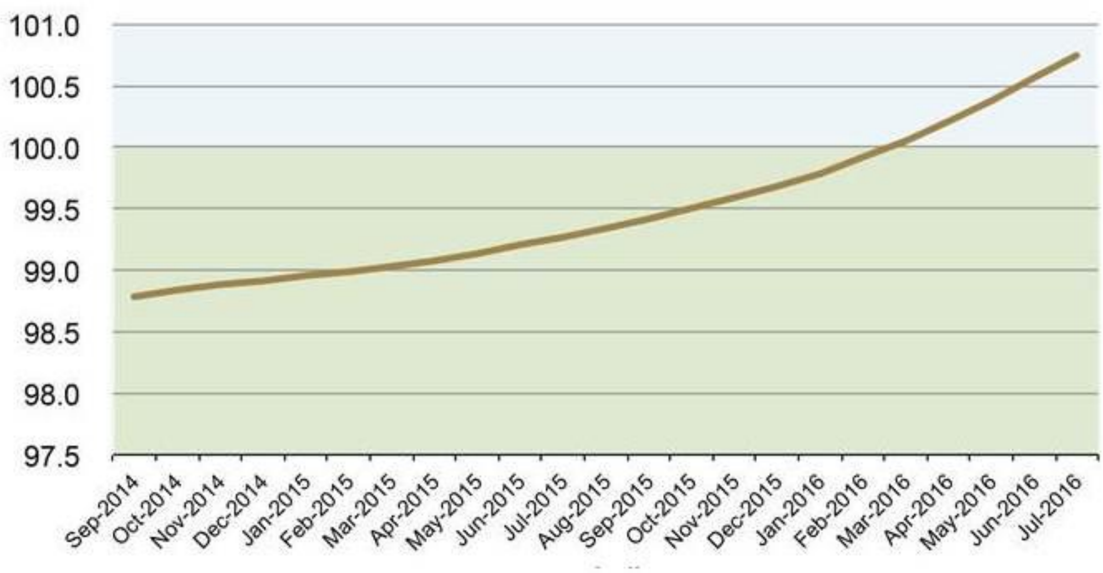


Figure 3: CLIs for India[3]

An improvement in the global growth outlook will be particularly beneficial for Asia's manufacturing exporters. It is not widely appreciated, but the CLIs for larger emerging economies like China and India are the ones currently driving the tentative improvement in the world economy. The OECD composite leading indicators for India had strengthened throughout 2015. This continued through the first seven months of 2016, making it a strong trend indeed. The OECD CLIs for China has also started recording sustained improvement.

A more stable China

Signs suggest that Beijing has after determined efforts succeeded in stabilising the Chinese economy in 2016. The regular monthly economic data release for August reveals continuing progress since July. China may still face some serious medium term structural problems. But it is becoming clear that the near-term outlook for the Chinese economy is quite decent. To be more precise: it is better than the majority of western analysts are prepared to admit. Credit growth is still likely to slow a little over coming months. We believe the People's Bank of China (PBoC) will refrain from further major monetary easing; its focus will likely remain on credit risks among state owned enterprises (SOEs) and in the private sector. On the whole, recent monthly indicators are turning up[4].

Naturally, China's stabilisation has positive effects elsewhere in Asia. Slowdown in China is ceasing to be such a drag on regional trade. This is a big positive for most Asian economies because it removes one of their biggest headwinds to growth. EM growth momentum has underperformed developed DM for a number of years, but this is essentially a commodities story. This

[4] Source: Trading Economics, Manufacturing PMI for September 2016 and Services PMI for August 2016 recorded improvement in two consecutive months.

underperformance is less true of Asia's manufacturing-biased economies. Asia (ex-Japan and China) real GDP growth has been stable over the past 2½ years at around 4.5%, for example[5].

Emerging Asia – Opportunities for 2017

Emerging Asia economic data looks a lot better than six months ago. Headline export growth no longer shows such steep declines today. In year-on-year terms, the worst declines took place in the first quarter of 2016[6]. Most readings were flat to slightly up in July and August. For ASEAN, the share of world imports and world exports has been essentially flat in recent years. This means that the world trade slowdown is more symptomatic of global issues than the Asian bloc losing out to other regions[7]. Furthermore, Purchasing Managers' Indices (PMIs) in many Asian countries have recently moved back above the waterline. Consider India. India's manufacturing sector is finally showing strength. Now add the successful passage of the Goods and Services Tax (GST) and the rapid deceleration of Consumer Price Index (CPI) inflation thanks to cheaper food prices from a better monsoon. The resulting outlook for India now appears brighter than at the start of the year.

In North East Asia, South Korea delivered robust growth in the second quarter of 2016. This was due to firmer consumer spending and a recovery in the local property market. Taiwan's domestic economy is weak, but the equity market has performed well. This was supported by strong portfolio inflows attracted by Taiwan's high dividend yield and positive investor sentiment towards the IT sector.

ASEAN has pockets of strength too. Admittedly, Malaysia as a net commodity exporter isn't doing quite so well due to the collapse in oil and palm oil revenues. But in Indonesia, a cabinet reshuffle has provided hopes for accelerated reforms; the tax amnesty could also bring in more revenue by year-end. Even Thailand has recently picked up a bit of steam, thanks to more government fiscal spending and a strong recovery in tourism.

One potential risk to bear in mind is that Asia's renaissance may owe something to relatively benign global financial market conditions, reflected in the rush of foreign portfolio capital into local bond and equity markets. The latter in turn has also allowed a number of Asian central banks to cut interest rates and others to forego hikes. This is because stronger currencies have added to the attractions of the region to foreign investors.

The big question is whether the recent momentum can be sustained. Long term, yes. There is little doubt that Asia has better growth potential than the US, Japan or Europe. But for now, the outlook for exports remains murky. Much of emerging Asia still depends on exports to propel growth. This is even more the case in economies where debt levels have climbed sharply in recent years (South Korea, Thailand, Malaysia, Singapore and Hong Kong). On the cautionary side, new export orders for the Asian region barely increased in August. What improvement there has been may be attributed to the launch of new consumer electronic products, a boost that may fade in coming

[5] Source: HSBC Global Research, 'On top of the data,' p.4, 15 September 2016
[6] Source: Trading Economics. In China, the year on year change for export in July and August were -4.4% and -2.8%, compared to February which was -25.4%; In Taiwan, export figures for July and August were 1.2% and 1.0%, compared to -12% in February.
[7] Source: ASR Ltd./Thomson Reuters Datastream.

months. Beyond this, without a sustained rise in global capex, it is difficult to see exports from Asia returning to their former glories soon.

Conclusion

Equity returns in recent years have often given the appearance of being back-end loaded. But we would stay a little cautious entering fourth quarter 2016 in view of the eventful political calendar, equity valuations that look cheap only when compared to expensive bonds, and a global earnings forecast for 2017 of 12 to 13 per cent that analysts are likely to begin trimming soon.

We think there is a reasonably good case for gradually increasing exposure to Asia ex-Japan equities at this point within a global equity or multi asset portfolio. But we still view the US economy as having the most robust economic fundamentals right now. Asian economic data has clearly improved. But this improvement remains tentative and gradual. As a result, the US stock market still retains pole position within our global equity portfolios, reflecting America's better comparisons on domestic growth, inflation, earnings and macro-economic policy. A more aggressive pro-growth equity strategy including a much bigger Asia/EM overweight is not justified at the moment. If we see more evidence of a stronger pickup in world trade, we may reconsider. This is something we'll be monitoring very closely.

For now, global and Asian exports can only be described as still sluggish. Volumes remain quite dull in US dollar nominal terms – the metric that matters most to investors in emerging market equities. But the charts are much improved compared to 12 months ago. The base effects from a strong dollar and low commodity prices have fallen away. Real demand has stabilised and is expected to firm somewhat in 2017. Besides a gradually improving global economy and strong consumer demand for IT products, there is one missing ingredient that would justify a major upgrade of Asia ex-Japan within a global equity portfolio: stronger developed economy investment spending. Developed economies tend to have relatively high import content, including IT and semiconductors that favour Asian manufacturers.

Disclaimer

Manulife Asset Management is the asset management division of Manulife Financial. This material, intended for the exclusive use by the recipients who are allowable to receive this document under the applicable laws and regulations of the relevant jurisdictions, was produced by and the opinions expressed are those of Manulife Asset Management as of the date of writing and are subject to change. The information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable but Manulife Asset Management does not make any representation as to their accuracy, correctness, usefulness or completeness and does not accept liability for any loss arising from the use hereof or the information and/or analysis contained herein. Information about the portfolio's holdings, asset allocation, or country diversification is historical and is not an indication of future portfolio composition, which will vary. Neither Manulife Asset Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained herein.

The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline or other expectations, and is only as current as of the date indicated. There is no assurance that such events will occur, and may be significantly different than that shown here. The information in this material including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. This material was prepared solely for informational purposes and does not constitute a recommendation, professional advice, an offer, solicitation or an invitation by or on behalf of Manulife Asset Management to any person to buy or sell any security. This material should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any investment products or to adopt any investment strategy. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. Past performance is not an indication of future results.

Investment involves risk. Investors should not base on this material alone to make investment decisions and should read the offering document (if applicable) for details, including the risk factors, charges and features of any investment products.

Proprietary Information – Please note that this material must not be wholly or partially reproduced, distributed, circulated, disseminated, published or disclosed, in any form and for any purpose, to any third party without prior approval from Manulife Asset Management.

This material is issued by Manulife Asset Management (Asia), a division of Manulife Asset Management (Hong Kong) Limited.

This material has not been reviewed by the Securities and Futures Commission (SFC).

Manulife Asset Management

Market Snapshot

Asia's long term growth prospects are good

Growth potential remains strong in the long-term, but the near-term outlook is less certain

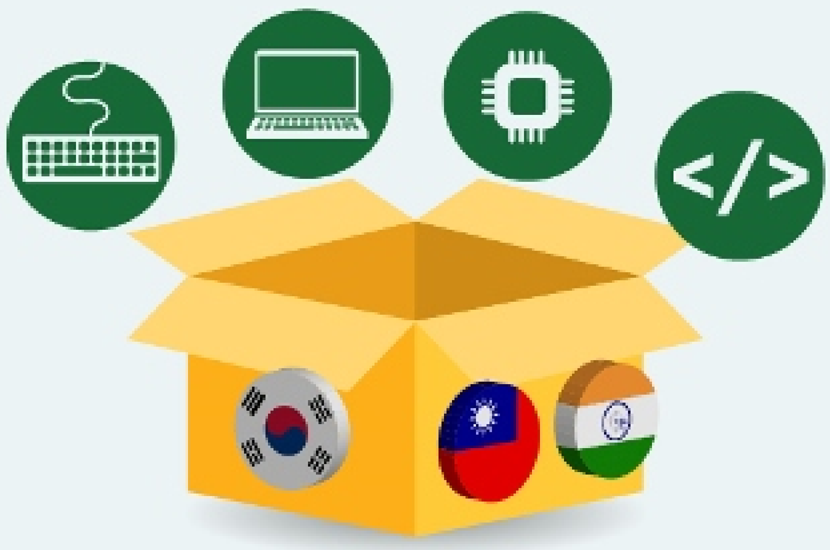
OECD leading indicator[1] pointing to an improving economy

Composite leading indicator continues to point to stable growth momentum in OECD area.
The prolonged period of sluggish world growth after the global financial crisis may finally be coming to an end.

Growth of larger emerging economies[2] picking up

The OECD leading index for India had strengthened throughout 2015 and continued through the first seven months of 2016. OECD leading index for China has also started recording sustained improvement.

Increased investment spending from developed economy will benefit Asian manufacturers



Developed economy investment spending has relatively high import content, including IT and semiconductors that favour Asian manufacturers like India, South Korea and Taiwan.

"Asian economic data has clearly improved. But this improvement remains tentative and gradual. In terms of global exports, real demand has stabilised and is expected to firm somewhat in 2017. In the past, South Korea and Taiwan have tended to outperform developed market exporters in the early stages of a global trade cycle due to their relatively high technology bias. They are expected to do so again. "

Geoff Lewis, Senior Strategist, Manulife Asset Management Asia

Sources:
1. OECD, 21 September 2016
2. OECD Composite Leading Indicators News Release , 8 September 2016