Manulife Asset Management

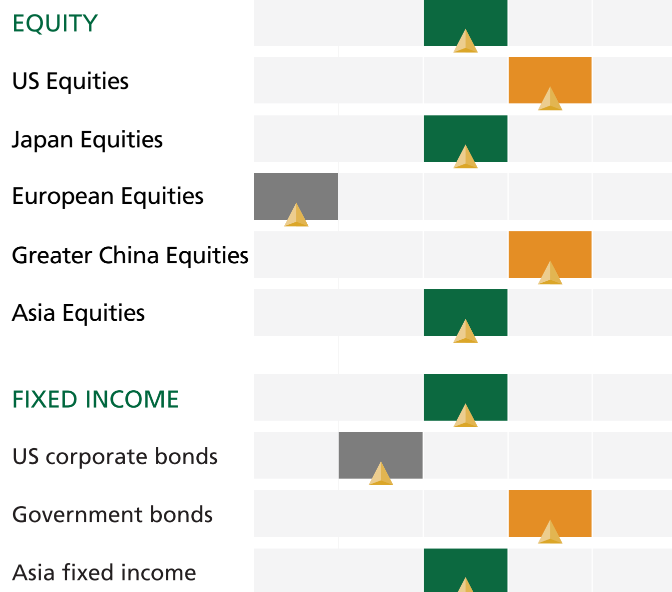
Asset Allocation View

Fourth Quarter 2016

Peter Warnes
Head of Portfolio Solutions Group International

We may be approaching a major junction for financial markets. Ultra low interest rates brought the global economy back from the abyss but have failed to substantially boost growth or inflation. Hence the efficacy of these policies are being questioned and market rates have risen in recent months as investors anticipate the next Fed rate hike, potentially lower asset purchases in Japan and Europe, and the possibility of fiscal policy taking a greater role going forward. Investors also need to navigate a number of major political events, as well as contend with limited value in many of the major asset markets and the prospect of more volatility going forward.
What does all this mean for asset allocation over the next quarter, and where could there be investment opportunities? Peter Warnes, Head of Portfolio Solutions Group International, explains in this quarter's Asset Allocation View.

Tactical asset allocation view (3 to 12 months)



Greater China equities: Will benefit from the stabilisation of the Chinese economy. Stocks are trading on attractive valuations relative to their own history and regional peers. Payouts are low relative to regional peers, but progress in State-Owned Enterprise (SOE) reforms may increase focus on shareholder returns.

US equities: Valuations versus government bonds remain attractive and US equities are less cyclical and more defensive than other regions. US equities have been driven by multiples expansion; given lofty valuations, another significant rise from here will need to be driven by better earnings. US equities should continue driving the broad direction of global equities.

Government bonds: These continue to play an important role in multi-asset portfolios and we do not expect a dramatic rise in yields over the next few months. However, we have reduced our duration exposure and concentrated our holdings in higher yielding government bonds and higher quality corporate credit.

Brief market review

The impact of Brexit on global financial markets proved different and much more short-lived than we expected. Investors largely ignored the potential negative demand shock on the UK economy. They also ignored the much broader potential implications for the longer term future of the European Union (EU). Brexit was instead treated as a positive global interest rate shock: such as being likely to trigger further easing in monetary policy by central banks.

Consequently, bonds rallied strongly through late June and early July. Many developed government bond yields had fallen to all-time lows by mid-July, before rising thereafter as it became increasingly clear during the quarter that the Federal Reserve would hike rates again in December (a 25 basis points December rate hike is currently 67% priced in)[1].

Outside the US, the Bank of Japan modified their monetary policy to target the level of yields. The ECB has yet to announce an extension of its QE programme. Some commentators suggest they could announce an extension and simultaneous tapering of their asset purchases. These factors helped push yields higher through the quarter's end and into early October[1].

Meanwhile, the "hunt for yield" continues. Investors continued moving up the risk curve to gain yield. Most bond markets delivered very strong absolute returns in US dollar terms, except for US Treasuries and Japanese Government Bonds, which posted small negative returns during the quarter[2].

Equities had a surprisingly strong quarter with developed markets producing mid-single digit returns in US dollar terms. Emerging markets continued to outperform. Amongst the majors, previously lagging markets like Japan and China produced the strongest returns.

Macro-economic data continued to point to a gradual improvement in global conditions, albeit from a low base. US data softened in August. Data points have recently shown improvement, while consumption remaining resilient. In China, economic data stabilised. Earlier fears of an economic hard landing and/or a major renminbi (RMB) depreciation have been alleviated. Notably, UK data massively exceeded expectations, though the full force of Brexit ("hard" or "soft") will not be felt for a while.

In terms of currencies, the major mover was sterling, which continued its post-Brexit slide. The yen and euro eked out modest rises versus the US dollar whilst the RMB depreciated slightly. At time of writing, the US dollar has appreciated once again back to levels last seen in early March. This was driven by expectations of a December Fed hike[1].

At time of writing, the US dollar has appreciated once again back to levels last seen in early March. This was driven by expectations of a December Fed hike.

[1] Source: Bloomberg, Manulife Asset Management (Asia), as of 18 October 2016.
[2] Source: Bloomberg, as of 30 September 2016.

Outlook

Since the end of June we have added some risk to our portfolios via increasing exposure to US and Asian equities. We still retain some cash as we expect to have a better opportunity to add risk at lower levels in the coming months.

US stock indices are near all-time highs, bond yields are at super-low levels and volatility across asset classes having risen only modestly in recent weeks. We believe there is still a lot of investor complacency given the numerous risks.

In the West, we have our eyes on various upcoming elections. In the US, a victory for Mr. Trump is no longer a tail-risk, but Mrs. Clinton has recently established a significant lead in the polls. Financial markets traditionally welcome a Republican victory, but the unpredictability and lack of clarity over some of Trump's key policies may lead to a Clinton victory being more welcomed by investors.

In Europe, there are numerous potentially game-changing elections coming over the next 12 months and we recognise that the Brexit vote, the ongoing refugee crisis and the rise of nationalism across the continent have changed the political landscape considerably, therefore increasing the risk of less market-friendly outcomes.

There are two other issues which concern us: the waning efficacy of monetary policy and the ongoing belief in many quarters that fiscal policy is set to come to the rescue. Aggressive monetary policy has not succeeded in creating either growth or inflation over the last few years, despite unprecedented levels of asset purchases and in some countries, negative interest rates. It now appears that global monetary policy is inflecting. Yields have risen and curves steepened. In hindsight, markets clearly became too complacent re the growth/policy trade-off and too dovish on rates.

Within equities, our preferred regions are the US and Greater China. We continue to own bonds. But have reduced our duration exposure and concentrated our holdings in higher yielding government bonds and higher quality corporate credit

This does create some cracks in the low yield story and the irrational period of negative yields is ending. But we regard this as more of a normalisation of developed market yields from extra-ordinary post-Brexit levels. Base effects from oil will lead to higher headline inflation in the first half of 2017, but we still believe medium term fundamentals point to low bond yields persisting and no significant, sustainable acceleration in growth or inflation.

We also doubt there would be a smooth passing of the baton to fiscal policy given the high levels of existing government debt globally, the questionable ability of the next US President to promote fiscal easing if the Republicans retain control of the House, whilst in Europe, Germany is unlikely to be easily persuaded to give up fiscal austerity.

In recent years equities have largely been driven by price-to-earnings re-rating. This left valuations extended in many major markets. Higher bond yields will limit further re-rating. Earnings will need to accelerate if markets are to move significantly higher from current levels. With such high corporate margins in the US, we are skeptical that revenue growth can be the key driver given our views on global growth. With that said, earnings revisions have improved in recent months. We will be closely watching guidance for the third quarter results season. Within equities, our preferred regions are the US and Greater China.

We continue to own bonds. But have reduced our duration exposure and concentrated our holdings in higher yielding government bonds and higher quality corporate credit. Bonds retain an important role in our portfolios for downside protection and diversification purposes, as long as correlations between equities and bonds are negative. Nonetheless, we will need to remain very tactical in the near term.

We expect nominal growth (and returns) to remain relatively low, markets to be largely macro driven, and more volatile than in recent years. We will focus on relative value trades in the near term, and expect to take advantage of volatility to add risk in both equities and bonds.

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).