Manulife Asset Management

Asset Allocation View

First Quarter 2017

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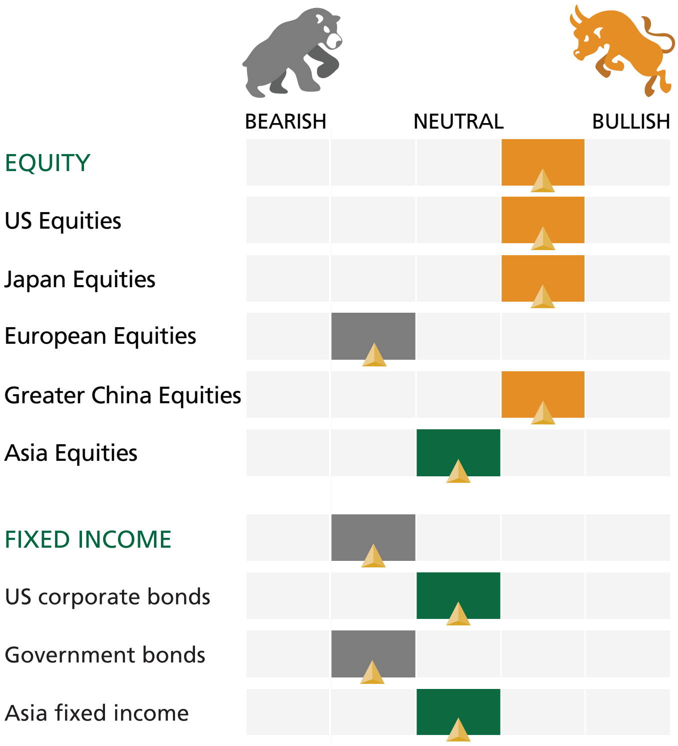
Overall, 2016 ended on a strong note, with a solid improvement in global economic data. However, the seminal event during the fourth quarter - for both the global economy and financial markets - was the US presidential election. The surprise victory of Mr Trump prompted a number of interesting developments in financial markets. We have clearly moved into a new era of geo-political uncertainty.

What does this mean in terms of the outlook for economic growth and inflation? How has it impacted our views on fixed income and equities? Peter Warnes, Head of Portfolio Solutions Group International, explains in this quarter's Asset Allocation View.

Tactical asset allocation view* (3 to 12 months)



US equities: US equities should continue to drive the broad direction of global equities. There are signs that profit margins are turning back up while top-line sales are also being revised upward, on Trump's policies that are corporate margin friendly (e.g. deregulation and lower taxes) and that boost aggregate demand (e.g. fiscal stimulus), benefitting earnings growth. That said, we continue to be wary of valuation headwinds as the market reaches new highs.

Japan equities: Valuations are attractive relative to developed market peers. There is upside potential for return on equity (RoE) on the back of improvement in capital management, margins and corporate governance.

Greater China Equities: Greater China equities will continue to benefit from the stablisation in the Chinese economy and the improving global macro environment. Greater China equities are attractive on a valuation basis, relative to both their own history and regional peers. Payouts are low relative to regional peers, but progress in state-owned enterprise reforms may lead to a greater focus on shareholder returns.

*Source: Porfolio Solutions Group, Manulife Asset Management, January 2017. The tactical view is by no means, reflective of Portfolio Solutions Group's current positioning. 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. 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.

Brief market review[1]

The seminal event during the fourth quarter for both the global economy and financial markets was the US presidential election, resulting in the surprise victory for Mr Trump. His pro-growth, pro-cyclical, "America First" message sparked a "risk rally" in equities, as well as a sell-off in government bonds. Within stock markets, the dispersion of returns has risen quite dramatically, with substantial outperformance from cyclicals and financial sectors, and underperformance from the more defensive sectors. There was also polarisation within bonds with lower rated credit and high yield significantly outperforming government bonds.

Equities: Overall, the MSCI World index rose 1.5% during the fourth quarter in US dollar terms. The S&P 500 Index returned 3.3%, the Dow Jones 7.9%, and US small caps 8.4% during the quarter. Outside America, the strong US dollar (+7.1% in trade weighted terms) crimped stock market returns for the dollar investor: the MSCI Europe Index actually fell 0.7% in dollar terms over the quarter, while Japan's Topix dropped 0.2% in dollar terms.

Bonds: There was a substantial move in bonds, with the 10 year US Treasury yield rising 85 basis points to 2.44% during the fourth quarter. Most other government bond yields also rose, but to a lesser degree. The Barclays Global Aggregate Index fell 7.1%, but a contraction in spreads led to high yield outperforming, with US high yield[2] producing a return of 1.8% during the quarter.

There has been a steady improvement in global economic data in recent months, with confidence both for consumers and corporates having risen since the US election. Real economy data releases around the world have generally continued to surprise on the upside, as measured by various economic surprise indicators.

2016 ended on a strong note. The global manufacturing Purchasing Managers' Index (PMI) was at its highest since February 2014, and the global composite PMI was at its highest since April 2015. The global economy appears to be enjoying a synchronised improvement, with America, Asia, and Europe all contributing. This was reflected in the Organisation for Economic Co-operation and Development's (OECD) global leading indicator regaining its long-run average, signalling world growth in the first half of 2017 close to trend. US data in January was a little mixed, but recent numbers have yet again come in stronger than expected.

Elsewhere, in Europe, Germany posted stronger-than-expected inflation and PMI numbers. Furthermore, the German economy expanded by 1.9% in 2016, which was the fastest growth rate in five years. The European Central Bank (ECB) recently indicated interest rates will be kept low for an extended period of time.

In Asia, Japan's GDP growth remained weak, with no visible signs of the fiscal stimulus approved in October 2016. China's economy grew by 6.8% annually in the fourth quarter, which was slightly ahead of expectations.

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[1] Source: Portfolio Solutions Group, Manulife Asset Management, February 2017; Trading Economics. Bloomberg, as of 30 December 2016.
[2] US high yield is represented by Bloomberg Barclays US Corporate High Yield Total Return Value unhedged.

Outlook

At time of writing, President Trump has just completed his first month in office and, so far, things have been far from dull! We have clearly moved into a new era of geo-politics and political uncertainty has risen dramatically. Regardless of how much of his agenda he manages to deliver, the path is likely to be bumpy and uneven. Our view is that the net impact of pro-growth fiscal policy is likely to be less than the consensus expects: the impact of his stimulus – be it tax reform, infrastructure spend, or de-regulation – is likely to need to be offset against any potential negative impact of "America First" trade policy, particularly that which might lead to a retaliation from some key trading partners (such as China).

Another key influence on financial markets will remain the magnitude and pace of withdrawal of monetary support. Inflation is rising globally, partly due to base effects from the recovery in the oil price, but is still generally below most central bank targets. Investors will be trying to anticipate whether inflation continues to rise as these effects diminish in the coming months, and to that end, will be closely watching wage growth (particularly in the US). Although we do not expect any significant changes from either the ECB or Bank of Japan (BoJ) in the near term, Ms Yellen's recent comments confirm the Fed will continue to hike rates this year, and there is a risk that monetary tightening (and a stronger US dollar) could dominate the hope of fiscal easing. If this were to happen, the failure to reignite the economic cycle would prove a major challenge to both profits and valuations.

Another key influence on financial markets will remain the magnitude and pace of withdrawl of monetary support. We do not expect any significant changes from either the European Central Bank or Bank of Japan in the near term.

Our cautious view on fixed income stems from the view that a better outlook for economic growth, limited risk of recession, and higher inflation should lead to better returns from equities rather than bonds.

In the near term, the synchronised improvement in global PMIs, coupled with a modest pick-up in inflation and reasonably well behaved bond yields, is generally a positive backdrop for equities. Looking ahead, we remain concerned about stock markets' expensive valuations (albeit differing degrees by region), the sustainability of monetary support, and the sustainability of economic growth recovery given the length of the current expansion.

Global equities are anticipating the end of the profits recession and trading on an 18 times trailing earnings, which are very dependent on continued earnings revisions and corporates delivering positive earnings surprises. The US election result has improved the corporate earnings outlook, and we are seeing earnings momentum improve globally.

However, some short term caution is warranted given how stock markets have swiftly priced in that upside and how little clarity there is regarding the magnitude, details, and timing of future policy. Another concern we have is that volatility across asset classes is once again at levels which we believe is too low and unsustainable. Thus, whilst we have a bias towards equities, we remain selective and prefer regions where there is sustainable support from economic growth, shareholder returns have room to improve, earnings are more stable, and which are less vulnerable to possible policy headwinds under President Trump.

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Despite the recent pickup in global bond yields, absolute yield levels remain relatively low. This means that duration risk remains elevated and the fixed income asset class (in aggregate skewed toward government bonds) is still unattractive on a valuation basis. This is a key reason we prefer higher-yielding corporate credit over government bonds.

That said, the new era of political uncertainty (and unpredictability) under President Trump increases the range of possible outcomes – both in terms of economies and financial markets – and therefore bonds continue to play a role in our portfolios given their safe-haven status. Outside of the US, we expect global economic growth to continue improving while remaining relatively modest, with generally dis-inflationary conditions persisting in non-US developed market economies.

Hence, although we have increased our exposure to risk assets, we retain some cash in our portfolios to take advantage of volatility to further extend risk.

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Weathering Uncertainty

The surprise victory of Mr Trump prompted a number of interesting developments in financial markets. How has it impacted our views on fixed income and equities?

A new era of geo-politics and political uncertainty

At a time of geo-political uncertainty, the path is likely to be bumpy regardless of how much of Trump's agenda manages to deliver. The net impact of pro-growth fiscal policy is likely to be less than the consensus expects.

A positive backdrop for equities

In the near term, a positive backdrop for equities is supported by:

- synchronised improvement in global PMIs
- modest pick-up in inflation
- reasonably well behaved bond yields

Bonds continue to play a role in the portfolio

The new era of political uncertainty under President Trump increases the range of possible outcomes, both in terms of economies and financial markets. Against a backdrop of market uncertainty, there is still a role for fixed income investment as part of a diversified portfolio.

"We have already moved into a new era of political uncertainty and unpredictability. Although we have increased our exposure to risk assets, we retain some cash in our portfolios to take advantage of volatility to further extend risk."

Peter Warnes, Head of Portfolio Solutions Group, International