Manulife Asset Management

Monthly Macro View

For retail use, May 2017

Was it all really just about France?

Global markets continued their rally in April after Emmanuel Macron's victory in France's election. Equity markets in Europe moved higher on the election news and data showing continued economic improvement. First quarter earnings in the United States surprised to the upside showing a healthy corporate sector despite seemingly weak GDP data. Investors are right to capitalise on politics-driven market dips. But underlying economics are the key to forming a more sustainable investment strategy. Read why in this edition of Macro Monthly View.

April Markets Overview: Europe takes centre stage[1]

For April overall, the MSCI World index rose 1.3% in US dollars, taking the year-to-date (YTD) gain to 7.3%. Unsurprisingly, the eurozone was the outright winner among regions, with a 1.3% return in local currency terms, increasing to 3.21% with euro appreciation thrown in. This marks the YTD return of 10.18% in US dollars.

Emerging markets, however, took a back seat in April. A couple of laggard markets in Asia saw catch-up gains, with Malaysia up 3.4% and the Philippines 5.1%, both in US dollars. India continued to power ahead, with a 2.3% MSCI gain in US dollars that took the YTD return to a "best-in-class" 19.8%.

In the US, the S&P500 only managed a 1.0% rise in April. At 6.7% YTD, the S&P appears to have surrendered equity market leadership to Europe and emerging markets, particularly after the results of the French election.

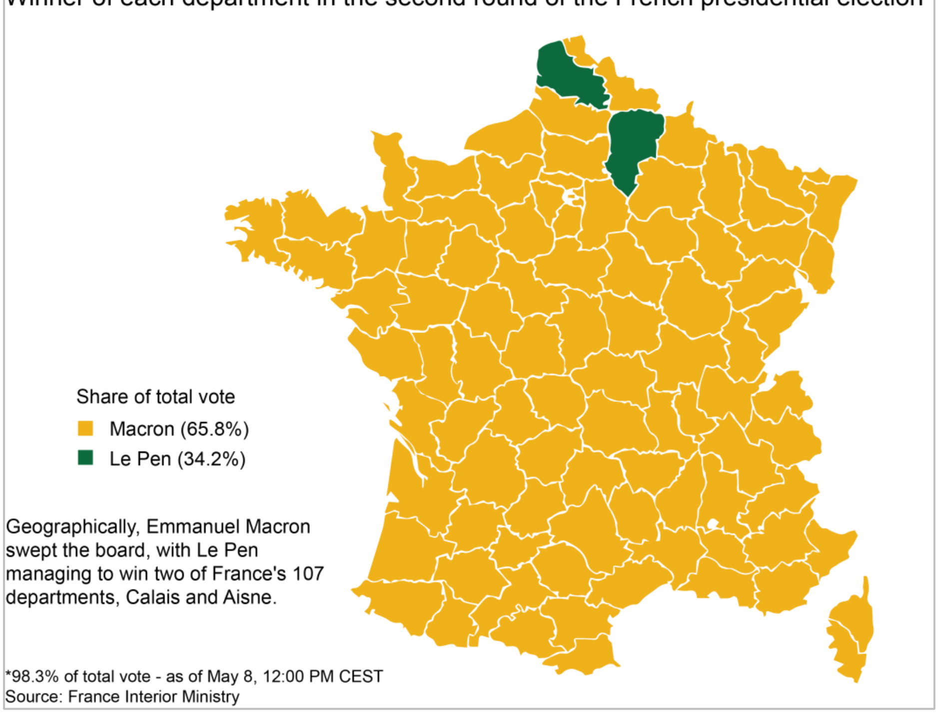
French election: Populism is on the back foot for now

Macron's landslide victory (near 66% of votes) was the second widest in recent French history, but his biggest issue may lie ahead. Without an established party machine, it seems unlikely his "En Marche!" party can win a working majority in the June National Assembly elections, though polls suggest it may well win the most seats, an incredible achievement for a party that celebrated its first birthday on 6 April. President Macron will likely need to form a national coalition, something that does not have a strong tradition in France, and possibly name a Prime Minister from another party.

[1] Bloomberg, as of 8 May 2017.

Chart 1: Macron's landslide victory

Winner of each department in the second round of the French presidential election*



Source: Statista Infographics Bulletin, 8 May 2017.

Manulife's Chief Economist, Megan Greene, argues that France's new president may face an uphill battle in tackling France's structural problem[2]. He can expect considerable resistance to some of his proposed economic reforms from the traditional centre left, given the considerable influence of the French trade unions. His election victory is cause for short term celebration given the unpalatable alternative, but success is by no means assured when it comes to reversing France's lacklustre economic performance since the Global Financial Crisis.

For Europe, we have long maintained that Italian politics may represent a key risk. The ECB tapering its quantitative easing (QE) programme as Italy goes into a general election early next year represents one potential risk for the eurozone. A win by the anti-EU populist Five Star Party (M5S), which has promised a referendum on continued Italian EU membership, could trigger a Europe-wide equity correction or even a run on Italian banks.

All that said, the near-term outlook for European politics has improved. Macron may get off to a reasonable start in France, Mrs Merkel looks safer in Germany, and a serious Brexit negotiation row with the UK is probably twelve months away. Business is improving in Europe and equity valuations appear cheaper than in the US.

[2] See "Victory For Macron, But Challenges Ahead," M. Greene, Manulife Asset Management, 8 May 2017.

For now, we repeat our earlier advice to investors: take advantage of market dips due to politics. But stay more focused on the underlying economics. In Europe, there will always be an election in the offing somewhere or other, which might seem a good excuse for more hesitant investors to hold back. That rarely turns out to be a good investment strategy. Do not let your investment decisions depend solely on some future date in the political diary. Maintaining large cash holdings has generally proven to be a killer of long term portfolio returns, with YTD experience being a prime example!

Earnings and economic fundamentals give support to markets

After strong equity returns of the first quarter of 2017, we suggested in last month's Monthly Macro View that equity investors would probably need to be “shown the money” if the rally was to continue. The numbers have duly obliged, with first quarter corporate results strong across all geographies. In the US, about 77% of the 95 S&P 500 constituents beat analysts' EPS estimates in the first quarter of 2017[3].

Energy bounced the most, although earnings-per-share (EPS) and sales improvements have been broadly based, with IT and financials looking well placed to strongly contribute to 2017 earnings growth. Encouragingly, S&P500 sales growth in the first quarter is on track to be the strongest in over five years, up 8% year-on-year.

It is improving nominal sales growth – revenues in current not constant dollars – that matter most to equity investors and which has been so lacklustre in recent years. This now seems to be changing. An improving global economy may be sufficient to sustain above-trend earnings growth through 2017. Equity analysts in the first quarter have been revising up their earnings forecasts for 2017 globally. This is a big departure from the pattern of downward revisions in the first quarter to the year ahead seen over the last five years.

China is fulfilling the role of regional growth driver for Asia

Outside of Europe, the latest economic data releases and surveys are also encouraging. In Asia, for example, Japan's Shoko Chukin survey of SME sales is currently the best since mid-2014.

In South Korea, business and consumer confidence appears to be little affected by the election of left-leaning Moon Jae-in as the new president. The latest business surveys of manufacturing and the whole economy from the Bank of Korea are surprisingly upbeat. There is also a good chance of progress on corporate governance reforms in South Korea, which is an issue that has traditionally held the Kospi back.

In China, PMIs disappointed in April as did exports. That said, China's economic recovery still appears to be broadening out as manufacturing and private sector Fixed Asset Investment finally join the upswing. China is again fulfilling the role of regional growth driver for Asia, as

[3] CNBC: “Stocks closed lower as Wall Street braces for French election, but post weekly gains.” 21 April 2017.

Asia ex-Japan exports to China were up 28% year-on-year in the first quarter of 2017, versus a much lower 15% for exports to other Asian destinations[4].

In summary: global trade picked up significantly in the second half of 2016 due to policy stimulus in China, but annual growth in international trade remains far from pre-crisis levels. Despite the latest gains, cyclical momentum in the global economy may currently be close to peaking.

"Hard" economic data should continue to improve in the second quarter. A sharp reversal in global momentum appears unlikely. However, a growing risk for 2018 is that Chinese policymakers tap on the brakes of policy stimulus following this autumn's party conference. That would surely cause a slowdown in China, and noticeably reduce its contribution to world growth.

The US economy is somewhat self-contained, so a China slowdown in 2018 is unlikely to have a major direct impact on US GDP growth. It may, however, have a major direct impact on EU and Japanese growth. Investors should keep an eye on this emerging risk in the months ahead.

Weak first quarter US GDP could be a false signal

US GDP growth for the first quarter of 2017 came in even softer than expected, at 0.7%. Like the Fed, we saw the weak first quarter numbers as providing a false signal of the economy's true health. Besides seasonality in the data, other factors depressing first quarter growth included a large inventory draw down and unusually weak consumption. This was partly weather-related. Warm weather in January and February resulted in lower utilities consumption by US households, while tax refunds from the IRS were delayed this year. Auto sales were poor in March. This is significant because they are a key component of spending on consumer durables, which can be volatile from month to month.

One takeaway is that quarterly GDP statistics are inherently volatile and a potentially misleading guide to the underlying trend. To quote our Chief Economist Megan Greene on this key point, the UD GDP print "has done nothing to change our view that the US is fundamentally a 2% growth economy. There may be temporary, policy-driven sugar hits or drags on the economy in the next few years, but they are unlikely to move the dial on potential US GDP growth."[5]

[4] See CLSA 'Greed & Fear,' 5 May 2017.
[5] See "Q1 GDP Disappoints, But The US Remains A 2% Growth Economy," M. Greene, Manulife Asset Management, 2 May 2017.

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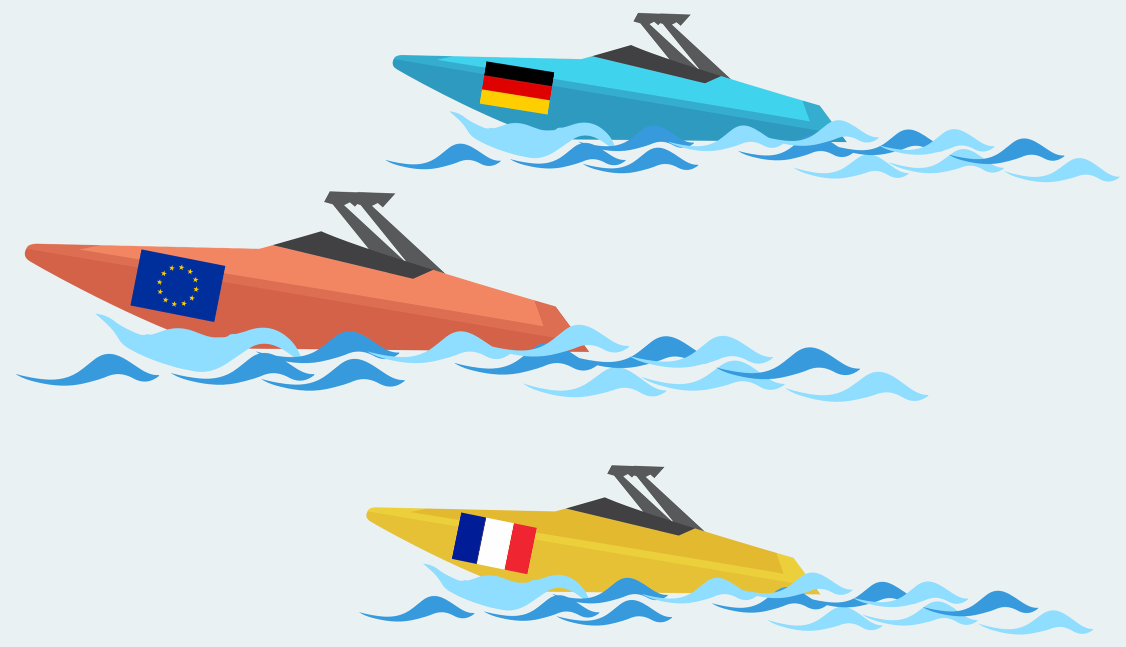
Markets Higher After France's Election Results

Earnings and economic fundamentals give support to markets

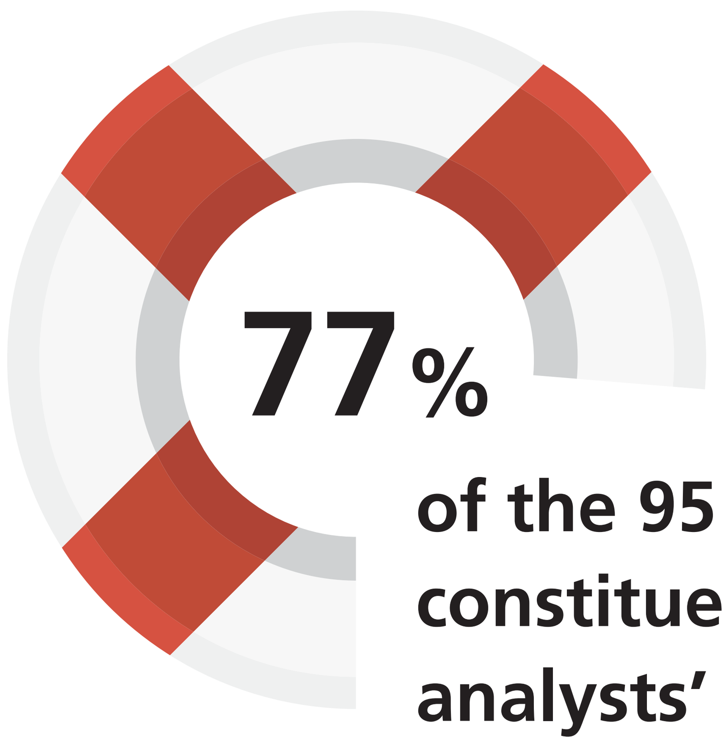
Business is improving in Europe



The near-term outlook for European politics has improved, including France and Germany. Economic momentum in Europe could see profit margins as well as earnings expand in 2017 and beyond.

Encouraging earnings give support to markets[1]

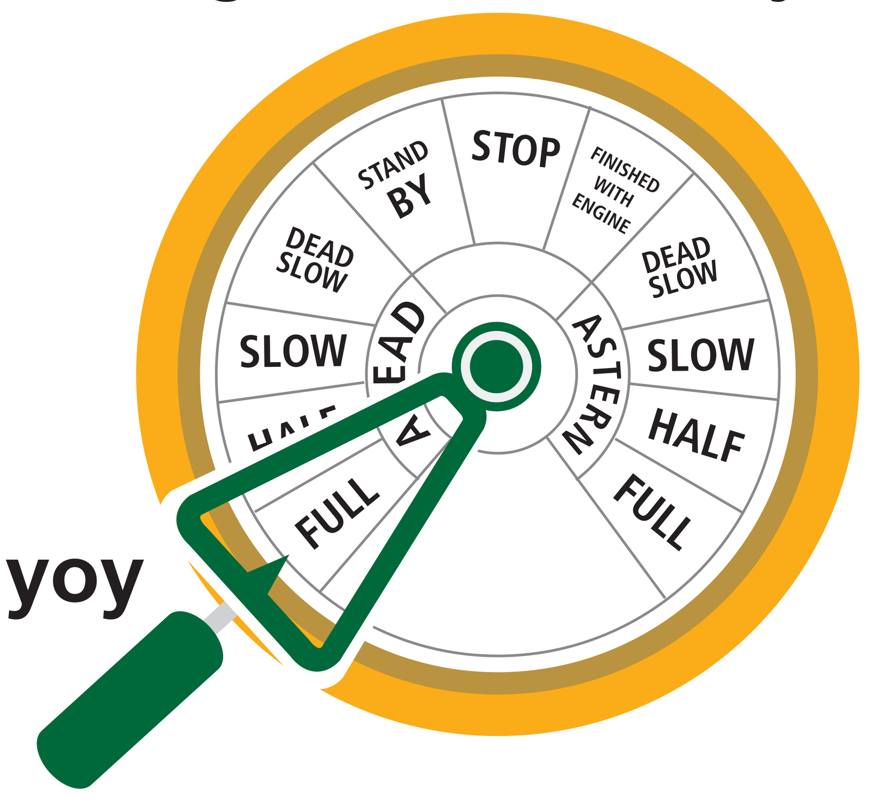
An improving global economy may be sufficient to sustain earnings growth through 2017.



77%

of the 95 S&P 500 constituents beat analysts' EPS estimates

S&P 500 sales growth strongest in over five years



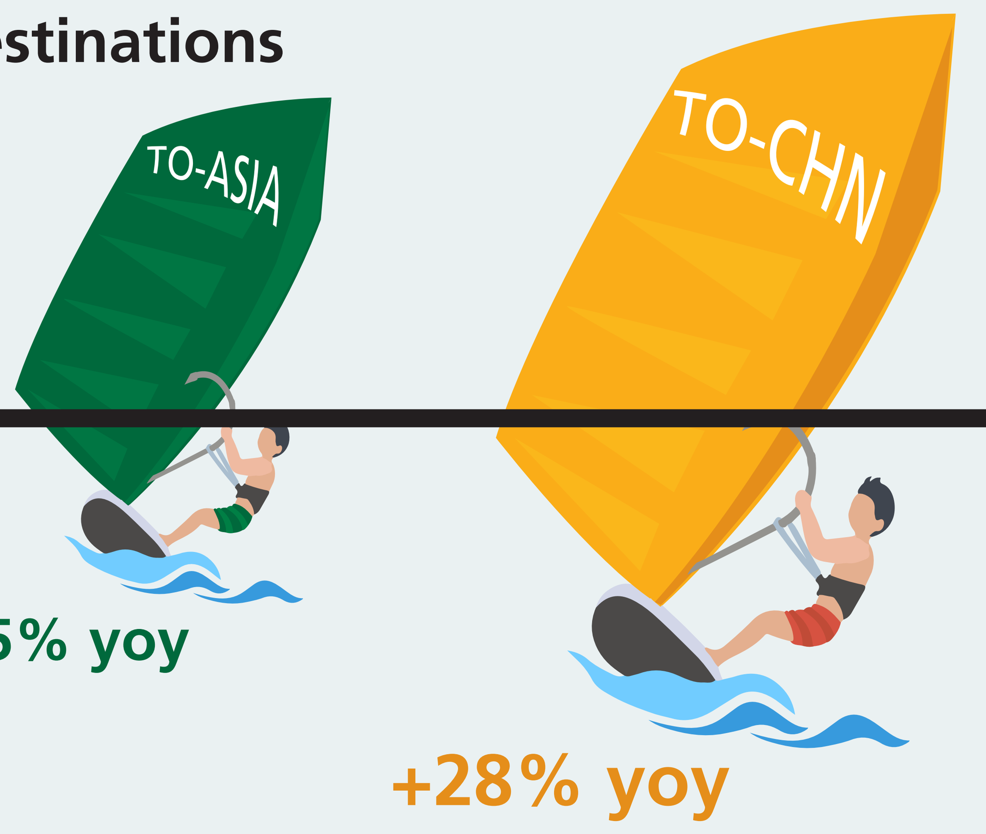
+8% yoy

China is fulfilling the role of regional growth driver[2]

China's economic recovery still appears to be broadening out as manufacturing and private sector Fixed Investment finally join the upswing.

Asia ex-Japan exports to other Asian destinations

Asia ex-Japan exports to China



+15% yoy

+28% yoy

Source:
1. CNBC: "Stocks closed lower as Wall Street braces for French election, but post weekly gains." 21 April 2017.
2. See CLSA 'Greed & Fear,' 5 May 2017.

"Equity markets in Europe moved higher on the election news and data showing continued economic improvement. Q1 earnings in the United States surprised to the upside showing a healthy corporate sector despite weak GDP data. Investors are right to capitalise on politics-driven market dips. But underlying economics are the key to forming a more sustainable investment strategy."

Geoff Lewis, Senior Asia Strategist, Manulife Asset Management