Manulife Asset Management

Monthly Macro View

For retail use, August 2017

Will markets weaken in August?

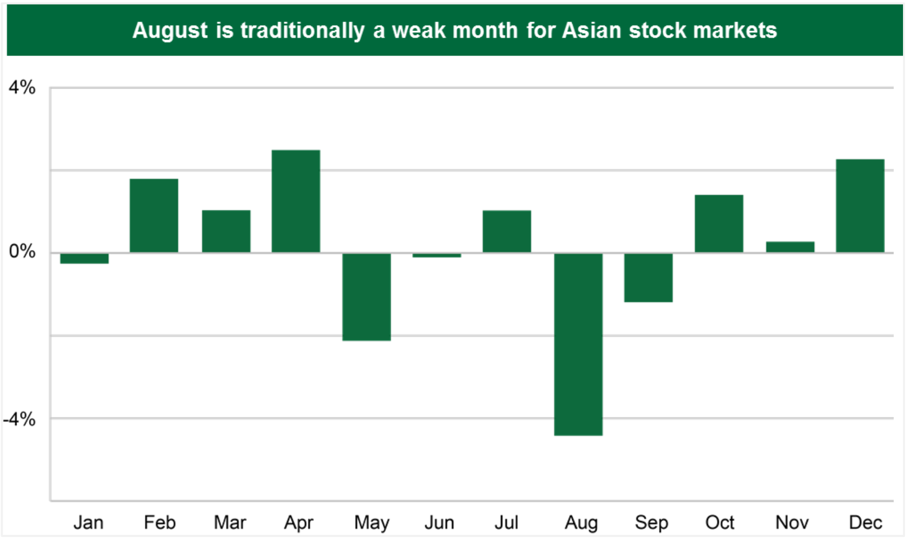
Will markets weaken in August? There are justified concerns surrounding the strong euro, global economic momentum peaking, and increased volatility on the horizon besides geopolitics and North Korea. Lewis believes the chance of a US market correction is increasing. Even if markets do cool significantly in August or September, it could prove a buying opportunity, as on a 12-month horizon emerging markets' fundamentals still appear sound.

Markets in July[1]

Shrugging off any hint of the summer doldrums, July saw a strong start to the third quarter for global stock markets. Key highlights:

- The MSCI AC World index rose 2.8%, its eighth consecutive monthly gain and the fourth longest winning streak on record[2].Japan and the US both gained 2.0%, lagging Europe on 3.0%.
- Emerging markets (EM) had another exceptionally strong month (+6.0%), supported by strong growth in Chinese exports.
- Within EM, Latin America did some catching up (+8.3%), supported by firmer commodity prices, where the Dow Jones commodity index rose by 3.5% in July.
- Telecoms (4.8%), materials (4.7%) and IT (4.2%) were the best performing sectors in July, with consumer staples (0.6%) and healthcare (0.1%) as the main laggards.

Figure 1: August is traditionally a weak month for Asian stock markets[3]



[1] Bloomberg, unless otherwise stated, figures quoted are represented by MSCI market indices and sector indices, total returns in US dollar, as of 31 July 2017.
[2] Societe Generale, Global Equity Market Arithmetic, 1 August, 2017.
[3] Source: WSJ Daily Shot, Bloomberg, August 2017. Returns represented by MSCI Asia ex-Japan index, calculated in US dollar, for the past 20 years.

If history is any guide, August could see a modest dip in Asian stock market performance. The region has one of the strongest third quarter negative seasonal patterns, with August the month that typically disappoints most (see Figure 1).

While some investors in Asian and EM equities with strong year-to-date numbers may be tempted to book some profits, the reluctance of the market to turn minor dips into corrections suggests there are also investors who missed out on this year's first half rally and who are waiting to enter the market on any dips. If markets do cool significantly in August or September, as the US debt ceiling issue approached, it could prove a good buying opportunity, as on a 12-month horizon, EM fundamentals still appear sound.

EM fund flows expected to stay positive...

Portfolio inflows into Asian and global EM debt and equity funds have been strong year-to-date, which is hardly surprising in view of the strong rally in these markets. In the first seven months, EM debt (EMD) and global emerging market (GEM) inflows totalled US$42 billion in August, with US$ 30 billion going to passive funds and US$12 billion to active funds[4].

There is ample scope for the Asian region's strong fundamentals to continue attracting positive portfolio inflows in the remaining months of 2017. For EM, the long list of positive fundamentals includes firmer currencies and commodity prices; fewer worries over China; improving profit margins; and better capital discipline. This marks a major turning point in corporate earnings and valuations that compare favourably to developed markets (DM), even if they are no longer cheap in absolute terms.

Strong demand for EM bonds

EM and Asian debt continues to be an asset class experiencing strong, sustained demand. There were positive inflows to all the major EM bond markets in the latest data week (2 August), reported in HSBC Global Research's comprehensive "Global Bond Flows Compass"[5], including Thailand, India, Indonesia, South Korea, Mexico and Turkey. We do not agree with the over-simplified view that EMD debt flows are tightly linked to expected US short rate differentials. With inflation low across most of the EM universe, central banks in emerging economies have continued to cut interest rates even as the Fed gradually tightens policy. India is the latest example of this, as the Reserve Bank of India (RBI) lowered the repo rate by 25bps to 6.0% at the July monetary policy meeting[6].

The Shifting euro

The strong euro is making its presence felt in equity markets, having risen to its strongest level since 2014. European companies are facing an earnings headwind from euro appreciation, while in the US companies should benefit from an increasing currency tailwind thanks to the weak dollar.

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[4] HSBC Global Research, Monthly GEMs Equity Flows, 4 August 2017
[5] HSBC Global Research, Global Bond Flows Compass, 4 August 2017.
[6] Third Bi-monthly Monetary Policy Statement, 2017-18 Resolution of the Monetary Policy Committee (MPC) Reserve Bank of India, 2 August 2017.

- Since last October 2016 to July 2017, earnings forecasts have been increased by about 2% in the US, whereas they have been lowered by a similar amount in Europe[7]. The result of this growing currency pressure can be seen in market performance.
- MSCI Euro in local currency terms dipped by 2% in July, although currency gains meant it still rose by 1% in US dollar terms.
- Germany's DAX is down 6% from its peak six weeks ago[8].
- The ratio of analyst upgrades to total estimate changes for the Eurozone fell sharply to 43% last month[5]. That level historically has been associated with low single-digit earnings growth rather than the double-digit growth that investors are expecting in 2017.

Global economic momentum is peaking...

For now, we continue to take a constructive view of the global economy, since a gradual deceleration in activity appears more likely than a move into recession, where the usual late-cycle pressures and imbalances are almost completely absent.

Looking beyond the second half of 2017 into 2018, one frequently encounters the view that “the US economy is on the cusp of moving from late cycle to downturn”. Whilst a gradual loss of momentum in 2018 that causes the US economy to ”gently” slip into recession cannot be ruled out, it is not a high probability scenario. A bigger risk might be a policy mistake from the Fed. It would surely be ironic if the Fed in their eagerness to build an interest rate cushion before the next recession were to trigger that recession by raising rates too quickly. We believe that the Fed understands though, so the risk of a major policy mistake is low.

A wide variety of surveys – including the latest annual survey of global corporate capex intentions from S&P – suggest private investment is finally starting to improve. This may be enough to keep the global economy on a moderate expansion path in 2018.

Volatility likely caused by event-type risk but recovery phase will soon follow

In the second week of August the war of words between the US and North Korea over the latter's missile launches caused VIX to spike higher, but only to 16, a level equal to the local peaks that occurred in April and June. One of investors' biggest fears is that the current low volatility regime may soon end in tears, with central bank tightening the most likely trigger for the Chicago Board Options Exchange (CBOE)’s Volatility Index (VIX) of US equity volatility to move higher based on option pricing.

Our view is that while low volatility per se does not equate to investor complacency[9], the chances of a US market correction occurring within the next 12 months have risen, with the potential to spill over into other markets (including non-US equities, bonds and currencies). The most likely cause is some event-type risk, with the US Treasury debt negotiations and threat of a Federal government shutdown in October an obvious potential hurdle.

[7] Societe Generale, 'Global Equity Market Arithmetic,' 24 July 2017
[8] Bloomberg, 19 June 2017 to 31 July 2017
[9] For more on complacency, see 'Are Markets Complacent: Thoughts on Risks And Valuation,' Manulife Asset Management Investment Note by our CIO for US Fixed Income, John Addeo, 8 August, 2017.

Our expectation would be that a failure to raise the debt ceiling (or any similar catalyst) could produce a normal or run-of-the-mill S&P correction in which the index falls by 10 to 15%, which is soon followed by a recovery phase. Something much worse than this we think deserves a low probability. There is no strong evidence that the recent period of low volatility has encouraged the build-up of systemic risk on a worrying scale.