Manulife Asset Management

Monthly Macro View

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For retail use, February 2018

After the equity market correction: Keep calm and carry on

The long-anticipated market correction finally arrived. Both the Standard and Poor's 500 and the Dow Jones Industrial Average indices fell by at least 10% in early February with the roaring return of market volatility. [1] While disconcerting to some investors, the correction is likely a precursor for further gains rather than the onset of a bear market.

Per usual, some investors chose to panic. Not us. In this Monthly Macro View, Senior Asia Strategist Geoff Lewis examines how solid economic fundamentals and robust earnings remain key supports for equity markets in 2018.

Our 2018 forecast still calls for healthy gains in global equities. However, while investors should remain calm they should not return to the complacency seen in January. The trajectory of wage inflation, interest rates and bond yields in the US plus movements in the US dollar should be watched closely to gauge further swings in market sentiment moving forward.

The February market correction: A return to fundamentals

In the January 2018 "Macro Monthly View" we wrote that: "Global equity markets continued to rally hard in the first half of January. So much so that sentiment barometers look stretched. A market correction now would inevitably generate considerable media angst, with predictions that overpriced markets have finally brought the period of low volatility to an end. Whatever the short-term disruption, a 10% correction could be a healthy development regarding the longer-term market evolution. 2018 can still be a decent year for investors, albeit one with lower returns than last year."

The correction that we warned about duly arrived. Equity markets began to falter in late January, entering a full-blown correction phase in February. Rather than a mere 5% dip, it has been a more meaningful correction with the S&P500 down by over 10% from the January. More maybe to come, as markets still appear quite nervous and unsettled. While we suspect that the worst of the correction is behind us, one cannot be sure.

For 2018, we think global equities can deliver high single-digit returns, possibly a bit more, accompanied by a modest contraction in valuation (PE) ratios. In short, there is nothing in the recent market correction that makes us want to abandon our generally positive twelve-month outlook. After such a long run of uninterrupted monthly gains, a pullback in equities was long overdue.

There are good reasons not to be turn bearish about what lies ahead, since fundamentally not all that much has changed. We still focus on three fundamentals driving this rally.

[1] Bloomberg, 26 January 2018 to 8 February 2018.

- Global growth remains robust.[2] The global composite purchasing manager index (PMI) in January, for example, was at its highest level in over three years. Europe's growth conditions are particularly good.

- Earnings are still strong.[3] Global earnings for the fourth quarter of 2017 have been robust in all regions, beating estimates by a wide margin. The consensus forecast of 11 to 12 per cent earnings growth in 2018 looks achievable.

- Financial conditions remain benign despite the upward shift in interest rate expectations and bond yields, if judged by the various indicators of financial and monetary conditions. Monetary conditions will not tighten much in 2018; 2019 will be the year in which QE starts to unwind more rapidly.

To argue that the US stock market faces a deep and sustained correction in what looks set to be the best year for the economy since the Global Financial Crisis strikes me as too bearish. Thus, we believe that investors may be well served to take advantage of the volatility that has presented itself since the fundamentals globally continue to be very strong. A temporary shakeout is more likely than an equity bear market.

Rising US wages a bigger risk than bond yields

Recession in the US is not imminent; however, investors should still watch the trend in inflation. This is now on every investor's radar screen. There are clear signs from data that the trend in inflation will move up a notch during 2018. We forecast headline CPI inflation to rise to 2.5%, or just above, by December. It would probably require inflation to move above 3.0% to trigger a major adverse reaction from markets, not to mention the Fed. On balance, there are few signs at present that point to a rising US recession risk within the next 12 months.

Of all drivers, US wages pose the biggest risk to inflation in 2018. Higher wage inflation would see the Fed respond by raising interest rates more aggressively. Wage costs are now the most important labour market indicator to focus on in 2018. But all we are seeing so far is a continuation of the very gradual uptrend in US wages that has been visible since 2016. With unit labour costs flat year-on-year, it is much too soon to declare that we have a wage inflation problem. Not until wage inflation exceeds 4.0% can we expect some pressure on corporate profit margins.

If inflation in 2018 begins to accelerate sooner and by more than we are forecasting, investors will face a dilemma. Under a strong inflation trend in 2018, equities and bonds would become positively correlated, with negative prospective returns for both asset classes. Although we are not in the high inflation camp, February's market correction is a reminder to investors to stay vigilant on inflation as the year unfolds.

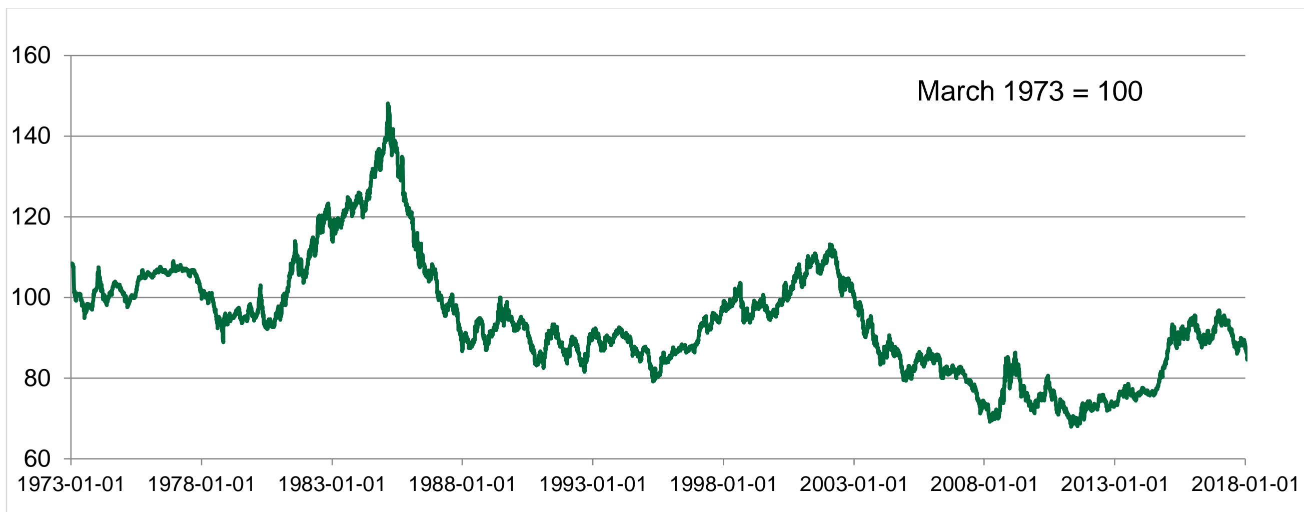
US Dollar: On a weaker trajectory

The US dollar is often regarded as the most important single price for the global economy, since it plays such a crucial role in international trade and in the international financial system. The US dollar appears

[2] The headline JPMorgan Manufacturing PMI, compiled by IHS Markit, 1 February 2018; Institute for Supply Management, 5 February 2018.
[3] FactSet Insight, 16 February 2018.

oversold short term after strong falls last year, while near-term fundamentals in the form of expected short term rate differentials are mildly supportive. The dollar index (DXY) did not respond at all to the recent US$ 200 billion boost to government spending in the FY18 budget recently agreed by Congress. Currency markets appear increasingly concerned at the potential for a sharp blow out in US trade and current account deficits because of the large fiscal stimulus when the US economy is so close to full employment

Chart 1: A chart of the US trade-weighted dollar index[4]



The longer-term outlook of continuing synchronised global expansion is dollar bearish and the conditions for the return of dollar strength in 2018 and secular appreciation are missing. Nevertheless, a rising as opposed to a firm or gradually weakening dollar is a key risk for emerging markets in 2018. Indeed, sharp swings in the trade weighted US dollar can create both winners and losers. If the dollar weakens during 2018 as we expect, American export firms benefit from increased competitiveness and the revaluation of overseas earnings.

For the Eurozone, it would constitute a headwind, reducing export competitiveness and leading to tighter financial conditions in Europe. Japan would not like to see a weak dollar in 2018, since Abenomics has been predicated on maintaining a cheap Japanese currency. A weaker US dollar in 2018 would also give emerging markets scope to cut interest rates if appropriate, boosting growth. Currency movements are very difficult to predict. All we can say for sure is that the path taken by the US dollar in 2018 is unlikely to please everybody.

Conclusion

From our perspective, the long-anticipated market correction is not the start of a protracted bear market. Indeed, economic fundamentals, such as global growth, market liquidity, and robust earnings remain firmly in place. Our expectation is still for positive returns from global equities in 2018. However, while investors should remain calm they should not return to the complacency evident in January. The

[4] Federal Reserve Bank of St. Louis, data as of 9 February 2018.

trajectory of wage inflation, bond yields and interest rates in the US plus movements in the US dollar should be watched closely to gauge market sentiment moving forward.

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