Manulife Asset Management

MONTHLY MACRO VIEW

Do higher rates augur trouble for global markets?

MAY 2018

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Markets generally moved higher in April as investors repriced the strength of a late-cycle US economy. The 10-Year Treasury passed the 3.0% threshold hitting its highest level in four years, while the Fed acknowledged rising inflationary pressures, raising speculation over the pace of future rate hikes.

In this edition of Monthly Macro View, Geoff Lewis, Senior Asia Strategist, explains that despite rising rates, the repricing of risk is a necessary part of policy normalisation. We remain moderately overweight on global equities, as global growth, despite facing challenges, will drive corporate earnings in 2018. In particular, Chinese equities offer unique opportunities due to multiple catalysts: earnings continue to surprise to the upside, new listing regimes promote listing of innovative companies, and Chinese bond and equities inclusion in global indices should lift market demand.

Index

01 April Market Review[1]

Equity markets were able to achieve a degree of stability in April. The majority delivered positive returns despite ongoing concerns over rising US rates and bond yields, inflation and trade friction.

Equities and commodities gained in April

- The MSCI World index gained 1.2%, the MSCI US rose 0.4%, Europe 2.9%, and Japan 0.7%.
- Emerging Markets fell 0.4% in April. But this was largely due to problems specific to several Latin American (LatAM) countries. While the MSCI LatAm index fell 1.25%, Asian markets had a positive month. The MSCI Asia ex-Japan index returned 1.0%, with South Korea the strongest performer, responding to the positive political developments with North Korea.
- Bond markets had a poor month in April, taking their cue from the US 10-year Treasury, whose yield rose from 2.74% at end-March to 2.93% in April. The Barclays Global Aggregate index lost 1.6%. Of the key fixed income sub-classes, only high-yield posted a flat return in April.
- The US dollar has strengthened in recent weeks, with the dollar index appreciating by over 4%[2]. The dollar's firmness appears to reflect an increased focus in currency markets on cyclical over structural factors.
- Commodity prices saw further gains in April, responding to strong global growth. The HSBC commodity index gained 4% over the month; it is up 19% from April 2017. Oil prices took the lead, with Brent up 7% due to rising geopolitical risks, OPEC production cuts and a reduction in global inventories.

Chart 1: April market movements in a snapshot

MSCI equity indices	Total Return in US dollar (%)		
	April 2018	1 year	Year-to-date 2018
All Country World Index (ACWI)	1.01	14.77	0.16
US	0.40	13.26	-0.23
Europe, Australasia, Far East (EAFE)	2.39	15.07	0.94
Europe	2.94	14.34	1.02
Japan	0.67	19.58	1.66
Emerging Markets	-0.42	22.14	1.04
Asia Pacific ex-Japan	1.00	20.34	0.44
Lat Am	-1.25	18.15	6.76

Currencies/Currency indices	Price return (%)		
	April 2018	1 year	Year-to-date 2018
US dollar index (DXY)	2.08	-7.28	-0.31
JP Morgan Asia dollar index (ADXY)	-0.87	5.16	0.99
EUR	-1.87	10.58	0.97
GBP	-2.32	6.06	1.71
JPY	-2.80	2.01	2.99
RMB	-0.88	9.10	3.06
SGD	-1.11	5.37	0.84

Bond indices	Total Return in US dollar (%)		
	April 2018	1 year	Year-to-date 2018
Citi World Government Bond Index	-1.89	5.08	0.56
Barclays Global Aggregate	-1.60	4.09	-0.26
Barclays Global High Yield	-0.23	4.60	-0.59
Barclays EM USD Aggregate	-1.02	0.87	-2.48

Commodities	Price return (%)		
	April 2018	1 year	Year-to-date 2018
Brent crude	6.97	45.31	12.41
Reuters/CoreCommodity CRB commodity total return index	3.55	12.58	4.76
Gold Futures	-0.27	4.01	0.76
Copper Futures	0.89	17.56	-7.51

[1] Source: FactSet, Manulife Asset Management, total returns in US dollars, 30 April 2018.
[2] Source: Bloomberg, 26 March 2018 to 7 May 2018.

The Fed and US interest rates: Inflationary pressures rising

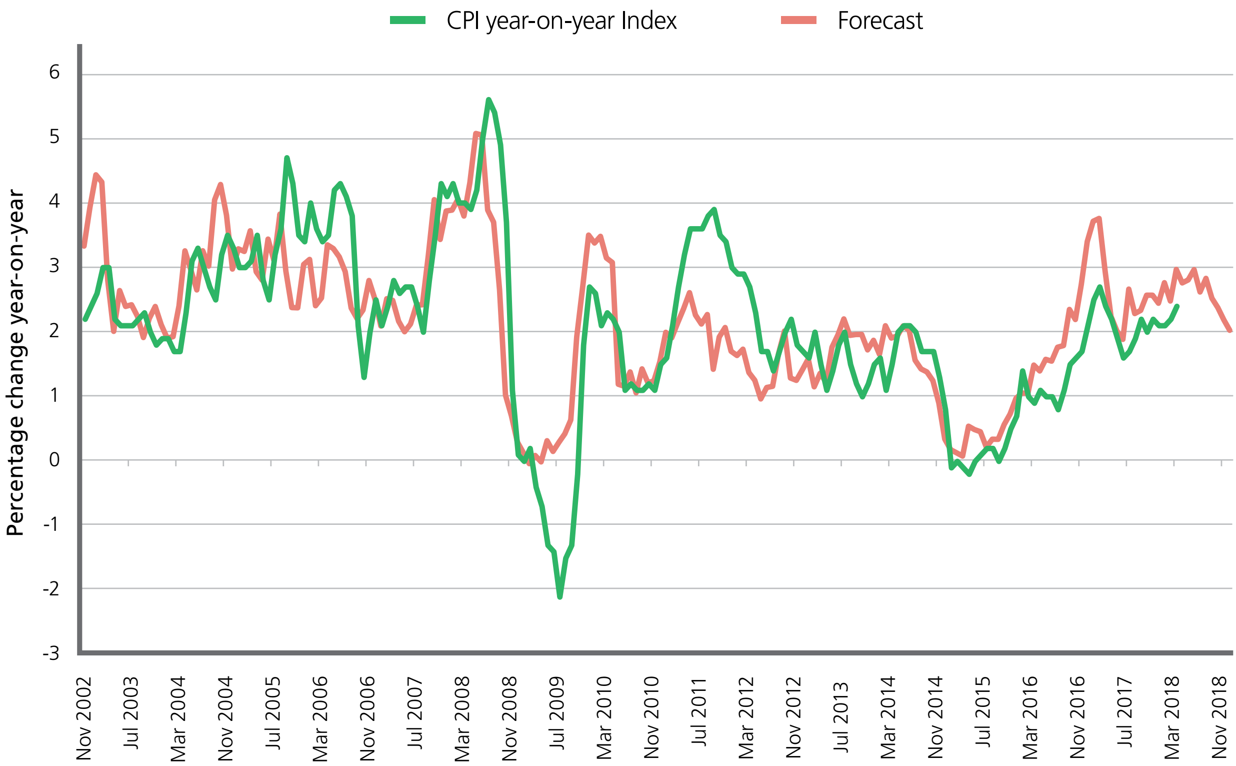
As widely expected, the Fed left short term interest rates unchanged at the Federal Open Market Committee (FOMC) meeting in early May. There was no change in the FOMC Statement paragraph on forward policy guidance, where *"economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate*[3]*"*. Thus, we think the Fed will hike rates again in June and either once or twice in the second half of 2018, depending on the extent to which fiscal stimulus gives a short term boost to GDP growth in the second and third quarters.

The May FOMC recognises that inflation is no longer below the Fed's 2% target. In what was probably the most significant change in wording, the FOMC noted that annual inflation is *"expected to run near the Committee's **symmetric 2 percent objective** over the medium term."* This is the first time that the FOMC Statement has referred to an inflation target that is symmetric.

We think the Fed's aim here is to reassure investors that a temporary move above 2% in the core personal consumption expenditure (PCE) deflator is no reason to panic. This may soon become an issue of some importance, as our analysis of short term US inflation trends indeed suggests that core PCE will overshoot its target and remain above 2% in the coming months before slowing into year-end (see second chart below).

Whether the Fed succeeds in communicating this important message could have an important bearing on equity market volatility in the months ahead, not just for the S&P500, but globally.

Chart 2: US inflation is about to increase in the summer months[4]



[3] Source: FOMC Policy Statement, 2 May 2018
[4] Source: Manulife Investments, Bloomberg, 31 March 2018. Assumes US$65/barrel oil price, wages, owner-equivalent rents & the dollar index remain on trend.

Yield curve inversion[5]: How big a worry is it?

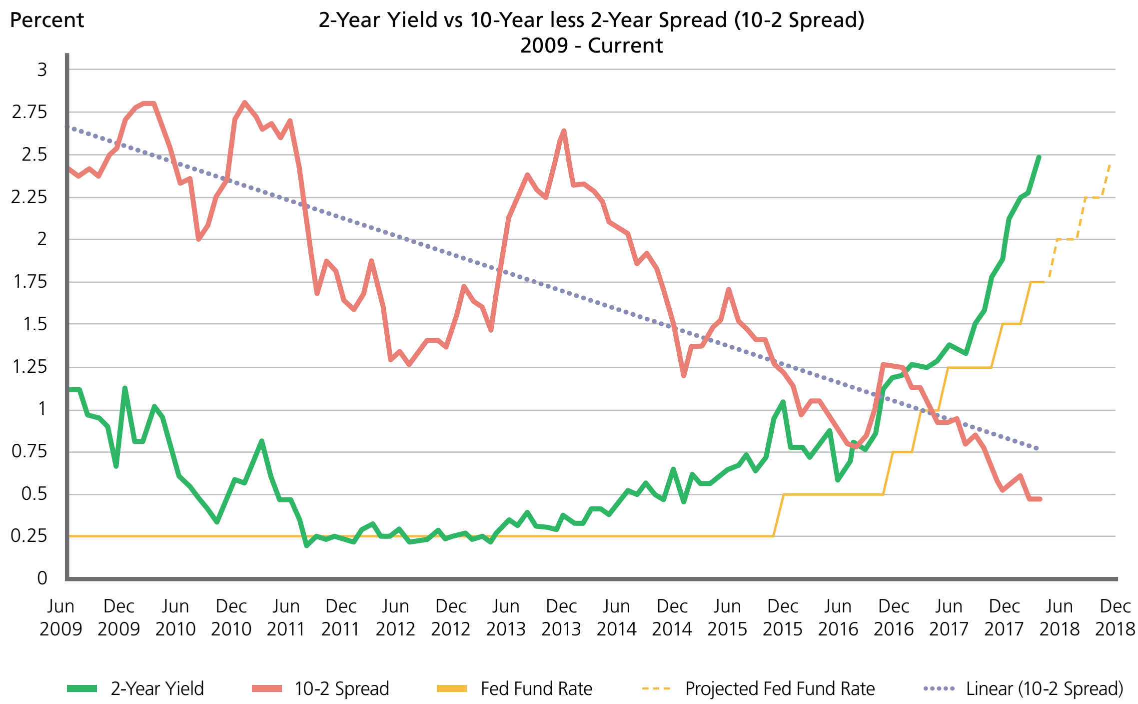
Besides the pace of interest rate hikes, the other factor currently giving many investors growing cause for concern is: what will happen to financial markets if the US Treasury yield curve inverts? In previous business cycles, yield curve inversion has been one of the best leading indicators of US recession and hence of bear markets in equities. The yield curve must invert if the Fed pushes hard enough at the front end. So, the question could be re-phrased as: how likely is it that the current policy tightening cycle by the Fed ends up in recession?

The answer is not particularly reassuring. Since 1950, there have been 13 interest rate cycles; 10 of the 13 ended in recession. Only in 1966, 1984, and 1995 did rate hiking cycles result in a "soft landing" for the US economy, successfully avoiding a recession. However, the recent rise in 10-year yields has led to the curve steepening, taking us away from the "inversion" danger zone.

But even if the US Treasury yield curve were to flatten further in the second half of 2018, we would not be inclined to panic. We simply do not see the macro catalysts in place to trigger a cumulative contraction in activity of recessionary magnitude. US recessions typically result from deliberate policy tightening by the Fed, so there is a causal link from inverted yield curve to the economy entering recession. Except, that is, in the few cases where there have been external shocks, such as the OPEC oil price hikes in 1973 and 1979.

If core inflation only drifts a little above the 2.0% target in coming months, the market is unlikely to anticipate a switch to a more aggressive pace of rate hikes from the Fed. If, however, inflation accelerated more sharply (not our base case scenario), bond investors would be unwilling to wait for a Fed that was falling "behind the curve". But for now, the "vigilantes" in the bond market are not in the ascendant. Providing some degree of comfort, the bond market has not yet begun to take over the Fed's role of imposing tighter credit conditions.

Chart 3: US yield curve has been flattening since 2013[6]



[5] Note: An inverted yield curve is an interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality. This type of yield curve is the rarest of the three main curve types and is considered to be a predictor of economic recession.
[6] Source: Manulife Investments, Bloomberg, 31 March 2018.

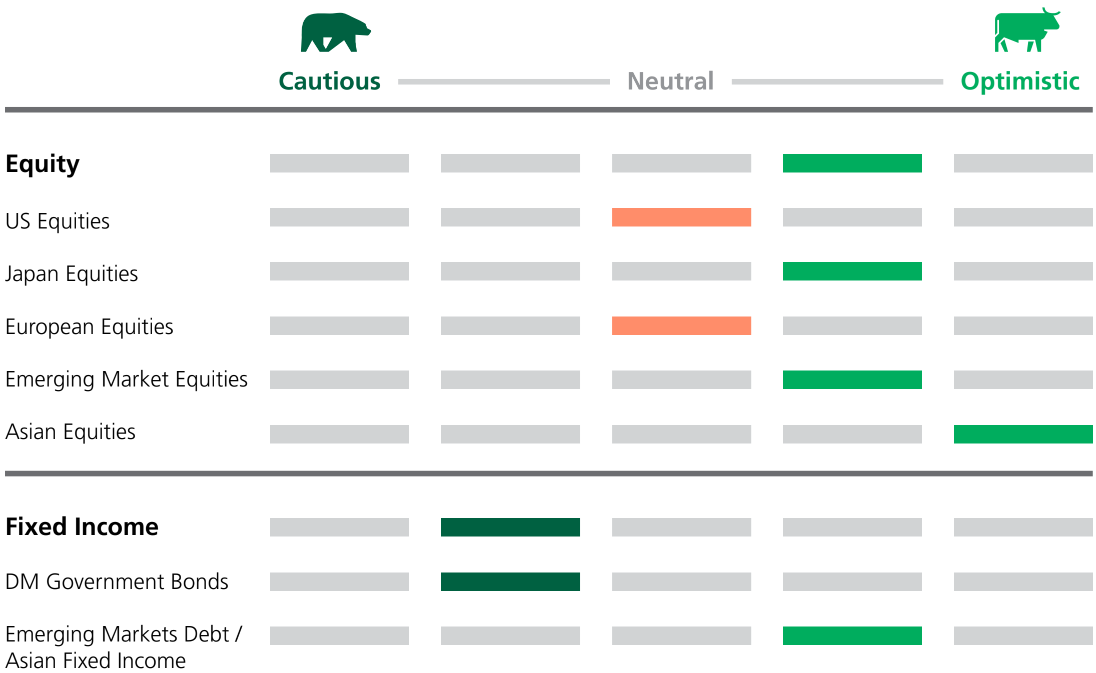
Another separate issue worrying investors is the absolute level of 10-year bond yields. Some see 3.0% or 3.5% as a threshold beyond which further rate increases will cause significant damage to the economy and thus to equities. It is difficult to gauge what level of long term rates will trigger contractionary forces great enough to harm the economy, or even if such a threshold or tipping point exists. And even if the 10-year yield did move quickly up to 3.5%, unless accompanied by higher wage and inflation data, we suspect such a move up would not be sustained for very long but would soon reverse.

02 Asset Allocation

Our global multi-asset portfolios continue to be moderately overweight equities whilst remaining short duration in fixed income. Within equities, our preferred sectors are energy, financials and technology. Equity markets have been treading water now for some time. This could be regarded as a relatively resilient performance in view of the long list of potential negatives currently facing investors. For the latter, our "Blacklist" would include trade friction fears; US policy and political uncertainty; inflation and wage concerns; divergent monetary policies at key central banks; negative economic data surprises; and the consequences of unwinding quantitative easing (QE), which may be thought of as "QT", or Quantitative Tightening.

Broadly speaking, the macro and fundamentals picture remains supportive of equities, even though this is no longer being reflected in market behavior. Global Purchasing Managers' Index (PMI) readings, for example, continue to indicate positive sentiment and financial conditions are still accommodative. We also continue to see positive earnings surprises. However, we have seen some signs of moderation or rolling over of economic data in some regions. There is a chance that "synchronised growth" – the main story for global equities since 2017 — may start to fade, though if it does it will most likely be gradual.

Chart 4: Asset allocation view over the next 12 months[7]



[7] Source: Portfolio Solutions Group, Manulife Asset Management, as of April 2018. The asset allocation 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.

Equity markets are currently locked in a sideways holding pattern, with no strong signals to move aggressively in either direction. Given this, it is quite possible that when markets do make up their mind, the resulting move could be a powerful one. One cannot rule out a resolution to the upside in the S&P 500 index, although the long list of current worries suggests that this may require more time.

After the dollar's strong run over the past month, any pause or retracement now would benefit Emerging Market (EM) equities. That said, however, in coming months, there are various issues that could contribute to a more challenging environment for EM debt and equity: ongoing US-China trade tensions, renewed dollar strength, higher US Treasury yields, rising inflation, weaker current accounts, and geopolitical issues. This could result in a deeper, more protracted correction for EM. We still like the asset class, but in the short term the path may be bumpy. There is a need for greater selectivity in EM, e.g. underweighting markets like Turkey, where corporate balance sheet concerns have risen after a surge in borrowing in recent years (corporate debt is currently close to 70% of GDP) and Argentina, where the successful implementation of economic reforms is proving difficult[8].

Markets are certainly not yet pricing in a longer more confrontational US-China trade spat, or a permanent cooling off in economic relations. Tactically, a more cautious stance towards EM seems appropriate, though our longer term conviction on a 12-month horizon is undimmed.

Turning to fixed income, absolute yield levels remain subdued, especially relative to underlying economic growth/ inflation outlook. This makes duration risk elevated and the fixed income asset class (in aggregate skewed towards government bonds) still unattractive on a valuation basis. This is a key reason why we prefer higher-yielding corporate/sovereign credit relative to government rates – for extra yield/carry pick-up (on the condition that credit conditions and quality are not deteriorating).The outlook for European sovereign and corporate bonds in the second half of 2018 looks particularly unappetising, and a cautious stance is recommended.

That said, fixed income plays an invaluable role for downside protection and diversification over time. This useful role is highlighted by tactical bond rallies on bouts of heightened geopolitical risks. Also, we expect (on a structural basis) global economic growth and inflation rates to stay modest in absolute terms and relative to past business cycles. Under such an outlook, the rise in yields may be quite moderate.

03 Catalysts exist to boost Chinese markets

We remain positive towards China equities and remain overweight in regional portfolios. Trade issues with the US remain a near-term headwind with both sides far apart on the key issues. US-China trade talks are likely to be protracted, and as such may be less likely to shock markets. We see the recent dip in relative performance of MSCI China relative to MSCI Asia ex-Japan as a period of consolidation after the outsized gains by Chinese equities last year[9].

Still bullish on China which has multiple positive catalysts

There are no slowdown worries yet for the Chinese economy. The April PMIs were range bound but consistent with decent economic growth. The first quarter corporate results season is over. Chinese companies did not disappoint. China A-shares earnings grew 15.6% year-on-year (including three overseas large caps).[10] This was ahead of consensus by some 50 basis points (bps), with the materials, property and IT sectors leading the way. Within the financial sector, insurers performed well, with earnings up 30% year-one-year.

[8] See HSBC Global Research, "Turkey: Scrutinizing corporate debt," 3 May 2018.
[9] Source: Bloomberg, as of 7 May 2018.
[10] Source: Credit Suisse, 3 May 2018.

There is no sign of a reversal in Chinese earnings growth as return on equity continues to rise. There are other positive catalysts in 2018 including higher QDII quotas, higher Stock Connect daily limits, plus an expected reform push at the Fourth Plenum of the 19th CPC Central Committee in October. In addition, Hong Kong's new, more flexible listing regime will make offshore Chinese IPOs more attractive to issuers.

Most importantly, on 31 May, China A-shares will join the MSCI Emerging Markets and Asia ex-Japan indices, a step announced by MSCI last June. In view of the small initial weight, the short-term impact will be muted. An inclusion factor of 5.0% for the 234 large cap A-shares implies an initial weight of just 0.73%, to be phased in by September for the MSCI Emerging Markets Index (the inclusion factor for June is only 2.5%, an initial weighting of 0.39%). Fewer investors, perhaps, are aware that roughly 60 non-A share Chinese companies will join the MSCI indices at the same time, with a weight of 1.6%, almost double the initial A-share weight.[11]

Global investor interest in China A-shares can only grow over time as the MSCI weight increases. Currently, Chinese companies account for 15% of global revenues, and the A-share market is deep and liquid, with around 1,600 listed stocks trading above US$10 million[11]. Chinese equities also offer potential for diversification as correlations with US markets remain relatively low.

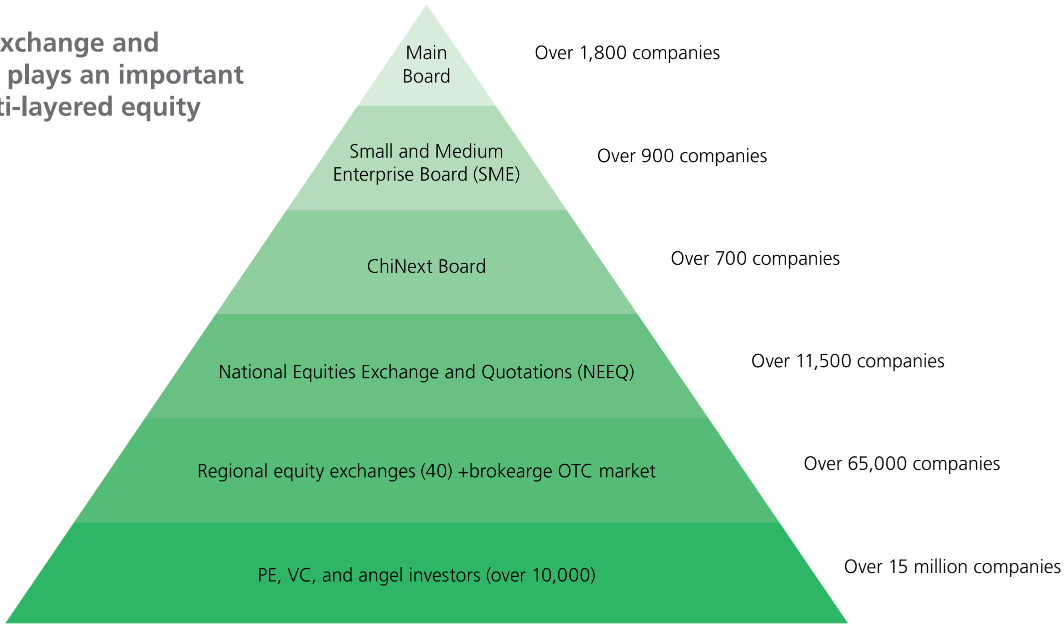
Chinese equities and bonds will play a bigger role in global markets

Currently, China has about the same number of listed stocks as North America[12]. However, there is great potential for this to increase over time. The diagram from HSBC Global Research (see Chart 5) illustrates why. It shows the current Chinese corporate ecosystem, with 1800 Main Board companies at the apex, followed by the 900 small and mid-cap of the SME Board, and over 15 million small, unlisted companies forming the base.

Moreover, it is not just Chinese equities that will play a bigger role in global markets. Bloomberg announced in March of this year that Chinese government and policy bank bonds will join their widely followed Global Aggregate Bond Index in April 2019. Chinese bonds will have an initial weight of 5.5%, phased in from April 2019 to November 2020.

Chart 5: Listing of Chinese companies has just begun[12]

National Equities Exchange and Quotations (NEEQ) plays an important role in China's multi-layered equity market



Source: Shenzhen Stock Exchange, National Equities Exchange and Quotations, Wind, HSBC Research

[11] Source: MSCI, 14 May 2018; Societe Generale, Asia Quantitative Strategy, April 2018.
[12] Source: HSBC Global Research, May 2018.

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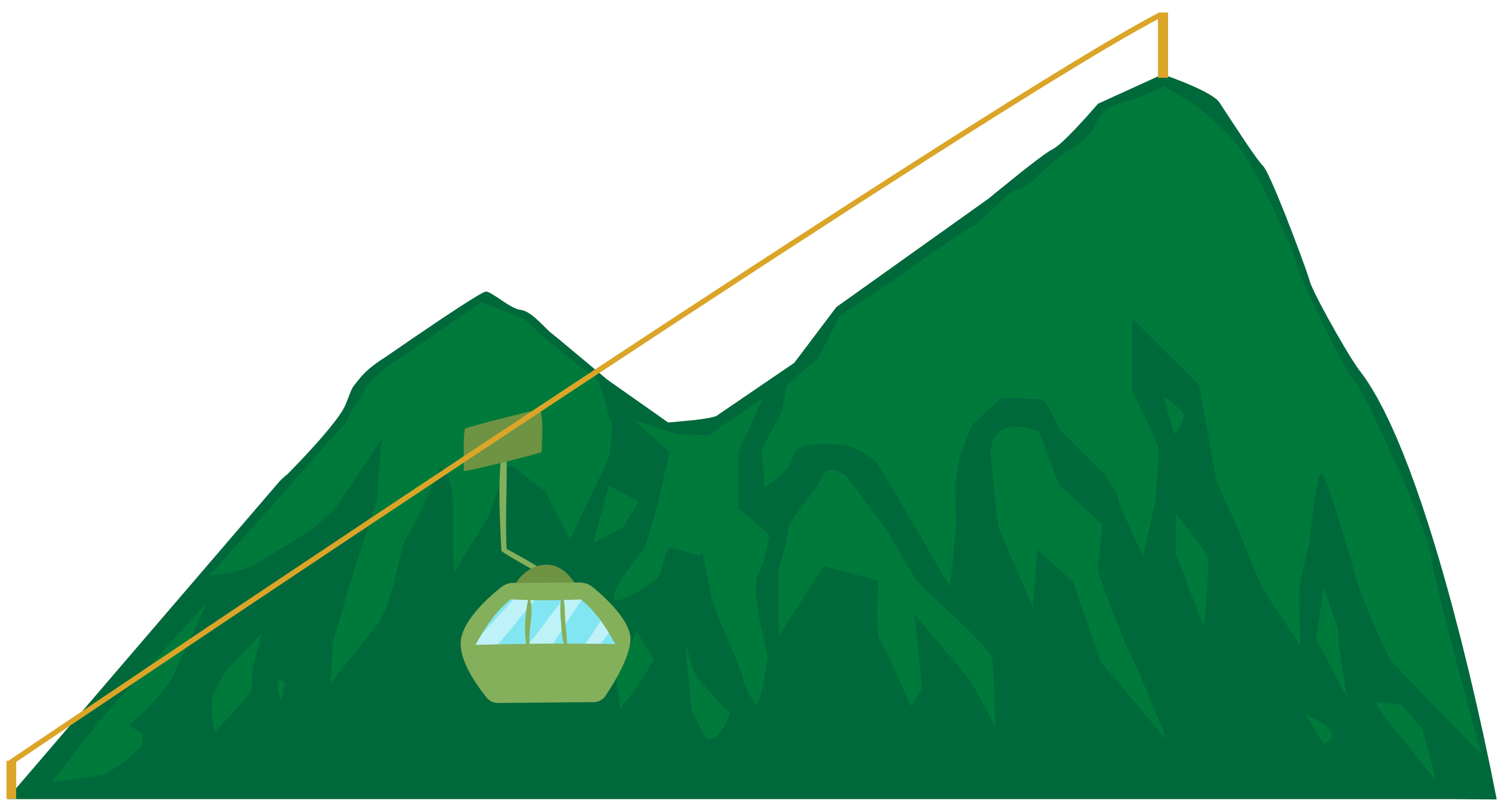
Monthly Macro View

Global growth continues despite challenges



US Inflation

Rising inflationary pressures

We expect the Fed will hike rates in June and one or two times in the second half of 2018. However, a temporary move above 2% in the core PCE deflator is unlikely to trigger a switch to a more aggressive pace of rate hikes.

Moderately overweight equities

Equity markets are currently locked in a sideways holding pattern. It is possible that when markets make up their mind, the resulting move could be powerful.

Catalysts boost Chinese markets

US-China trade talks are likely to be protracted and no slowdown worries yet for the Chinese economy.

"Despite rising rates, the repricing of risk is a necessary part of policy normalisation. We still remain moderately overweight on global equities, as global growth, despite facing challenges, will drive corporate earnings in 2018. In particular, Chinese equities offer unique opportunities due to multiple catalysts."

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