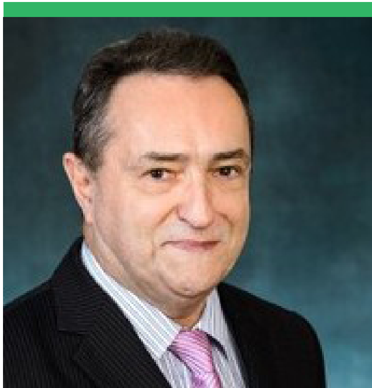
Manulife Asset Management™

MONTHLY MACRO VIEW

Volatile markets put Emerging Markets in focus

JUNE 2018



Geoff Lewis
Senior Asia Strategist

Geopolitical and financial risks came to the fore in May: the US exited from the nuclear deal with Iran and went ahead with planned import tariffs on steel and aluminium, while the political crisis in Italy also roiled global markets. Sharp currency falls in Argentina and Turkey contributed to the risk-off sentiment towards emerging markets. Emerging Asia was also in focus as central banks in the region raised interest rates to stem inflationary pressures and bolster currencies.

Despite the gloomy mood of global equity markets, we believe the current volatility is more likely an extended correction rather than the start of a bear market. If the S&P 500 recovers its upward trend, we think that other markets also will be able to find their footing. In the short term, the US stock market may continue to hold up better than most due to strong technicals and fundamentals. But over a 6- to twelve-month horizon we prefer to overweight Europe, Japan and emerging markets (EM).

Index

P.02

01 | May Market Review

May was certainly a volatile month in terms of geopolitical news. Not surprisingly, most equity markets lost ground last month.

P.04

02 | Asset Allocation

We retain a moderate overweight for equities over bonds in our global multi-asset portfolios. What we are currently seeing in equity markets is more likely an extended correction rather than the start of a bear market.

P.06

03 | Challenges for EM

Recent weakness in EM equities is primarily due to the rebound in the US dollar from its recent 3-year lows. We think the dollar index is close to a peak. Once the dollar loses momentum, sentiment towards EM should first stabilise and then improve. Emerging Asia remains attractive.

01 May Market Review[1]

May was certainly a volatile month in terms of geopolitical news: as the US pulled out of the Iran nuclear deal, trade war concerns intensified as the US went ahead with tariffs on steel and aluminum, Spain's parliament called for a vote of confidence in Prime Minister Rajoy (which he duly lost) and Italy suffered a brief but dramatic constitutional crisis that ended with the installation of a populist, euro-sceptic government. Italian 2-year bond yields jumped an incredible 190 basis points (bps) as the crisis broke (29 May), while a flight-to-safety by investors saw the yield on 10-year US Treasuries drop roughly 15 bps in one day[2].

In addition, there was a stream of negative news from EM in May, especially from Latin America. Argentina and Turkey suffered sharp currency depreciations amidst a balance of payments and economic crisis. Argentina looked once again to the International Monetary Fund for support. Upcoming elections in several Latin American countries added to the negative sentiment as did the truck drivers' strike in Brazil while Mexico suffered a setback in the NAFTA (The North American Free Trade Agreement) negotiations with the US and Canada.

Although the problems of Argentina and Turkey are not common to other EM, there was inevitably some contagion. Fund flows for both EM debt and equity were strongly negative in May.[3] Not surprisingly, in view of the above risks, most equity markets lost ground last month.

Chart 1: May market movements in a snapshot [4]

MSCI equity indices	Total Return in US dollar (%)		
	May 2018	1 year	Year-to-date 2018
All Country World Index (ACWI)	0.21	12.43	0.37
US	2.44	14.47	2.21
Europe, Australasia, Far East (EAFE)	-2.11	8.50	-1.19
Europe	-3.08	5.49	-2.08
Japan	-0.97	14.95	0.67
Emerging Markets	-3.52	14.43	-2.52
Asia Pacific ex-Japan	-0.81	16.25	-0.37
Lat Am	-14.01	4.01	-8.19

Bond indices	Total Return in US dollar (%)		
	May 2018	1 year	Year-to-date 2018
Citi World Government Bond Index	-1.21	2.06	-0.66
Barclays Global Aggregate	-0.76	1.72	-1.02
Barclays Global High Yield	-1.51	1.74	-2.08
Barclays EM USD Aggregate	-0.73	-0.57	-3.19

Currencies/Currency indices	Price return (%)		
	May 2018	1 year	Year-to-date 2018
US dollar index (DXY)	2.33	-3.04	2.01
JP Morgan Asia dollar index (ADXY)	-1.02	3.27	-0.05
EUR	-3.45	4.16	-2.51
GBP	-2.91	3.82	-1.25
JPY	0.32	1.73	3.32
RMB	-1.33	6.34	1.58
SGD	-1.02	3.32	-0.19

Commodities	Price return (%)		
	May 2018	1 year	Year-to-date 2018
Brent crude	3.22	54.22	16.03
Reuters/CoreCommodity CRB commodity total return index	0.43	12.83	4.63
Gold Futures	-1.45	2.21	-0.70
Copper Futures	0.41	18.80	-7.14

1 Source: FactSet, Manulife Asset Management, Bloomberg,total returns in US dollar, 31 May 2018.
2 Source: Bloomberg, 10-year Treasury yields dropped 14.6 basis points on 29 May 2018.
3 Source: The Institute of International Finance (IIF) Capital Flows Tracker, 4 June 2018.
4 Source: Bloomberg, Factset, Manulife Asset Management, as of 31 May 2018.

- Regional equity performance diverged sharply. Supported by strong economic data, the S&P500 returned 2.4% over the month. Most other major markets struggled, however, and did not follow the US lead. Among developed stock markets, Europe fell most due to the political problems in Italy and Spain and disappointing economic data releases throughout the month. MSCI Europe fell 3.1%. Within the Eurozone, Italy and Spain both fell sharply (by 11.2% and 8.5% respectively), as did the equity markets of weaker members like Greece and Hungary. The MSCI ACWI World index saw a marginal rise of 0.2%[5].

- With amplification in political and financial risks globally, EM had a poor month. The MSCI EM index fell 3.5%. However, by region, Asia overall held up better – the MSCI Asia ex-Japan index only fell 0.8%. China managed a positive return despite falling in the latter half of May, while Hong Kong and Taiwan ended broadly flat. In contrast, Latin America with its predominantly negative news flow plunged 14%.[4]

- Popular global bond indices like the Citi World Government Bond Index and Barclays Global Aggregate posted negative returns in May (-1.2% and -0.8%, respectively), due to the weakness of developed markets (DM) currencies against the dollar, notably the euro. US fixed income, in contrast, delivered a positive return, with the Barclays US aggregate index up 0.7%.[4]

- As markets retreated into "risk-off" mode, DM sovereign bond yields fell except for those directly in the firing line, like Italy and Spain. The 10-year US Treasury closed the month 10bps lower at 2.83%, while the yield on German 10-year bonds fell 22bps, closing at 56bps.[4]

- Foreign exchange markets showed classic "safe-haven" behaviour in May, with the Japanese yen and Swiss franc ending the month 0.3% firmer against an appreciating US dollar, which gained 2.3% (measured by dollar index). The euro and British pound fell 3.5% and 2.9% respectively against the greenback, while the Canadian dollar gained 0.2%.[4]

- Commodities had another good month. The HSBC all commodity price index gained 6% and is up 28% year-on-year. Higher non-oil commodity prices are an indication that the global industrial production cycle remains healthy. The drop in the oil price towards the end of May suggests Iran-related supply side fears may be easing.

- Technically, the oil price became overbought in May and is correcting lower. The prospect of renewed US sanctions on Iran, the record elimination of inventories last year and continuing strong global demand could see oil move above US$80 per barrel (pbl) for a time. However, it is not in Saudi Arabia's or OPEC's interest to encourage an oil price so high it brings forth a surge in US shale oil output. Our sense is that if the oil price is sustained above US$80pbl, there would be a strong supply response from US shale producers, pushing the price back down.

Among the notable positive developments in May, the NASDAQ returned 5.5% after strong results from leading US technology stocks. US small caps also rallied strongly as the Russell 2000 index soared 6% over the month. Both these indices are up by more than 20% over the past year. It is among America's smaller firms where business confidence has been boosted the most by the policies of the Trump administration.[6]

Another major positive—data releases in the US economy in May have been simply stellar. The Atlanta Fed's Nowcast forecast for real GDP growth in the second quarter is currently well above 4%.[7] Nowcasts have tended to be revised lower as the quarter progresses. But following strong data prints for industrial output, personal consumption and nonfarm payrolls, most US forecasters expect a "3" handle for second quarter GDP.

Looking at global equity performance by sector, leadership in May lay with IT (6.4%), energy (1.9%) and materials (1.6%), rather than with the traditional defensive sectors. The latter suffered as global telecoms fell 5.4%, utilities fell 2.1%, and consumer staples lost 1.2%. This pattern hardly seems consistent with normal market corrections.

---

[5] Source: FactSet, MSCI indices, total returns in US dollar. Markets in Italy and Spain are represented by FTSE MIB Index and IBEX 35 Index, total returns in US dollar.

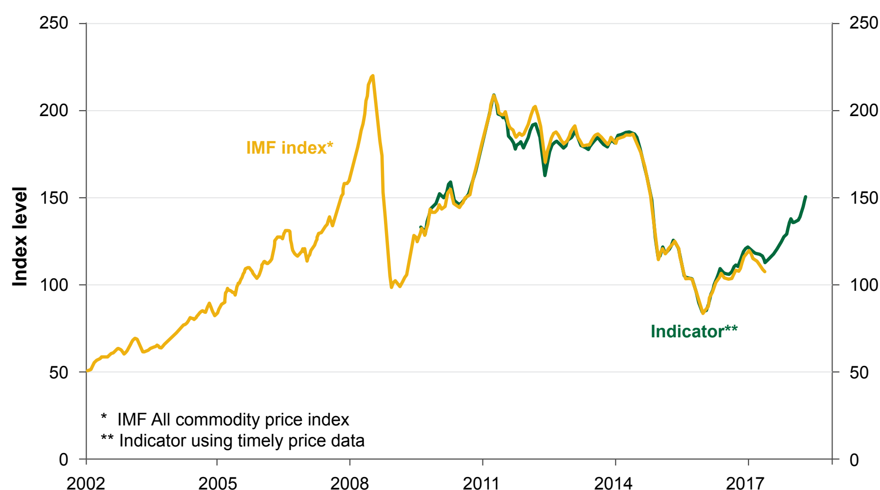
[6] Source: Bloomberg, total returns in US dollar, 1-year return starts from 30 April 2017 to 31 May 2018.

[7] Source: Federal Reserve Bank of Atlanta, 16 May 2018.

Even in Europe, despite the political issues and weaker economic data in recent months, the market still managed to retain "a risk-seeking tone with small-caps outperforming large and consumer discretionary, industrials, materials, and technology all hitting fresh relative highs[8]."

Conversely, defensive sectors like consumer staples, telecoms and utilities have appeared vulnerable during the recent bouts of market volatility.

Chart 2: Rebounding commodity prices do not suggest a weakening global economy[9]



02 Asset Allocation

We retain a moderate overweight for equities over bonds in our global multi-asset portfolios. What we are currently seeing in equity markets is more likely an extended correction rather than the start of a bear market. We think that investors on a 6- to twelve-month horizon should be prepared to bet on a continuation rather than an interruption of global growth.

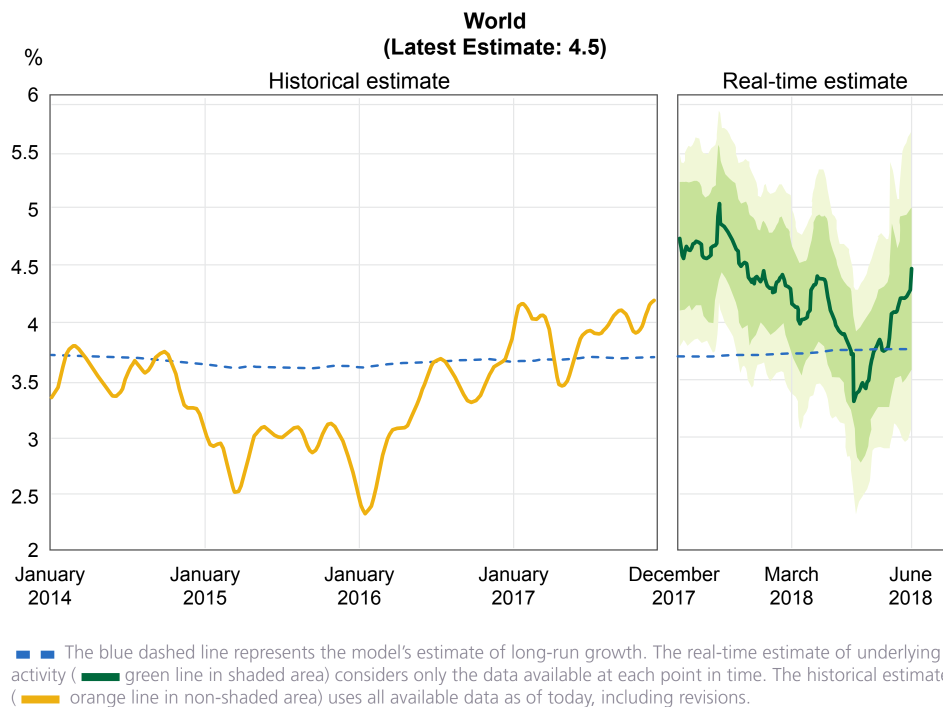
For global growth, we view the dip in Purchasing Manager's Index (PMIs) that occurred in the first quarter as indicating a "soft-patch" only and not the end of the current global expansion, which is likely to continue in 2019. The high frequency, real-time activity indicators maintained by Fulcrum Asset Management have already turned higher in the second quarter[10]. This suggests that investors will before long regain their confidence in the global economic expansion continuing through 2018 into next year.

After a slight slowdown early in 2018, the Fulcrum activity indicators strongly suggest global activity growth is reverting the above trend. Importantly, the second quarter rebound is led by the US and China plus emerging Asia, so that growth is retaining its synchronised linkages across DM and EM. This is positive for global equities, although it also sets the stage for a bearish short-term outlook for rates.

However, Europe is still a drag, based on the high frequency Fulcrum analysis. Notably the European region may now be growing only fractionally above trend. If this persists, this would be over and beyond the temporary effects of adverse weather, strikes and faulty seasonal adjustment related to Easter. It would be a major risk to our bullish view on the prospects for the euro versus the US dollar in the second half of 2018.

[8] Source: Strategas, Technical Strategy, 7 June 2018.
[9] Source: HSBC Global Economics, June 2018.
[10] Source: Financial Times.

Chart 3: Second quarter global "soft patch" looks to be over[11]



The blue dashed line represents the model's estimate of long-run growth. The real-time estimate of underlying activity (green line in shaded area) considers only the data available at each point in time. The historical estimate (orange line in non-shaded area) uses all available data as of today, including revisions.

Of course, the current business cycle upswing must end at some point, and the market's focus appears to have shortened to the second half of 2019 or first half of 2020. There is no clear consensus on the end of the cycle or on what factor(s) may bring the expansion to a close. Perhaps the most commonly held view is that an overheating US labour market and rising wage pressure eventually forces the Fed's hand. But we are not there yet. That point could be delayed until beyond 2020 if US labour force participation was to increase (as it has in Japan in recent years) in conjunction with higher capex spending that boosts productivity.[12] In short, the US economy is still performing well and it is too early to become gloomy over upcoming prospects.

Global growth continue to draw support from the US and China

While risks appear to have multiplied lately, such as Italy, oil, rising interest rates, trade frictions and the rebound of the US dollar, we see global growth continuing to draw fundamental support from the US and China, the world's two largest economies. It would seem strange to us if global growth close to 4% and an earnings recovery were accompanied by a bear market in stocks. Chris Verrone, technical analyst at US research firm Strategas, notes that on the rare occasions when solid economic and earnings growth have been met by a flat stock market (e.g., 1984, 1987, 1994), returns in the following year have been strong[13].

We are taking the view that the short-term risks from Italian and Spanish politics are more likely to fade than increase, with the real challenges likely to occur much later. A few market strategists are calling on Italy to be the catalyst for the next global financial crisis and recession. This is unduly alarmist, in our view. Although such a scenario may occur eventually, an "Ital-exit" is not imminent. It is in both the European Union (EU) and Germany's interest to reach a compromise with the new Italian government over fiscal policy and leave it to markets to pass judgment on the coalition's economic policies via Italian bond yields.

[11] Source: Fulcrum Asset Management, Financial Times, June 2018.
[12] For more on this argument, please see Gerard Minack, "Down Under Daily," 6 June 2018.
[13] Strategas Technical Strategy, 6 June 2018.

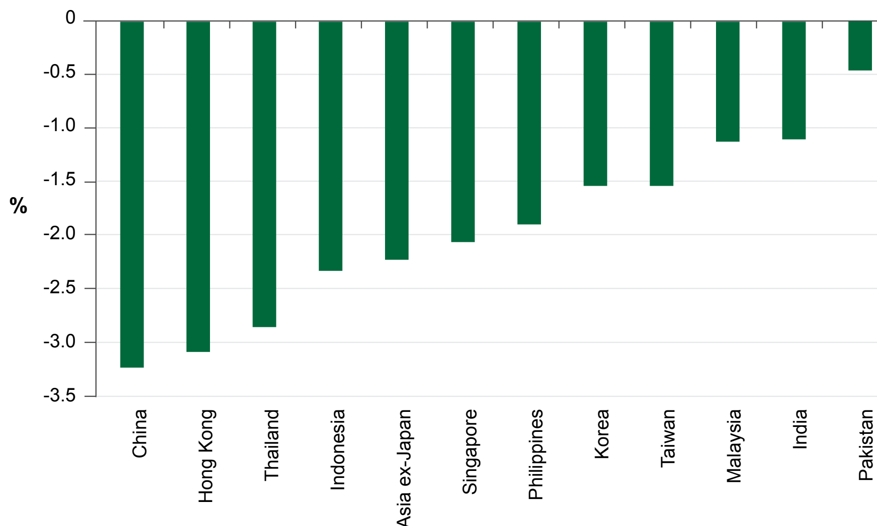
Similarly with US-China trade war fears: news of the agreement with a technology company and China's offer to increase imports from the US by US$70 billion encourages us to believe that an all-out trade war scenario between the two nations deserves a low probability.

In the short term, the US stock market may continue to hold up better than most, given better technicals, strong corporate results (thanks to tax cuts) and an expected acceleration in growth in the second quarter. But over a 6- to twelve-month horizon we prefer to overweight Europe, Japan and EM. Non-US stock markets are further behind in their business cycles and have greater scope for earnings to catch up, provided that the global upswing can be maintained, which we think is likely.

03 Challenges for Emerging Markets

EM equities have struggled in recent months and outflows in the last week of May were the greatest since December 2016.[14] We believe recent weakness is primarily due to the rebound in the US dollar from its recent 3-year lows, leading markets to extrapolate a further leg of sustained appreciation.

Chart 4: Sensitivity of Asian stock markets to US dollar index[15]



Dollar index close to a peak

With the dollar well above most Purchasing Power Parity (PPP) estimates and pressure building from the US "twin deficits", we are not in the strong dollar camp; we think the dollar index is close to a peak. Once the dollar loses momentum, sentiment towards EM should first stabilise and then improve. Especially if we start to see better economic data from Europe and Japan[16].

We are less concerned about higher US Treasury yields than the dollar. Historically, higher US yields have not been a major drag on EM performance. With US and global inflation remaining below historical trends, a gradual grind higher in 10-year yields in the second half of the year appears more likely than a sharp move higher.

Recently, a new fear has emerged for EM: that global liquidity conditions are about to tighten dramatically, given further Fed rate hikes and the progressive reversal of quantitative easing (QE). This would put added financial pressure on EM companies that have borrowed in US dollars.

[14] Source: Bloomberg, Institute of International Finance, 6 June 2018.
[15] Source: HSBC Global Research, "Exploring Asian equity market sensitivities", May 2018. Regression on weekly data as a guide to average historical impact.
[16] Note: The latest Reuters monthly Tankan survey for Japan saw an improvement in business sentiment for the manufacturing sector and a rise in service sector sentiment to an all-time high.

We think such fears are exaggerated. Firstly, global dollar liquidity is only likely to tighten gradually—the European Central Bank and Bank of Japan respectively, after all, have yet to exit QE. Secondly, once Chinese companies are excluded, EM corporate debt is actually a lot lower, on average, than that of US companies, while the debt burden is becoming more manageable after the recent strong growth in earning before interest, taxes, depreciation and amortisation (EBITDA).

Elevated external debt levels may reflect greater foreign ownership of domestic securities besides corporate borrowing in overseas currencies (as in the past). Indonesia's total external debt, for example, is 35% of GDP but only 14 percentage points of this is corporate issuance.[17] There will clearly be pockets of risk and potential stress points, however, since some EM corporates will have levels of US dollar denominated debt that are much higher than average.

Emerging Asia Remains Attractive

In Asia, many investors have expressed concern over the recent interest rate hikes in Malaysia, the Philippines, Indonesia and India. They wonder if this is the start of an uptrend in regional interest rates without which liquidity would be "sucked" away from the region as foreign investors continued to pull their money out.

However, foreign portfolio equity outflows from Asia ex-Japan over April-May have reached levels that in the past have signaled capitulation. Positions have been unwound, with selling each month over February to May and a year-to-date (YTD) outflow of US$14.7 billion, reversing 90% of last year's net inflow.[18]

Some of the recent rate hikes in Asia were taken for domestic reasons. The hike by the Reserve Bank of India in early June came as no surprise, since price pressure had been building for some time. In the Philippines, a sustained period of high growth saw inflation move above the government's target range (3% ± 1.0 percentage point), justifying the hike in rates by the BSP, the central bank of the Philippines.

In Indonesia, the two 25bps rate hikes in May were taken to pre-empt further capital outflows and bolster confidence in the rupiah. Inflation is expected to end the year close to 3.5%, the centre of the official target range, so there are no real domestic concerns. Recent actions are in line with Bank Indonesia's broad policy mandate, which includes currency stability. It shows that policymakers at the central bank are capable of being proactive when it comes to defending their currency.

Finally, in none of the four Asian countries that raised interest rates in May and June—India, Indonesia, Malaysia and the Philippines—are external trade and current account deficits close to levels normally associated with a balance of payments crisis. Nor do the relatively limited falls seen in Asian currencies represent a big risk via pass-through to domestic prices. In view of this, investors in Asia should resist the urge to panic.

We do not think Asian central banks will be forced to move in lock step with every 25bp hike in the US Federal funds rate. Though historically, interest rates in Asia and EM have usually followed the trend in DM rates (full monetary independence is not possible under the present US dollar-based international monetary system, not unless a country has robust capital controls in place).[19]

We have seen relatively little change in Asia's positive fundamentals since the markets became more volatile. GDP growth for Asia ex-Japan in the first quarter of 2018 picked up a little, boosted by the data from Hong Kong, India, the Philippines, Singapore and Thailand. The latest monthly economic data releases suggest little change in trend growth. Export numbers have been a little better, although weaker purchasing manager's index (PMI) new export orders suggest a note of caution. Even if exports weaken in coming months, domestic demand remains firm in most Asian countries.

Rather than simply favour EM countries based on their relative macro strengths, a complimentary strategy now would be to look for good bottom-up investment opportunities in markets that have sold off heavily on trade and geopolitical concerns; adding quality companies with good secular growth prospects and a strong business franchise that have become oversold.

[17] Source: HSBC Global Research, "ASEAN Perspectives", 31 May 2018.
[18] Source: HSBC Global Research, "How mutual funds are positioned across Asia", 29 May 2018.
[19] For empirical evidence on this point, see Helen Rey, NBER Working Paper 21162, initially issued in 2015; revised in 2018.

Disclaimer

Manulife Asset Management is the asset management division of Manulife Financial. The information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable but Manulife Asset Management does not make any representation as to their accuracy, correctness, usefulness or completeness and does not accept liability for any loss arising from the use hereof or the information and/or analysis contained herein. Neither Manulife Asset Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained herein.

This material was prepared solely for informational purposes and does not constitute a recommendation, professional advice, an offer, solicitation or an invitation by or on behalf of Manulife Asset Management to any person to buy or sell any security. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. The economic trend analysis expressed in this material does not indicate any future investment performance result. This material was produced by and the opinions expressed are those of Manulife Asset Management as of the date of this publication, and are subject to change based on market and other conditions. Past performance is not an indication of future results. Investment involves risk, including the loss of principal. In considering any investment, if you are in doubt on the action to be taken, you should consult professional advisers.

Proprietary Information – Please note that this material must not be wholly or partially reproduced, distributed, circulated, disseminated, published or disclosed, in any form and for any purpose, to any third party without prior approval from Manulife Asset Management.

These materials have not been reviewed by, are not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the following Manulife entities in their respective jurisdictions.

Indonesia: PT Manulife AsetManajmenIndonesia. Malaysia: Manulife Asset Management Services Berhad. Thailand: Manulife Asset Management (Thailand) Company Limited. Singapore: Manulife Asset Management (Singapore) Pte. Ltd. (Company Registration Number: 200709952G). Vietnam: Manulife Asset Management (Vietnam) Company Ltd. Australia, South Korea and Hong Kong: Manulife Asset Management (Hong Kong) Limited in Hong Kong and has not been reviewed by the HK Securities and Futures Commission (SFC). Philippines: Manulife Asset Management and Trust Corporation Japan: Manulife Asset Management (Japan) Limited. Taiwan: Manulife Asset Management (Taiwan) Pte. Ltd. (Investment is not protected by deposit insurance, insurance guaranty fund or other protection mechanism in Taiwan. For the disputes resulted from the investment, you may file a complaint to the Securities Investment Trust & Consulting Association of the R.O.C. or Financial Ombudsman Institution. License No. 106 Jin-Guan-Tou-Xin-Xin-008 "Independently operated by Manulife Asset Management (Taiwan) Co., Ltd." /6F., No.89, Songren Rd., Taipei, Taiwan 11073, Tel: (02)2757-5999, Customer Service: 0800-070-998.).