Manulife Asset Management

MONTHLY MACRO VIEW

With the first half over, time to pause and rethink

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Global markets struggled in June with across-the-board declines. Although investor concerns over increased US-China trade friction took the spotlight, a raft of other risks, such as a hawkish Federal Reserve, a flattening yield curve and rising oil prices, also took markets lower. But is it all bad news? We believe there are reasons to be optimistic.

Global earnings estimates remain strong along with attractive valuations, and the upcoming second quarter reporting season in the US may offer investors opportunities for alpha. Among battered emerging markets (EM), some provide long-term opportunities for investors such as India.

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01 Market Review[1]

Global markets struggled in June, with the majority posting declines. Investors everywhere continued to struggle with the twists and turns in America's policies towards Chinese trade and investment.

Markets hate this kind of policy uncertainty where risks are so hard to price. Asset classes most vulnerable to the negative trade sentiment fell most, such as Emerging Market (EM) equities and debt. Matters were not helped as 10-year US Treasury yields kept trying to move higher while the dollar index (DXY), another potential red flag for non-US risk assets, remained firm.

Mildly reassuringly, global equities overall as measured by the MSCI AC World index were broadly flat over the second quarter. This is despite the long list of concerns over trade protectionism, European politics, Fed rate hikes, the flat Treasury yield curve, and sharply rising oil prices. That said, consistent with a weak overall market, the percentage of stocks in "bear market territory"[2] has risen sharply with over 22% of the MSCI World names now down more than 20% – more than three times as many seen at the end of January.[3]

In January, we stated that our concerns focused on high initial valuations as a risk to equities in 2018 more than on economic prospects. Naturally, we are now less concerned about the valuations as markets have corrected while earnings have been upgraded.

At the global level, the second quarter saw little change in the forward price-to-earnings ratio for MSCI AC World. This remained at 14.9 times – almost 10% cheaper than in January and below the long-term average of 15.7 times[4]. Earnings estimates for the 2018 calendar year improved in all regions except Japan, rising on a global basis from 13.9% at end-March to 15.5% at end-June.

The coming earnings season, which starts in the second week of July and continues throughout August, could provide some support to those companies announcing better-than-expected results. Currently, the consensus bottom-up forecast for earnings-per-share growth is:

- 21.4% underpinned by sales revenue growth of 10.0% for the US
- 15.9% underpinned by sales revenue growth of 9.0% globally

1 Source: FactSet, Manulife Asset Management, total returns in US dollars, 30 June 2018.
2 "Bear market territory" is defined as a year-to-date fall of 20% or more.
3 Source: "Global Equity Market Arithmetic", Societe Generale, 2 July 2018.
4 Source: HSBC Global Research, Global Equity Data Monitor, 1 July 2018.

Chart 1: June market movements in a snapshot[5]

MSCI equity indices	Total Return in US dollar (%)		
	June 2018	1 year	Year-to-date 2018
All Country World Index (ACWI)	-0.50	11.31	-0.13
US	0.68	14.53	2.90
Europe, Australasia, Far East (EAFE)	-1.19	7.37	-2.37
Europe	-0.64	5.94	-2.71
Japan	-2.50	10.88	-1.85
Emerging Markets	-4.09	8.59	-6.51
Asia Pacific ex-Japan	-3.69	9.86	-4.05
Lat Am	-3.04	0.17	-10.99

Currencies/Currency indices	Price return (%)		
	June 2018	1 year	Year-to-date 2018
US dollar index (DXY)	0.52	-1.21	2.55
JP Morgan Asia dollar index (ADXY)	-2.39	0.82	-2.43
EUR	-0.33	2.08	-2.84
GBP	-1.41	1.26	-2.65
JPY	-1.54	1.25	1.73
RMB	-3.40	2.24	-1.76
SGD	-1.91	0.88	-2.10

Bond indices	Total Return in US dollar (%)		
	June 2018	1 year	Year-to-date 2018
Citi World Government Bond Index	-0.29	1.90	-0.94
Barclays Global Aggregate	-0.44	1.36	-1.46
Barclays Global High Yield	-0.45	1.11	-2.53
Barclays EM USD Aggregate	-0.66	-1.04	-3.84

Commodities	Price return (%)		
	June 2018	1 year	Year-to-date 2018
Brent crude	2.38	65.78	18.80
Reuters/CoreCommodity CRB commodity total return index	-1.21	14.65	3.36
Gold Futures	-3.51	0.98	-4.19
Copper Futures	-3.72	9.34	-10.59

Over the past few weeks we have seen little differentiation in price performance – quality outperformers have declined in line with stocks with weaker fundamentals. As we approach the second quarter results season, NASDAQ and tech stocks appear to be in good demand ahead of what we expect to be yet another positive set of corporate earnings.

Earnings may be the catalyst for alpha generation, given the across-the-board declines we have seen. Furthermore, the US dollar strength looks technically overextended, as too does US equity outperformance versus EM.

As the summer progresses, we could see some mean reversion in both cases. If the US dollar were to weaken over the summer, this could set the stage for Asia and emerging markets to stage a rebound rally and claw back some of their recent underperformance.

Regional Equity Performance

Regarding regional equity performance in the second quarter, there was considerable regional variation (recorded in US dollars).

- The MSCI US rose 3.6%;
- The eurozone fell 0.9%;
- Japan lost 2.8%; and
- EM broke a run of five consecutive quarterly gains with a fall of 7.9% – the worst three months since the third quarter of 2015.[6]

In EM, the 6% rise in the DXY[7] was a key factor in EM's woes but local factors also played an important part. The worst performing market in the second quarter was surprisingly not Turkey or Argentina, but Brazil, which fell 27% (measured in US dollar) as political concerns weighed heavily on the BOVESPA.

[5] Source: Bloomberg and Manulife Asset Management, as of 30 June 2018. Total returns in US dollar, all currencies returns are versus US dollar. All commodities' price returns are calculated in USD. Past performance is not indicative of future results.
[6] Source: HSBC Global Research, Global Equity Data Monitor, 1 July 2018.
[7] Source: Federal Reserve Bank of St. Louis, trade weighted US dollar index, 31 March 2018 to 30 June 2018.

EM Underperformance: Asia ex-Japan falling, Chinese equity weakness, and more

The combination of a strong US dollar, the growing likelihood of a "tit-for-tat" trade war, weaker economic data, and current account concerns for several EM economies led to the third highest monthly outflow from emerging markets (EM).

Asia Pacific ex-Japan fell 3.7% in June, reflecting weakness in Chinese equities, e.g.: Shanghai Shenzhen CSI 300 index fell 10.6%, as did Hong Kong's HSCEI (H-shares index, -7.6%). Whilst US-China tensions played their part, we think that the main reason for EM underperformance in the second quarter was the fear of a more aggressive US monetary policy tightening from the Powell Fed. Neither of these two negatives is likely to disappear in the weeks ahead.

Notably, China was the worst performing stock market in Asia last month.[8] Outside of the US-China trade tussle, there were additional concerns weighing heavily on domestic and overseas investors like corporate default rates near a record high, and a sharply weakening renminbi that led to speculation of ineffective intervention by the People's Bank of China (PBoC). However, while India has underperformed due to multiple factors, it may prove resilient with good opportunities in the coming future (more on this later).

Foreign currency exchange highlights

In foreign exchange (FX) markets, the US dollar was once again the winner in June. However, the DXY trade-weighted index only appreciated by 0.4%,[9] a small response in view of all the dollar-positive news last month. A more hawkish Fed in mid-June was followed by what was considered a dovish European Central Bank (ECB) withdrawal from quantitative easing while the Bank of Japan (BoJ) kept monetary easing at full throttle.

In our view, the recent US dollar strength is mainly down to policy divergence between the Fed and other central banks, but this factor may largely be played out for now. The euro, for example, was basically flat over the month. Among the other majors, the British pound struggled to gain direction, losing 0.7% against the greenback, taking its cue perhaps from an equally dreary and directionless Brexit. In Japan the BoJ continued to plough its quantitative easing furrow, and the yen fell 1.9% against the US dollar.

Renminbi Concerns: Justified or overblown?

The most concerning FX trend for some right now is not the US dollar but the renminbi. The renminbi has lost all vestiges of "pegged-ness", having fallen by over 5% versus the US dollar since April, a performance almost as weak as the euro's. Some China watchers view this as a potential warning shot by Beijing in the unfolding US-China trade war drama. We see it as simply confirmation of the renminbi's greater flexibility as the People's Bank of China (PBoC) stands back from persistent, frequent intervention.

This is a development to be welcomed, not criticised, reflecting a central bank and a currency that have "come of age". We agree with Paul Mackel, HSBC's Head of Asian Foreign Exchange, that "China should feel confident about having a more flexible exchange rate rather than reverting back to its old and outdated framework of aiming for FX stability[10]".

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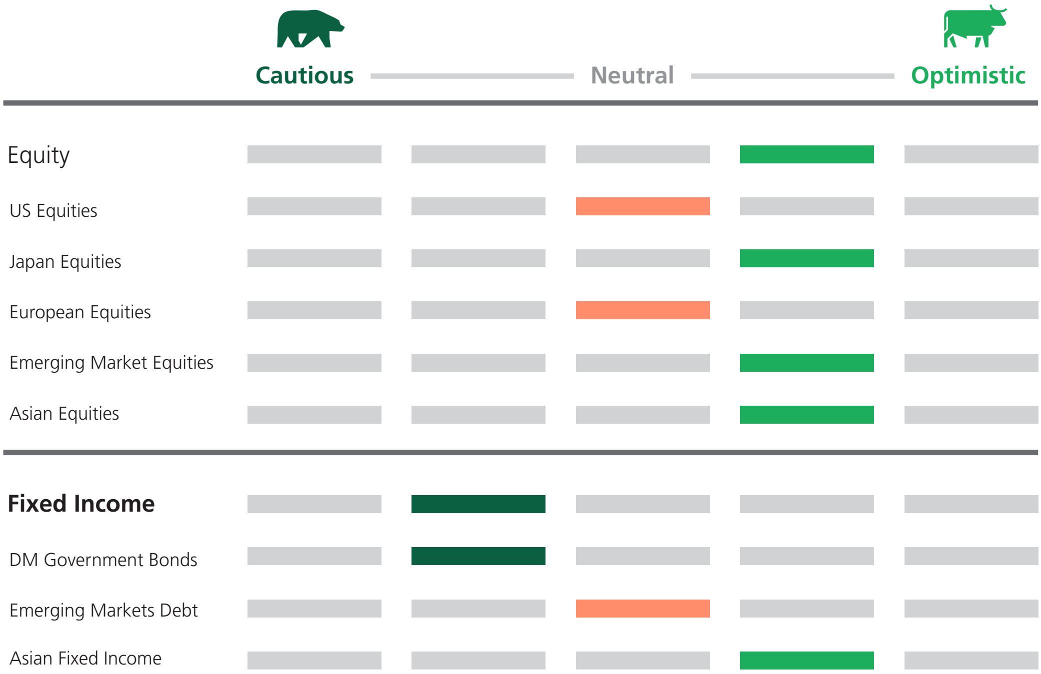
8 Source: Bloomberg measured by local market indices in US dollars, as of 29 June 2018.
9 Source: Federal Reserve Bank of St. Louis, trade weighted US dollar index, 31 May 2018 to 30 June 2018.
10 See 'Asian FX Focus: Tolerating flexibility,' HSBC Global Research, 3 July 2018.

02 Asset Allocation

Chart 2: Asset Allocation View (next 12 months) [11]



Overall, on a 12-month basis, we remain positive on equities as an asset class; however, we are less optimistic on European equities, as we believe prolonged economic weakness into the second quarter indicates there is little upside for investors over the next twelve months. While EM equities have retreated in recent months, we believe over a 12-month time frame cheaper valuations keeps it as an "overweight".

Looking at the US economy, recent data releases were all positive, with one stand out: The June nonfarm payrolls report where there was nothing at all to dislike. Second quarter real GDP growth is still tracking at 4% according to the Atlanta Fed Nowcast. Consumer confidence remains solid despite the ongoing dispute with key US trading partners. Since consumer spending accounts for around 70% of aggregate demand, if the consumer is in good shape, the economy often follows suit. S&P earnings are forecast to have risen around 20% in the second quarter of 2018, only a little less than the 23.2% advance in the first quarter. Sales and earnings before interest, tax, depreciation and amortisation (EBITDA) growth are also expanding strongly.

Thus, US equity investors may have to wait just a little bit longer before they are compensated for truly stellar earnings numbers. Indeed, it has been 104 days since the market has reached new highs – the second longest period without entering a bear market.[12] While this might suggest the odds of entering a bear market are increasing by the day, an alternative interpretation is that the market is girding its loins before attempting a decisive breakout. As a result, the US market may be in decline or flat until the midterm elections (November) – also when the US dollar may reverse as economic data weakens, helping boost EM. The market may be poised for a breakout after November: according to analysis by Ned Davis Research, equity returns tend to be back-end loaded during midterm election years,

[11] Portfolio Solutions Group, Manulife Asset Management, as of July 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.
[12] Source: Bloomberg, S&P 500 index, as of end of June 2018.
[13] Source: Ned Davis Research. Mid-term Election Handbook. 1 March 2018.

with post-election relief being rewarded by a strong rally into year end[13].

We also note that the negative impact of recent Fed tightening based on past experience may only affect the economy with a long (and variable) lag. And while the US dollar has strengthened substantially in recent months, a pause in the trend at last looks to be due, which would be welcomed by non-US risk assets. So our feeling is either global equities can grind slowly higher, or after a further period of pre-election volatility, a strong rally can take place in the closing months of 2018. Stock markets generally may be more resilient on the geopolitical front given evidence that earnings-per-share are holding up, with valuations now below average, investors more cautious than euphoric, and all the "known" risks (US dollar, yield curve, trade spat) substantially priced in.

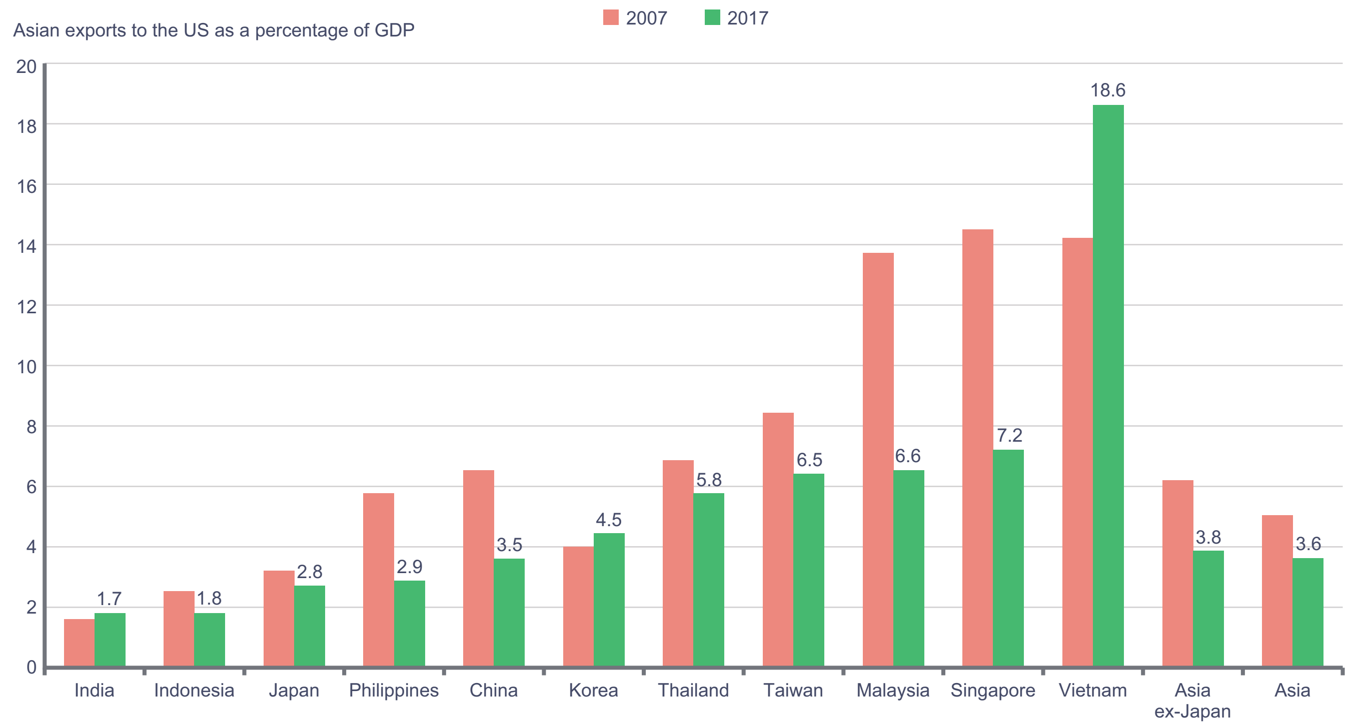
Finally, an important piece of advice to investors: do not follow very short-term trends in this environment (e.g. driven by tariff news), as it is easy to get whipsawed when negative news is quickly reversed by positive reprieves.

03 India: Investors look to domestic story

India has held up better than most markets in the region whenever trade tensions between the US and China rose. The key reason why India has outperformed in these risk-off episodes is that growth is more domestically driven, less export-dependent compared to other countries in the region, and less dependent on exports to the US in particular (see chart 4).

Year-to-date, India has still underperformed the region owing to deterioration in the macro environment, led by higher domestic inflation and higher crude oil import prices, leading to a larger trade deficit and weakening Indian rupee. We think that these macro hiccups are in the process of unwinding and have largely been priced in by markets. India's lesser vulnerability to trade tensions will continue to be seen as an advantage by investors in what could be a volatile period ahead of the US midterm elections in November.

Chart 3: Sensitivity of India to Exports to the US is low



Source: HSBC Global Research, 29 June 2018.

We remain very positive on the longer-term outlook for India and believe the recent short-term macro challenges will soon be behind us after India underperformed the Asia ex-Japan region by 4% year-to-date[14]. Like other regional markets, India in May saw foreign portfolio outflows of around US$1.4 billion. Foreign investors now own 44.2% of India's Free Float (FF) market cap, down from 45.6% a year ago.[15] Encouragingly, there appears to have been less selling pressure in the recent correction from domestic investors in equity mutual funds.

What were tailwinds for the Indian economy last year more recently became headwinds, with higher oil prices and US Treasury yields, a strong US dollar leading to fears of higher trade deficits, inflation, and domestic interest rates. Whilst India's twin deficits are still a cause of concern, though we think that slippage in the fiscal deficit and current account deficit can be contained at 3.5% and 2.5% of GDP, respectively. That should prove manageable. Recent signs of increased goods and services tax (GST) revenues are encouraging, as are recent real economy indicators like construction activity and vehicle sales. These indicators support the notion of an ongoing recovery in the Indian economy, with GDP growth in the 2019 fiscal year expected to top 7%[16].

The market had been expecting a response from the RBI to the cyclical pick-up in inflation evident since 2017. On 8 June, India's central bank duly obliged, raising the policy rate by 25bps to 6.25%. This was the first interest rate hike in over four years. We expect to see another hike in August, although the RBI continues to describe the policy setting as "neutral". The June rate hike was largely discounted in bond yields, as we think consumer price index (CPI) inflation is moving higher to 5.5% in coming months from 4.5% currently. India's growth trajectory is unlikely to be undermined by a moderate tightening in monetary policy. An oil price above US$80 per barrel would constitute a far more significant risk, though this is not our base case scenario for oil.

Domestic demand fundamentals intact

While not cheap, Indian equity valuations no longer appear as stretched after the correction, with the market on a price-to-earnings ratio of around 19 times on 2018 earnings. Despite the macroeconomic headwinds and tax collection issues, we also believe the domestic demand story remains intact for two reasons: (1) better quality government spending on infrastructure and rural development and; (2) economic formalisation due to completed reforms.

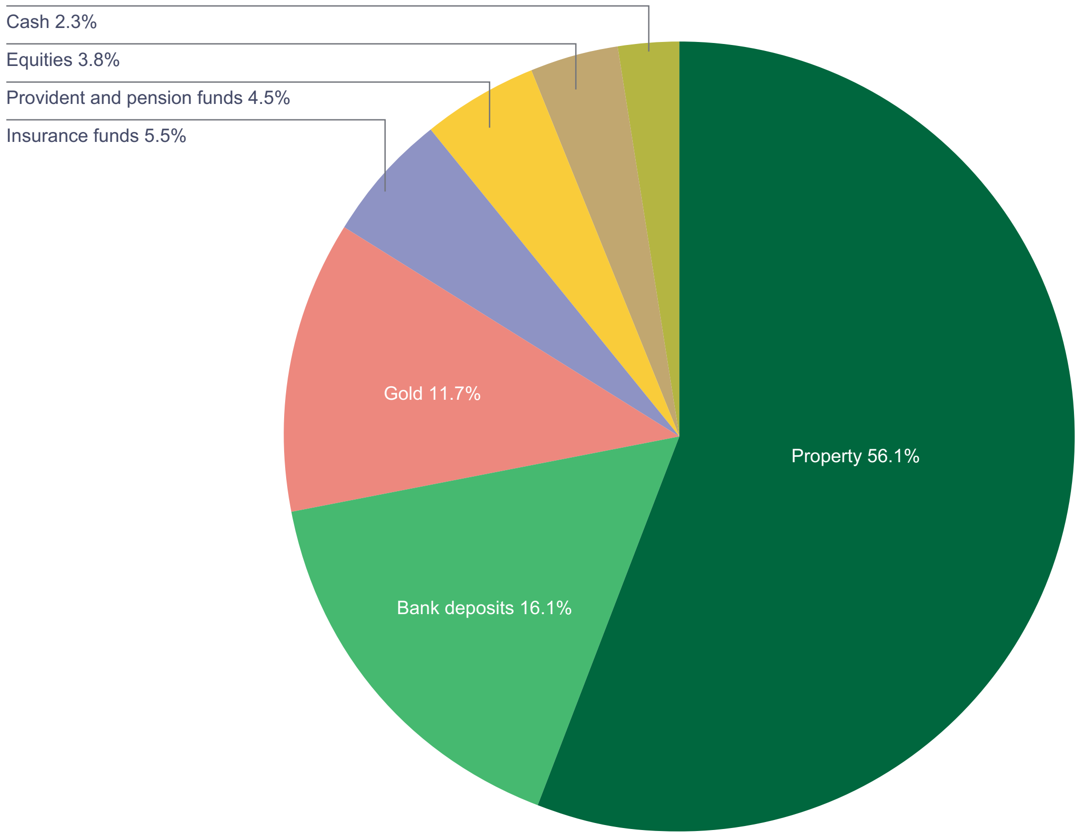
More efficient public spending on infrastructure, such as roads and power, and in rural areas (e.g. housing, sanitation, cooking gas connections) are increasing personal income. Rural individuals' rising income levels will drive discretionary spending and rural lending opportunities.

Economic formalisation, on the other hand, is driven by structural reforms (e.g., Goods and Services Tax and the Bankruptcy Act). Formalisation should lead to market share gains among better managed companies, which translates into better bottom-up growth opportunities. For example, stock picking opportunities exist in organised retail, retail and consumer lending, temporary staffing and real estate.

[14] Source: Bloomberg, MSCI indices, US dollars.
[15] Source: Manulife Asset Management, June 2018.
[16] The Reserve Bank of India, or RBI, forecasts 7.4%.

Chart 4: Still looking for that inflection point in company earnings[17]

Chart 5: Equity share in Indian household savings is very low – room to grow[18]



[17] Source: Credit Suisse, June 2018. MSCI India index.
[18] Source: CLSA, RBI, SEBI, Bloomberg, July 2017.

Tactically, we like information technology (IT) and health care. These sectors have underperformed due to their own challenges: IT firms are navigating the migration to the "cloud", while some health care firms have suffered from negative US FDA observations. We believe that companies in both sectors have now adjusted themselves to the new operating paradigm. Although longer-term challenges remain, their prospects could improve in the medium term with a weaker rupee serving as a key tailwind.

Policy continuity key to outlook

If the Indian economy continues to perform well and there are no major policy missteps ahead, Mr Modi looks set to gain another term in the national elections in April/May 2019. The Bharatiya Janata Party (BJP) increased its share of the vote substantially in the recent Karnataka election, but not by enough to form a majority and take office.[19] One lesson from the Karnataka election is that Congress is learning how to ally with regional parties to present a united front against the BJP. It will be interesting to see how this trend develops. Important state elections in Madhya Pradesh and three other states in November/December will provide investors with a clearer indication. While it's possible that election results can cause short-term volatility, a study of the last three decades reveals a great deal of policy continuity.

[19] Source: CNBC: "Major India vote boosts Prime Minister Modi's party, but markets suffer a rocky trade", 15 May 2018.

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