Manulife Asset Management

MONTHLY MACRO VIEW

Can wilting Emerging Markets recover after August?

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Geoff Lewis
Senior Asia Strategist

Markets continued their volatile ride in August as global stock markets moved lower due to concerns over an escalation in trade tensions and country-specific crises. Markets so far in September are putting on a braver face, despite the looming trade war. The US, Japan, Europe and Latin America are all up by 1% to 2%, with only Asian and Chinese equities posting losses month-to-date.

While the US dollar may have the momentum to stage one final leg higher into year end, our view remains that slower US growth, a less aggressive Fed, and growing "twin deficit" pressures should see the trade-weighted dollar reverse course in the first half of 2019 and depreciate, thereby bringing some much-needed relief to emerging markets.

Index

P.02

01 | Market Review

Global markets were once again in "risk off" mode in August, while markets so far in September are putting on a braver face, despite the looming trade war. The US, Japan, Europe and Latin America are all up by 1% to 2%, though Asian and Chinese equities have losses month-to-date.

P.05

02 | Latest views on the trade war

The negative sentiment on trade that has been depressing EM stock markets may be greater than the inherent risks present; additional tariffs may disrupt China's economy in the short term; we believe there is unlikely to be a lasting impact on China's longer term development.

P.08

03 | Top queries from clients in troubled times

We try to answer some of the key questions that are being asked most frequently by our Asian clients.

01 Global markets were in "risk off" mode in August

Chart 1: August market review[1]

MSCI equity indices	Total Return in US dollar (%)		
	August 2018	1 year	Year-to-date 2018
All Country World Index (ACWI)	0.83	11.99	3.77
US	3.31	19.73	10.12
Europe, Australasia, Far East (EAFE)	-1.92	4.90	-1.87
Europe	-2.78	3.27	-2.25
Japan	0.23	9.41	-1.23
Emerging Markets	-2.67	-0.32	-6.93
Asia Pacific ex-Japan	-1.10	3.34	-4.02
Lat Am	-8.33	-11.49	-10.46

Currencies/Currency indices	Price return (%)		
	August 2018	1 year	Year-to-date 2018
US dollar index (DXY)	0.62	2.67	3.27
JP Morgan Asia dollar index (ADXY)	-0.69	-2.67	-4.28
EUR/USD	-0.56	-1.64	-2.62
GBP/USD	-1.19	0.97	-3.65
JPY/USD	0.70	-0.17	1.60
RMB/USD	-0.03	-3.45	-4.80
SGD/USD	-0.60	-0.77	-2.48

Bond indices	Total Return in US dollar (%)		
	August 2018	1 year	Year-to-date 2018
Citi World Government Bond Index	-0.20	-1.72	-1.55
Barclays Global Aggregate	0.10	-1.36	-1.52
Barclays Global High Yield	-1.03	-0.41	-1.94
Barclays EM USD Aggregate	-1.35	-2.91	-3.56

Commodities	Price return (%)		
	August 2018	1 year	Year-to-date 2018
Brent crude	4.27	47.80	15.78
Reuters/CoreCommodity CRB commodity total return index	-0.81	6.69	-0.47
Gold Futures	-1.81	-8.87	-8.23
Copper Futures	-6.45	-13.97	-19.74

- **Equity Markets Performance**

Global stock markets were once again in "risk off" mode in August. There were days when investors saw nothing but a sea of red, with no place to hide other than the US. Global developed equity markets still managed a rise of 1.0% in August (MSCI Developed World index in US dollar), but there were large regional divergences. US stocks had a good month, as the S&P 500 added 3.0%, while the broader Russell 2000 universe rallied 4.2%. US technology names continued to outperform as the NASDAQ gained 5.7%, rallying to record highs. Europe was weak, falling 3.3% (in US dollar). The 6% performance gap in August between the US and Europe is something that investors have seen only eight times in the past 20 years[2]. Europe suffered from a disappointing results season and fears of an EU clash with Italia over fiscal policy after the summer break.

Elsewhere, contagion selling due to the currency and economic crises in Argentina and Turkey spread rapidly across much of the EM space. China and Hong Kong indices fell on trade concerns. Considering the rising likelihood of the US imposing further import tariffs, share price declines in the main China indices in August were actually quite moderate. This suggests that much of the bad news on trade may have been discounted by now. The MSCI China and Shanghai CSI 300 indices both fell 1.4% in August, while the MSCI Hong Kong index lost 0.7%.

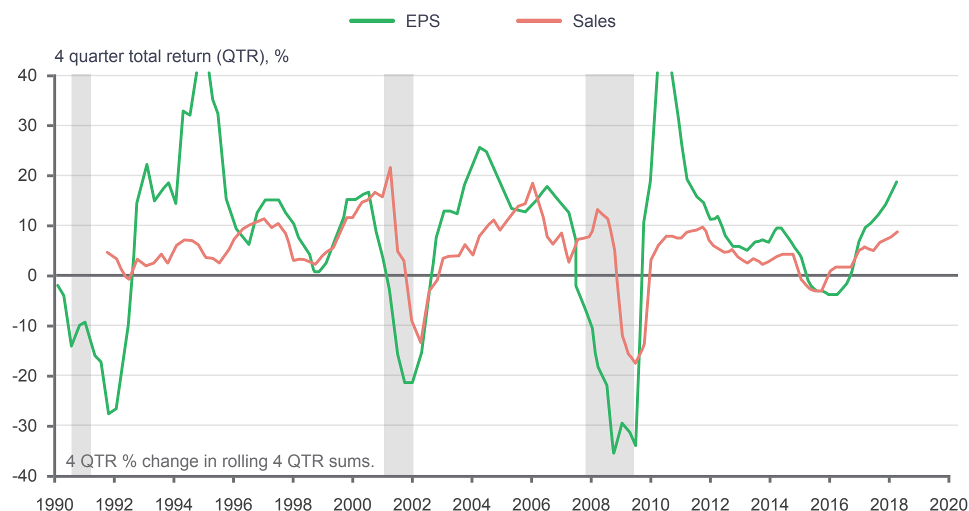
- **The US: Resilient and fundamentally solid, for now**

The resiliency of US equities this year despite all the negative geopolitical headlines is seen by some as remarkable, or even "hard-to-justify". We see it as testimony to the fundamental strengths of the US economy and as such we believe it will continue. For the time being, there is little sign that labour cost pressures in the US are strong enough to affect margins, even after the recent tick up in the growth of

[1] Source: Bloomberg and Manulife Asset Management, as of 31 August 2018. Total returns in US dollar, all currencies returns are versus US dollar. All commodities' price returns are calculated in US dollar. Past performance is not indicative of future results.
[2] Source: Societ Generale, Global Equity Market Arithmetic, September 2018.

average hourly earnings (AHE) to 2.9% in August, a nine year high[3]. In short, while a stronger US dollar at some point must take the lustre off sales growth and margins, if unit labour costs in the US remain under control, then earnings growth in the US can continue to outpace that in the rest of the world.

Chart 2: S&P500 sales best in seven years



Some see the S&P500 as the "Last Man Standing" among global equity markets and therefore vulnerable. We think fundamental support from sales & EPS growth is strong enough for the US rally to continue. We are also supported in this positive view by the S&P500's gradually strengthening technical support....

- **Asia ex-Japan: Still hindered by the US-China trade war**

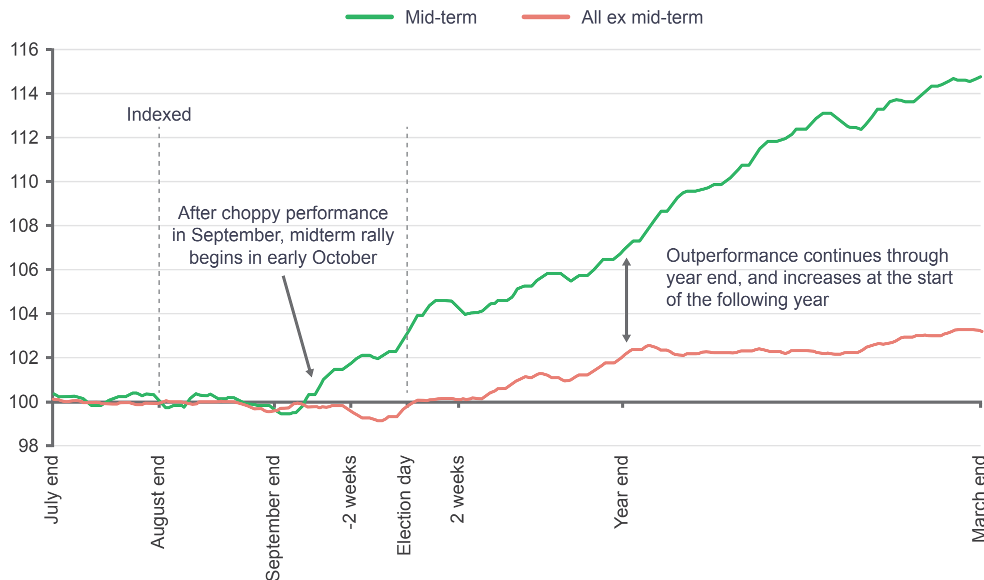
Looking at Asia ex-Japan, equities since earnings-per-share (EPS) forecasts peaked in March reveal some wide divergences. Surprisingly, perhaps, downgrades for export-oriented countries have been no larger than for more domestically-focused markets. Amongst the latter, India's recent re-rating is a stand out. Asia ex-Japan calendar year 2018 EPS growth forecasts have been cut by 4% (in local currency terms) since January. That may not be enough if US-China trade tensions continue to worsen, which would hurt the Asian supply chain. In January, EPS growth for 2018 was forecast over 13%. This has since been lowered to 7.5%[4], so the good news is that quite a bit of bad news appears to have been discounted.

On 6 September, the end of the public comment period saw President Trump press ahead with the next round of tariffs on US$200 billion of China imports. Consensus seems to believe that the impact on the Chinese economy will be manageable, as officials have enough space to ease policy. We agree. For now, we see further trade confrontation for China, a looser monetary policy, weaker currency, and a fiscal boost to infrastructure spending. If a positive trade deal is reached – most likely after the mid-term elections – then we might expect to see somewhat higher Chinese interest rates, a stronger renminbi, and less need to boost infrastructure spending.

Markets so far in September are tentatively suggesting an inflection in which US markets might for the first time be participating in the summer's stress experienced elsewhere. Congressional hearings with the main US internet companies were the trigger for US equities to join in the risk off mood, having been surprisingly immune up to that point. September is traditionally a seasonally weak month for the S&P500 and some pull back would not be surprising. Many US equity investors are anticipating a strong rally after the November mid-term elections, as that has certainly been the historical pattern (see Chart 3). Polls presently give the Democrats a 75% chance of regaining control of the House though not the Senate. That might not be such a bad outcome for markets. Historically, "gridlock" in the sense of "status quo", or no potentially divisive new legislation, has been welcomed by US equity investors.

[3] Source: Bureau of Labor Statistics, September 2018.
[4] Source: Manulife Asset Management, September 2018.

Chart 3: Post mid-term elections, the S&P500 often rallies



The chart is from a UBS study of the 17 mid-term US elections since 1950. It seems to be one of the more reliable calendar correlations. Regardless of the election outcome, increased political uncertainty ahead of the polls tends to dampen investor spirits in the preceding months, followed by a relief rally.

As for EM, we believe there is good long-term value after the recent declines on a selective basis, although with varying degrees of attraction between equities, foreign exchange (FX) and credits. Near-term catalysts that would encourage the return of global investor risk appetite appear to be missing or scarce just now, but that is usually when the best long-term opportunities present themselves.

Potential near-term catalysts would not seem to include trade de-escalation. President Trump has said he is ready to impose tariffs on a further US$267 billion of Chinese goods imports on top of the additional US$200 billion that received the go-ahead on 7 September. While some of which seem likely be hit with import taxes in a matter of days rather than weeks.

If President Trump's latest threat is carried out, it would result in 100% coverage i.e. tariffs on all Chinese goods entering the US. Some might say this is political rhetoric. But going from zero to US$250 billion in just a few months is foolhardy and reckless, yet here we are. Over time, stronger domestic opposition is likely to emerge within the US over soon-to-be-hurting Trump tariffs – not just from American consumers, but from the many US industry associations, small businesses, and social institutions that are lobbying hard against the tariffs.

- **Bonds and Currencies**

Most global Developed Market bond indices were flat to slightly down in August, while external EM debt fell 1.4% (Barclays EM US dollar Aggregate Index). Within EM, most Asian markets rose in August. The best fixed income returns were from the US, where the Barclays US Aggregate index returned +0.6%. The Merrill Lynch High Yield Master index gained +0.7% and is the only aggregate bond index that we follow which has a positive return year-to-date (+3.3%).

The path of the US dollar remains a key concern for all investors in all asset classes. EURUSD is the pivotal cross-rate to watch. We were looking for a peak in the US dollar and at the end of August, the key EURUSD exchange rate made what looked like a decisive move above 1.17. But this did not last long and, in early September, the euro pared back most of the earlier gains.

The worry now for investors is that the trade-weighted dollar appreciates further to EURUSD 1.10(or lower) by year-end. The direction would be consistent with the trend of recent economic data releases. Eurozone's CESI (Citi Economic Surprise Index) has lost momentum in early September, dipping lower on the back of softer-than-expected key European data like German factory orders. Against this, some key recent US data findings have been better than expected: e.g. ISM and Non-Farm Payrolls (NFP), causing the US CESI to pick up modestly from its late-August lows. So now, the two CESIs have crossed paths yet again, coinciding with the dip in EURUSD month-to-date.

Exacerbation of trade risks has also played a role in supporting the dollar. Italy's 2019 budget headlines were also a drag on the euro, but a 2–3% of GDP budget deficit has by now mostly been digested by markets. Unless we see more extreme outcomes, then Italian political risk may not be the trigger for further major weakness in EURUSD in the coming weeks.

While the US dollar may have the momentum to stage one final leg higher into year end, our view remains that slower US growth, a less aggressive Fed, and growing "twin deficit" pressures should see the dollar index reverse course in the first half of 2019 and depreciate, thereby bringing some much-needed relief to emerging markets.

02 Our latest views on the trade war

- **Trade Wars: Easy to start, hard to stop**

As we went to press we heard President Trump's announcement imposing a 10% import tariff on US$200 billion of Chinese imports from 24 September. Relations between the US and Chinese governments have suffered a setback that will not be quickly or easily repaired. As such, the US-China trade conflict may get worse before it gets better. Before long, we will start to see more of the negative economic impacts materialise, e.g. significant price increases for US consumers and job losses among some of the low margin, low-value added Chinese private sector exporters (many of whom exist perilously on razor thin profit margins).

It's still difficult to know what President Trump's ultimate objectives are in all this. It seems the US Administration wants to start unwinding some of the close economic ties that have built up between the US and China. To some extent, current China policy is being driven more by the US Department of Defense than by the Commerce Department and economic interests. We believe there is little or nothing that China can offer that will appease the US defence establishment. Against this, the US business sector overall still sees China as the one market they simply must be in for the long haul. China remains a top three investment destination for most US multinational corporations. Overall, there is a long battle to be fought in America between US business interests and the Trump administration.

Chart 4: China-US trade surplus is trending higher

President Trump's quest to reduce the US bilateral trade surplus with China reminds us of King Canute[5], who probably stood a better chance of success...

It's still possible that Trump will seek a deal when he meets Xi Jinping at G20 in late November. That is probably the earliest we could expect good news. Any deal will have to be sanctioned by Mr Trump in person. One obvious problem is that even if China makes major concessions on all the key points of contention (allowing President Trump to declare a quick victory), running the economy hot guarantees that the US-China bilateral trade deficit may not shrink by as much as the deal implies, and the overall US trade deficit can only increase.

- **Trade War: Current Implications for Emerging Markets**

Emerging markets (EM), for now, will remain susceptible to further bad news on US-China trade and so will stay very much in focus. External deficit countries like Indonesia, the Philippines, or India may see further currency pressure, requiring further monetary tightening measures that would otherwise have been unnecessary. But while EM equities will stay challenged in the short term and continue to flirt with bear-market territory, the decline has been relatively orderly rather than panic stations.

Valuations for EM equities in relative terms are now just 5% above the cycle low reached in January 2016, which Goldman Sachs has called a "significant" floor. We believe that the negative sentiment on trade that has been depressing EM stock markets may be greater than the inherent risks present.

[5] Source: Canute, whose father was Sweyn Forkbeard—was King of Denmark, England and Norway; often referred to as the North Sea Empire. He is most renowned for sitting on a throne at the edge of the sea and commanding the waves to go out and not wet his feet.

- **How Will China Be Affected?**

While 25% US tariffs may disrupt China's economy in the short term and may cause it to slow over the next year (possibly two), in the longer run we believe there is unlikely to be a big lasting impact, for the following reasons:

1. China's technology upgrading, productivity growth, etc. does not depend to any significant degree on US imports or technology. China has all the tools it needs to continue with its rapid economic development.
2. Over the longer term, the impact of US tariffs (a one-time shock) on China's secular growth path is likely to be small, even perhaps negligible.
3. Most vulnerable now to the Trump tariffs will be the low margin, low-value added private sector Chinese exporters (textiles/furniture, etc.). China is already gradually losing this business to Vietnam, Malaysia, etc. If US tariffs accelerate this process, it may not be totally unwelcomed by Beijing. It fits with the Made-in-China 2025 plan to upgrade to higher-value added industries.

It is also possible that broker estimates of the economic costs of US tariffs to China based on an import price elasticity taken from previous empirical research on trade are too high, since:

1. An assumed high price elasticity of -3.0 may be sensible for some price sensitive consumer items where there are close substitutes from other countries. But in some cases, Chinese consumer goods will still be cheaper than or as cheap as competitors, even after a 10% price hike, notably because of the huge economies of scale of the Chinese manufacturing supply chain.
2. The cost of many imported smaller components/ intermediate inputs is fairly price inelastic (at least in the short term).
3. Chinese manufacturers can do what they did in the case of solar panels – move final assembly plus some manufacturing operations to Malaysia. This only took 18 months to complete[6].
4. There is scope for "tariff-hopping" – China diverts sales of some goods to third markets, whose exporters replace China in the US market at a higher price than before. China and the third party benefit, the US consumer loses.

Regarding the solar panels and Malaysia, Chinese companies retain much of the benefits today. Solar panel exports from Malaysia to the US are outside the scope of the original tariffs (even if they possess a high China content). Thus, Malaysia's solar panel exports to the US have soared in recent years. The combined China/Malaysia share today is quite close to the Chinese share before the introduction of tariffs. This exercise could probably be repeated without too much difficulty for several other export products. It would have the advantage also of creating regional supply chains linking the economy of China with those of other Asian countries.

[6] Source: Gavekal, August 2018.

03 Top Queries from Clients in Troubled Times

Below we try to answer some of the key questions that are being asked most frequently by our Asian clients:

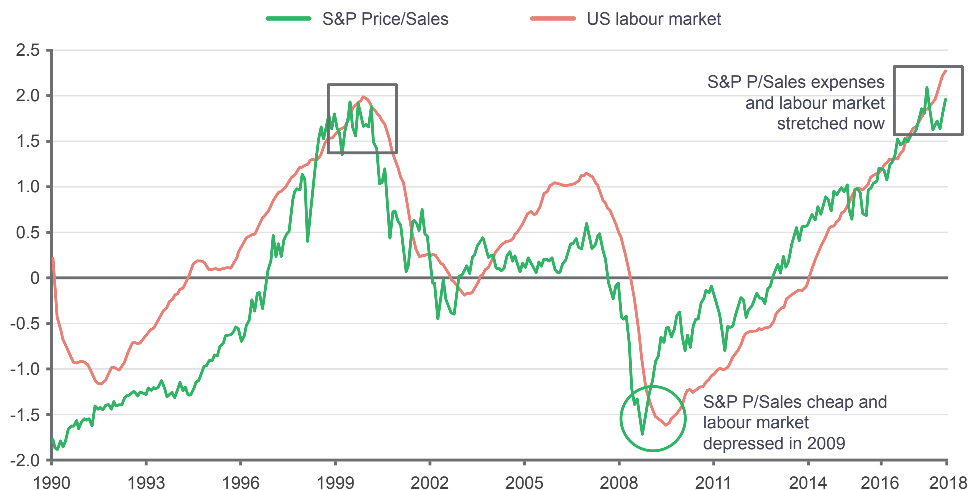
- **Q1. Should I be chasing US equity prices ever higher, or should I rotate into cheaper emerging markets, Europe, or Japan?**

The US stock market has momentum going into the final stretch of 2018, the US economy is rock solid, and the S&P500 tends to rally strongly after mid-term Congressional elections. With so many positives favouring the US, further outperformance from US equities in the short term seems likely.

But at some point in 2019, earnings growth forecasts for the US and other regions will start to converge as the boost from US tax cuts to 2018 earnings begins to wear off. We note that excluding the tax cuts and profit repatriation, US pre-tax net income growth peaked almost a year ago.

In our view, it would make sense for investors to utilise the rallies and dips in the S&P500 in the fourth quarter to start to reposition their portfolios from being overweight the US to being overweight other regions, with some preference for Asia and Japan over the Europe and Europe, Middle East and Africa (EMEA). Regarding relative performance, US research firm Strategas recently noted that the 65-day performance spread between the S&P500 and the MSCI Emerging Markets Index is at the fifth percentile of all historical observations, so investors may wish to allocate their assets accordingly.

Chart 5: Based on Price to Sales (P/Sales), the S&P500 is clearly not cheap!



The US stock market is diverging from global markets that peaked in January, similar to 2014. One reason for the divergence in USD returns is that the dollar is in an uptrend while a number of EM currencies such as the Argentine peso, Turkish lira, Indian rupee and Indonesia rupiah have been weak.

Q2. Which markets are most vulnerable to political shocks, and, in some, has enough bad news already been discounted?

2018 is the year when geopolitics, government policies, elections, and political upsets appear to have dominated markets more than fundamental developments. A good deal of the uncertainty has come from the US and the Trump Administration's desire to act as a major disruptor to force through changes and agreements that otherwise might have taken years of more conventional negotiations via diplomatic channels.

We believe that 2018 could bring good news on the North American Free Trade Agreement (NAFTA) and, eventually, US-China trade, where much of the bad news may have already been discounted. Areas where we think there may be some complacency over geopolitical risks include:

- The UK and Brexit, where markets appear to be discounting a smooth path.
- Italy and the EU, where the populist Lega/5SM coalition government is expected to behave responsibly, with a degree of fiscal orthodoxy acceptable to both Brussels and markets.
- The Middle East, which remains a dangerously unstable region.

Within the emerging markets, the economic problems facing Turkey, Argentina, and South Africa are well known by now. They do not have the power to shock us in 2019, when further contagion among EM on a significant scale is not expected.

Q3. Is there any past data reference to comfort investors during the late-cycle?

This question was covered in depth in the August edition of Monthly Macro View. While the late cycle is usually accompanied by rising pressure on global interest rates, equity markets historically still delivered positive, albeit lower returns. The spectre of yield inversion is stoking fears of economic slowdown. Yet our recession gauges are not even flashing amber. All the media focus on what may happen if the US yield curve inverts is simply worrying investors needlessly. The current 10-2 year spread at around 20 basis points (bps) is indeed the lowest since 2007. Historically, when the 10-2year spread has fallen below 30 bps and remained there, the US Treasury yield curve has later inverted on five out of seven occasions, with an average lag of seven months.

The consensus view is that the US expansion will end in the second half of 2019 or in 2020. But the US expansion could extend beyond if capacity expands fast enough to curtail inflation pressures. The key is whether labour supply can expand and keep wage pressures at bay. If that happens, then the Fed may signal a more dovish policy stance as we enter 2019. It is also worth recalling that in the mid-'80s and mid-'90s, there were long periods when the yield curve stayed flat without inverting and when US and overseas equity markets delivered decent returns.

Q4. Mainland China equities are in a bear market, like many other EM. How much worse can it get? Should I be reducing my exposure to Chinese shares?

No. Chinese stocks have underperformed in 2018 for a good number of reasons, including trade war fears; deleveraging and credit tightening worries; and weaker-than-expected domestic economic data for the first half of 2018. These negatives should (to a large extent) be discounted, which means we may be close to a bottom. Corporate metrics have generally been good in the first half of 2018, with no major negative shocks. We strongly believe that the Chinese government has enough policy options to maintain an economic growth rate within a range of 5.5% to 6.5%, despite US tariffs. Chinese equities are therefore good long-term value, in our view, although further tariff-related weakness cannot be ruled out. Now is the time to be taking advantage of cheap valuations to build up an overweight position in Asian equity portfolios, rather than selling close to the bottom and risking missing out on the rebound when it comes.

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