

Geopolitical tensions are increasingly clouding the global growth outlook. Sarah Lu, Senior Portfolio Manager, Multi-Asset Solutions Team, Asia, gauges the potential impact on markets and shares her latest asset allocation view amid rising inflation and lower growth.

Positioning in the looming stagflation environment

Russia's invasion of Ukraine is one of the true black swan events of recent years, and the raft of sanctions imposed could certainly affect global economies. As our Global Chief Economist and Head of Macroeconomic strategy [Frances Donald noted](#), there are three aspects we need to consider when assessing the macroeconomic impact of the recent geopolitical conflict:

1. Another stagflation shock makes the prospect of a return to Goldilocks conditions by the year end look less than solid
2. More dovish commentary is expected from the Bank of Canada, Bank of England, and, most importantly, the European Central Bank
3. The theme of global desynchronisation should become more important throughout 2022. Europe is most exposed to growth destruction from higher energy prices

¹ Fed Funds Futures show a 96.9% chance of a 25 basis points hike at the March Fed meeting. Upon the announcement of European Union sanctions, Germany's 10-year government bond price rose from 97.776 on 25 February 2022 to 100.799 on 1 March 2022. Meanwhile, 10-year bond yields fell from 0.2261% to -0.0799% over the same period. 7 March 2022, Bloomberg.

² Eurozone IHS Markit's Composite Purchasing Managers' Index climbed to a five-month high of 55.5 in February 2022. Bloomberg, 7 March 2022. On 8 March 2022, [the US has banned Russian oil exports](#). The European Union announced a series of sanctions against Russia. These

What's changed and our current assessment

Following the raft of sanctions imposed on Russia, interest rates futures immediately reflected the prospect of a lower-than-expected interest rate hike by the US Federal Reserve (Fed) in March, i.e., a 25-basis point rate rise became the consensus view¹. In response, some European government bonds have rebounded.

Earlier this year, before the military conflict started, we had a slightly positive view on Europe for 2022 as it possesses multiple growth drivers. Indeed, the latest PMI readings in Europe fare well. However, given the raft of sanctions imposed,² we have started to look at Europe less positively.

At the time of writing, the Russia-Ukraine situation remains fluid. As such, here is our current base-case assessment:

1. We believe that geopolitical events and a stagflation outlook will not lead to a global economic recession *at this point*. However, a rapid deterioration of the conflict and more severe sanctions against Russia may significantly weaken the global economy (subject to the scale of the conflict and its duration)
2. Europe, as Russia's major trading partner, would be most affected, and capital flows will likely return to the US

included a ban on all transactions with the Central Bank of Russia, which limits its ability to access foreign reserves. Also, seven Russian banks will be removed from the SWIFT international payments system and eurozone-based companies banned from exporting technology to Russian weapons manufacturers, pharmaceutical companies, military communications units and shipyards. Lastly, eurozone-based companies are banned from doing business with the designated state-owned companies specialising in military production. Financial Times, 4 March 2022.

3. Lower rate-hike expectations
4. Commodity-driven inflation is driving the need for inflationary hedges

Potential impact to broad asset classes

US dollar continues to be supported

The prospects for a more sustained stagflation shock, exacerbated by recent events, has seen adjustments in our asset-allocation positioning. As such, we believe that persistent volatility and more frequent bouts of risk aversion will occur in the first half of 2022. While the US is still on an above-trend growth path³ at this point amid the expected resumption of shale energy demand, we think the US dollar will continue to be supported, attracting capital inflow into US assets.

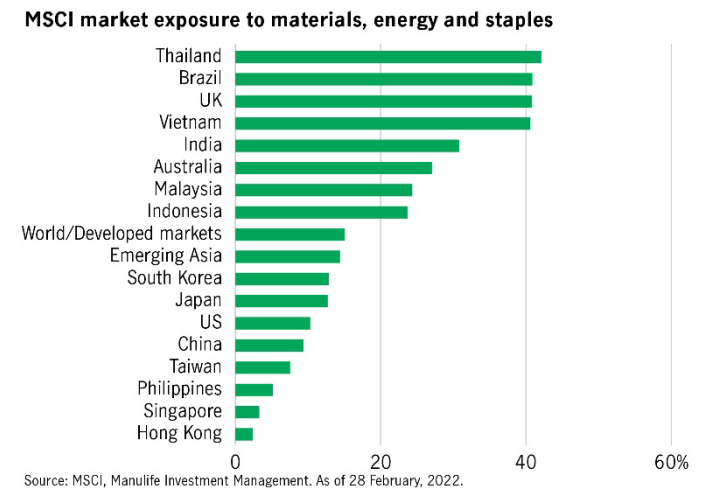
Equities: geographical and sector

Within developed markets, US equities are favoured over their European counterparts. Versus other regions, we believe the US will be minimally impacted by sanctions against Russia. Within the US, the energy and defence industry should expect to see higher substitute demand. For example, the US will play a more important role given the ban on Russian oil exports, as it can provide shale energy in lieu of energy embargo from Russia.

Given weaker economic growth momentum, coupled with ongoing geopolitical uncertainty, we expect equity markets to experience heightened volatility. However, markets with significant exposure to energy and materials (as inflation hedges) and consumer staples (as a defensive play) may find some insulation thanks to higher commodity prices.

Within emerging markets, we are relatively more positive towards select Asian equities (commodity-exporting markets, such as Malaysia, Indonesia, Thailand, and the Philippines, see chart 1).

Chart 1: MSCI market exposure to materials, energy, and staples



Select bonds that can outperform

The prospect of aggressive rate hikes is now lower, and the Fed is expected to raise interest rates by only 25 basis points in March (50 basis points had been anticipated by the market). Also, we think that bonds look more favourable, and our overall allocation has been revised to less of an underweight.

Assuming current geopolitical events and stagflation do not lead to a severe recession, we believe the US high-yield market has the potential to deliver relatively better performance versus risk assets like equities, as it is better compensated via higher coupons under rising inflation. Also, US high yield has a lower default potential versus other regions, as these bonds have a relative greater exposure to oil and gas sectors. Although signs of financial deleveraging in the face of liquidity withdrawal by the US Fed still needs to be watched carefully.

Meanwhile, floating-rate bonds (beneficiaries of a rising rate environment), China renminbi government bonds (a stable exchange rate and higher coupon rates versus other government bonds), and preferred securities (a fixed income-like product with higher coupon rates) are also expected to be more resilient than risk assets.

³ The US economy expanded by 5.7% year-on-year in 2021, a higher-than-trend growth of 2%-3%. Bloomberg, 7 March, 2022.

Other income-generating asset classes, such as REITs, will be supported, as rate differentials (REIT yields minus government bond yields) should narrow at a slower pace than before.

Commodities

We view commodities from two perspectives, both as inflation hedges and diversification tools. We expect commodity prices, such as oil and agriculture products, to remain elevated on the back of supply disruptions and geopolitical events. Commodities with inflation-hedge properties, like precious metals (gold and silver), oil, and farm products could perform better.

Conclusion

At the time of writing, the macro-outlook and geopolitical events are still highly fluid. The odds of slower growth and higher inflation are increasing, and we believe investors should seek active management and diversification to reshape their portfolios for an evolving investment landscape.

Disclaimer

A widespread health crisis such as a global pandemic could cause substantial market volatility, exchange-trading suspensions and closures, and affect portfolio performance. For example, the novel coronavirus disease (COVID-19) has resulted in significant disruptions to global business activity. The impact of a health crisis and other epidemics and pandemics that may arise in the future, could affect the global economy in ways that cannot necessarily be foreseen at the present time. A health crisis may exacerbate other pre-existing political, social and economic risks. Any such impact could adversely affect the portfolio's performance, resulting in losses to your investment.

Investing involves risks, including the potential loss of principal. Financial markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. These risks are magnified for investments made in emerging markets. Currency risk is the risk that fluctuations in exchange rates may adversely affect the value of a portfolio's investments.

The information provided does not take into account the suitability, investment objectives, financial situation, or particular needs of any specific person. You should consider the suitability of any type of investment for your circumstances and, if necessary, seek professional advice.

This material is intended for the exclusive use of recipients in jurisdictions who are allowed to receive the material under their applicable law. The opinions expressed are those of the author(s) and are subject to change without notice. Our investment teams may hold different views and make different investment decisions. These opinions may not necessarily reflect the views of Manulife Investment Management or its affiliates. The information and/or analysis contained in this material has been compiled or arrived at from sources believed to be reliable, but Manulife Investment 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 of the information and/or analysis contained. The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline, or other expectations, and is only current as of the date indicated. The information in this document, including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Manulife Investment Management disclaims any responsibility to update such information.

Neither Manulife Investment 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 here. All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment or legal advice. Clients should seek professional advice for their particular situation. Neither Manulife, Manulife Investment Management, nor any of their affiliates or representatives is providing tax, investment or legal advice. This material was prepared solely for informational purposes, does not constitute a recommendation, professional advice, an offer or an invitation by or on behalf of Manulife Investment Management to any person to buy or sell any security or adopt any investment strategy, and is no indication of trading intent in any fund or account managed by Manulife Investment Management. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Diversification or asset allocation does not guarantee a profit or protect against the risk of loss in any market. Unless otherwise specified, all data is sourced from Manulife Investment Management. Past performance does not guarantee future results.

Manulife Investment Management

Manulife Investment Management is the global wealth and asset management segment of Manulife Financial Corporation. We draw on more than a century of financial stewardship to partner with clients across

our institutional, retail, and retirement businesses globally. Our specialist approach to money management includes the highly differentiated strategies of our fixed-income, specialized equity, multi-asset solutions, and private markets teams—along with access to specialized, unaffiliated asset managers from around the world through our multimanager model.

This material has not been reviewed by, is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the following Manulife entities in their respective jurisdictions. Additional information about Manulife Investment Management may be found at manulifeim.com/institutional

Australia: Manulife Investment Management Timberland and Agriculture (Australasia) Pty Ltd, Manulife Investment Management (Hong Kong) Limited. **Canada:** Manulife Investment Management Limited, Manulife Investment Management Distributors Inc., Manulife Investment Management (North America) Limited, Manulife Investment Management Private Markets (Canada) Corp. **China:** Manulife Overseas Investment Fund Management (Shanghai) Limited Company. **European Economic Area:** Manulife Investment Management (Ireland) Ltd. which is authorised and regulated by the Central Bank of Ireland **Hong Kong:** Manulife Investment Management (Hong Kong) Limited. **Indonesia:** PT Manulife Aset Manajemen Indonesia. **Japan:** Manulife Investment Management (Japan) Limited. **Malaysia:** Manulife Investment Management (M) Berhad 200801033087 (834424-U) **Philippines:** Manulife Investment Management and Trust Corporation. **Singapore:** Manulife Investment Management (Singapore) Pte. Ltd. (Company Registration No. 200709952G) **South Korea:** Manulife Investment Management (Hong Kong) Limited. **Switzerland:** Manulife IM (Switzerland) LLC. **Taiwan:** Manulife Investment Management (Taiwan) Co. Ltd. **United Kingdom:** Manulife Investment Management (Europe) Ltd. which is authorised and regulated by the Financial Conduct Authority **United States:** John Hancock Investment Management LLC, Manulife Investment Management (US) LLC, Manulife Investment Management Private Markets (US) LLC and Manulife Investment Management Timberland and Agriculture Inc. **Vietnam:** Manulife Investment Fund Management (Vietnam) Company Limited.

Manulife, Manulife Investment Management, Stylized M Design, and Manulife Investment Management & Stylized M Design are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates under license.

550654