Manulife Asset Management

MONTHLY MACRO VIEW

Flight of the Doves

THE ASSET ALLOCATION TEAM

March 2019

Following pronounced market volatility and the US Federal Reserve's tilt toward dovishness in January, the markets have been broadly characterised by stronger equity prices and lower bond yields. This combination is a potent mix that, in our view, will serve to extend the business cycle. Over the last month, that behavior will have only been reinforced, as other major central banks have followed suit and adopted a dovish stance: The Bank of Canada toned down its rhetoric around normalisation, the Bank of England doubled down on its wait-and-see approach, and the European Central Bank changed course and extended its dovish forward guidance. Combined, these shifts have had a pronounced impact across asset classes. In this edition of Monthly Macro View, Asset Allocation's Macro Strategy Team analyses what could lie ahead for investors in the next two quarters.

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01 Market Overview: Flight of the Doves

- In equities, the S&P 500 Index's rapid ascent appears to have topped out—it's still up substantially,[1] but the initial euphoria in the first few weeks of the year has given way to reticence around messy data. Conversely, gains in international equities have accelerated over the last few weeks, with market reaction around central bank easing still playing a role; we also believe that recovering sentiment (after December's volatility) is playing an important role here.
- In fixed income, the incrementally dovish stances of the Canadian and European central banks have predictably exerted modest downward pressure on sovereign yields. Changes in US yields were the most subdued, with markets having the most time to digest the shift. Market reaction in Canada and Europe was more pronounced, with countries further out on the risk spectrum (Italy and Portugal come readily to mind) benefitting the most from easing interest-rate pressure.
- Foreign exchange rates have been stable so far this year, with the US dollar (USD) remaining generally unchanged against other major currencies during the month.

While monetary policy has clearly helped to extend the goldilocks environment, we continue to caution against being overly complacent about risks—geopolitics in particular remain an important tail risk. While the worst of the storm clouds around US-China trade relations appear to be clearing, the imminent threat of US auto tariffs being levied on Europe—and potentially Japan—looms large. Moreover, ongoing uncertainty around Brexit continues to weigh on sentiment.

From our perspective, this should be a year of volatility. We expect uncertainty at the beginning of 2019 to give way to increased confidence as we approach the middle of the year. However, we expect the optimism that could potentially build up over the second quarter will at some point be replaced by concerns of a likely US slowdown in 2020, which could lead to a re-rating of asset classes in autumn. Once again, flexibility and the ability to react quickly remain the order of the day.

Assessing the Global Growth Story

A key catalyst of the global risk-off environment that we saw in late 2018 was a growing consensus that global growth was deteriorating quickly. Going forward, the markets will need to believe that the global economy isn't imminently falling into a recession in order to maintain its current risk-on mode.

We believe Beijing's efforts to arrest the slowdown in the Chinese economy in the next 12 to 18 months are likely to be sufficient. With this in mind, we turn our attention to the US and Europe, where we expect growth prospects in both continents to continue to frustrate investors.

However, we do see some scope for a mild upswing in Europe and expect a notable improvement in US economic data this spring. This, we believe, should go some distance to easing fears of a global recession for the time being and provide some incentive for investors to add back some risks. However, we believe those same concerns will resurface in the fourth quarter of 2019.

[1] Market data sourced to Bloomberg, as of 28 February 2019, unless otherwise noted.

02 The US: 2019 Could be a Three-act Play

When asked about the economic outlook for the US, we've taken to answering with a question of our own: What's your time horizon? This is an important question, as we expect US economic data to operate in three distinct phases this year:

1. After an initial relief rally, the first few months of 2019 have been marked by volatility and risk around key data releases. We think the reasons behind this market behavior are fairly straightforward: In addition to an extended period of crippling cold weather, the US government shutdown has complicated things further by simultaneously distorting data (due to its disruptive effects) and compressing the timing of data releases, which has made older economic data appear fresher than it really is. Until recently, markets have been patiently looking through the data as noise, but February's non-farm payrolls (released on 8 March) appear to have tested that sense of discipline. While we're close to coming out of this period, it could continue until the end of April, when the first—and likely weak—estimate of Q1 2019 GDP is released.
2. We expect economic data to start to turn definitively positive from around mid-April. By then, we should receive further evidence that the residential real estate market is beginning to improve (several recent indicators have already turned positive). The consumer should also experience an improvement as a result of wage gains, sizable tax refunds, and lower gas prices. Overall, we expect the positive momentum to continue to build up in spring, which will in turn be supportive of equity markets. While we had initially believed that an improvement in market sentiment could lead the fixed-income market to price in further rate hikes, recent rhetoric lowered this likelihood.
3. In our view, the third phase is likely to begin to manifest itself in autumn as investors begin to turn their attention toward 2020, when both fiscal and monetary policy could become headwinds to growth. At this stage, we would be wary of increased volatility and uncertainty.

Chart 1: Our Roadmap for 2019 US Economic Data

Today – Data Distortion

- We're in an environment with heavy data distortions that mask underlying momentum.
- Data continues to be heavily distorted by the weather, the December/January government shutdown, delayed tax receipts, heightened geopolitical tensions in late Q4 2018/early Q1 2019, and related drops in business and consumer sentiment.
- We expect continued distortions in retail sales, manufacturing, housing, and payroll data.

April 2019 – Summer Smiles

- A stabilisation in economic data is expected as March readings are published. We expect March retail sales, due 16 April, to kick off a string of strong economic prints that will spur investor confidence into the summer. Recession probability indicators will also likely decline.
- Within this timeframe, we could enter a good news is bad news paradigm if markets were to price a Fed rate hike back into their outlook, which could nudge yields higher. However, if that were to occur, the move should be relatively mild and unlikely to push 10-year rates back to 3%.

August 2019 – Recession Restlessness

As temperatures begin to drop, so too will sentiment. August/September should see a mild-to-moderate pickup in inflation. This is likely to be coupled with a general slowdown in economic data, which should produce a resurgence of 2020 recession calls.

03 Europe: Are We There Yet?

Pessimism about European growth has been rampant over the second half of 2018 and into 2019, and European stocks, from a valuation perspective, appear relatively cheap. Indeed, the gap between US and European price to earnings is approaching decade highs.[2] Is it time to get excited about Europe again?

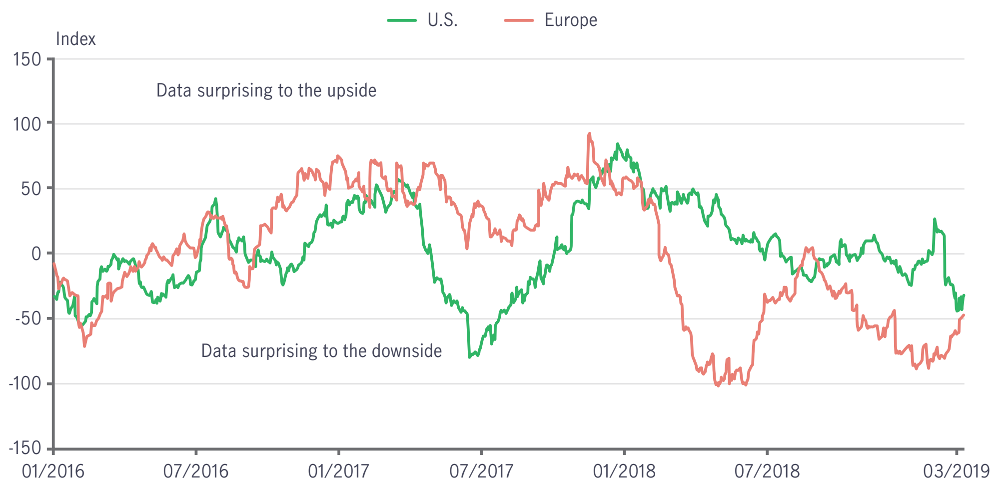
A disappointing year

Economic data in Europe has been very weak, with most major euro economies suffering from rapidly declining Purchasing Managers' Indexes (PMIs), faltering export activity, and slowing employment growth. Germany is in a manufacturing recession; the Italian economy also flirted with a recession in the second half of 2018, and prospects for growth are, to put it charitably, modest. Europe's troubles have been multipronged:

- Manufacturing activity has suffered from weak China-led global activity and soft external demand. Trade tensions have also exacerbated negative sentiment in the eurozone—while US-China relations have proven problematic, Europe also experienced unwanted and disruptive attention from Washington last summer, and we could see a repeat this year.
- Germany has been particularly hard-hit by a myriad of one-off economic effects: New emissions tests limiting the sale of noncompliant vehicles as of 1 September and low water levels on the Rhine (a key distribution channel for industrial goods) were particularly impactful.
- Political headwinds, including French labor protests, Italian federal budget concerns, and Brexit uncertainties, have depressed both foreign and domestic sentiment toward Europe.

These issues, however, now appear well priced into European assets; indeed, the European Citi Surprise Index has started to marginally improve (Chart 2). European data is not yet surprising to the upside, but the scope of its ability to disappoint is lessening.

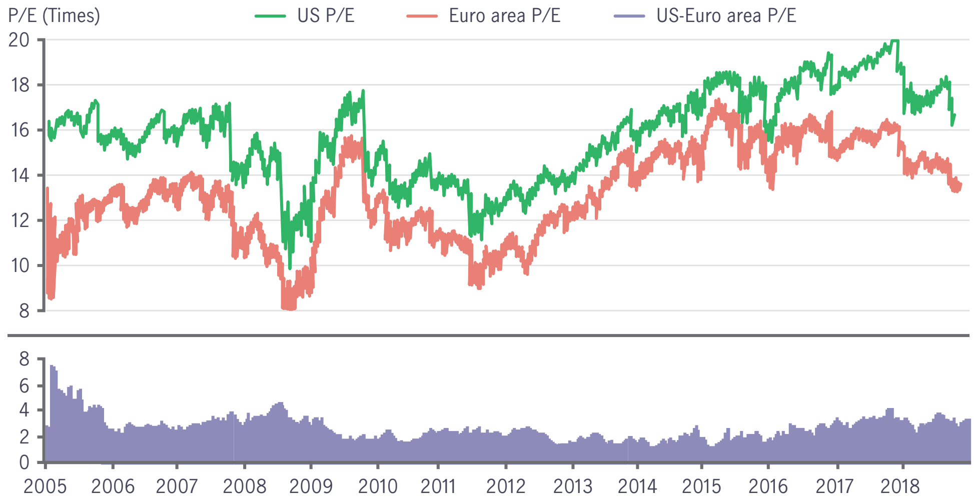
Chart 2: The European Citi Surprise Index has started to marginally improve



Source: Bloomberg, Manulife Asset Management.

[2] Manulife Asset Management, FactSet, February 2019.

Chart 3: US-Euro Area forward price-to-earnings ratio (PE)'s gap close to decade highs



Source: TS Lombard, MSCI, Bloomberg, Manulife Asset Management. As of 8 March 2019.

Upsides ahead

In our view, there are some moderate tailwinds that could help Europe find bottom in the second quarter.

- A stabilisation in Chinese growth is positive for Europe—we expect the full impact to be felt in the second half of 2019 when what's currently a headwind for global growth morphs into a tailwind for global, and specifically, European trade. Similarly, an improvement in US-China trade relations could help unlock pent-up demand that will support European sentiment.
- The European Central Bank made an important dovish shift in March; most notably, the central bank extended its forward guidance by stating that it wouldn't raise interest rates in 2019. This dovishness works through two channels: First, it keeps interest rates at a low level that's supportive of businesses and consumers. Second, it keeps a cap on euro currency appreciation, which in turn keeps European exports competitive. Equally important is its decision to reintroduce targeted longer-term refinancing operations (TLTROs) in autumn, which should provide crucial support to the financial system.
- We expect fiscal policy in the eurozone to become stimulative in 2019, particularly in France. This is in sharp contrast to the United States, where fiscal policy could quickly become restrictive in late 2019 and possibly tighter by early 2020.
- Wage growth is accelerating, thanks to tighter labor conditions and the introduction of country-specific regulations—examples include higher wages for German teachers and police and a rise in Spain's minimum wage. Lower inflation also supports the increase in real personal disposable income.

Tail risks remain significant

As much as we believe that the balance of risks for European growth is tipped more to the upside than the downside, we're not ready to be positive about the region's outlook until (i) we see a stabilisation in economic data and (ii) we're past two important tail risks:

1. Auto tariffs. On 17 February, the US Department of Commerce submitted a Section 232 report addressing the effect of auto imports on national security. The president has 90 days from that day to decide whether to impose import tariffs on some, or all, cars or car parts. If introduced, this could have important implications for German and European growth. It's difficult for us to have a positive view of European assets until this hurdle is cleared.
2. Hard Brexit. While the risk of a no-deal Brexit appears to have receded somewhat, the complexity of the issue means that uncertainty could flare up again unless meaningful resolutions have been undertaken. In the event of a hard Brexit, we would be concerned about further drags on European growth and the impact of a weakened euro and pound sterling, particularly against a stronger USD.

04 This month's FAQs

1. Will the US Federal Reserve (Fed) hike rates in 2019? This month, we revised down our probability of a rate hike in the United States to only 30%, meaning we no longer view the possibility of another rate hike as our base case. The change in our view is predicated on two developments: first, a shift toward a dovish stance in recent communications from global central banks in developed markets (e.g., the Bank of Canada, ECB, and Reserve Bank of Australia). In our view, this makes it more difficult for the Fed to maintain its hawkish bias. Second, Fed officials have made an important shift in tone in their communications over the past month, saying that they're interested in achieving average inflation of 2% over the cycle. This suggests that the Fed will not only allow greater than 2% inflation, but could also seek to create it. Raising interest rates would work against that goal in light of the current inflation outlook and would appear inconsistent.
2. You mentioned the importance of tax refunds to the US consumer this year. How are we tracking that compared with 2018? So far, tax refunds are tracking almost tick for tick with last year's release. While incremental stimulus is expected this year, possible volatility around the government shutdown could—to some extent—be slowing the pace of refunds. This is still a spot to monitor, but should, at the margin, provide a boost to consumption in the second quarter.
3. What do higher MSCI weightings for Chinese A-shares mean for flows? Last month, MSCI announced a four-fold increase in Chinese A-shares' weight in its indexes, which means the inclusion factor would rise from the current 5% to 20% by November. Average fund flows into Chinese equities rose from US$6 billion to US$16 billion a quarter,[3] when the index provider first included A-shares into its indexes in 2018, raising the inclusion factor from 0% to 5%. The more substantial increase announced for this year suggests we could see inflows of between US$50 billion and US$60 billion over the respective time period. While we expect investment sentiment toward China to improve in the near term as the positive effects of recently introduced monetary and fiscal stimulus measures begin to seep through, greater fund flows into A-shares should also help China outperform its emerging-market Asia peers.
4. Where are oil prices going next? We expect some mild upside in global oil prices (5%–10%) in the next 6 months as OPEC continues to implement production cuts and global demand concerns wane.[4] Recent gains in oil prices are also supportive of our view that inflation will reaccelerate in the second half of the year, a development that could be supportive of steepening yield curves.

[3] Exante data, as of 28 February 2019.
[4] Bloomberg, OPEC, EIA, as of 19 February 2019.

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