Manulife Investment Management

Q1 2023 | Global Macro Outlook

The year ahead

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Global overview

Trends that could define 2023

As we consider the year ahead, we expect to see a game of two halves, where challenging conditions will prevail in H1 before improving through H2. The aggressive pace of monetary tightening and its associated lagged effects should drive a synchronized global growth downturn in the first half.

We expect global growth to slow materially and come in substantially lower than the below 3% threshold that the International Monetary Fund uses to define global recessions.[1] A downturn of this magnitude—excluding the COVID-19 shock and the global financial crisis—could make 2023 the worst year for global growth since the 1980s. We expect the economic slump to become more apparent in the first half of the year, with a cyclical bottom only occurring in Q2/Q3.

Our analysis shows that most advanced economies are likely to experience a recession in the year ahead. Given that the U.S. Federal Reserve (Fed) has been hiking rates at the fastest pace in decades, the U.S. economy will be facing the lingering effects of substantial policy tightening, with real rates rising while inflation eases gradually.

2022 has been a year to forget for many investors. Persistent stagflationary dynamics, continued geopolitical upheaval, and an aggressive Fed drove double-digit declines across many asset classes, and there were few places to hide.

Market's view on the probability of a global recession (%)

Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 13, 2022.

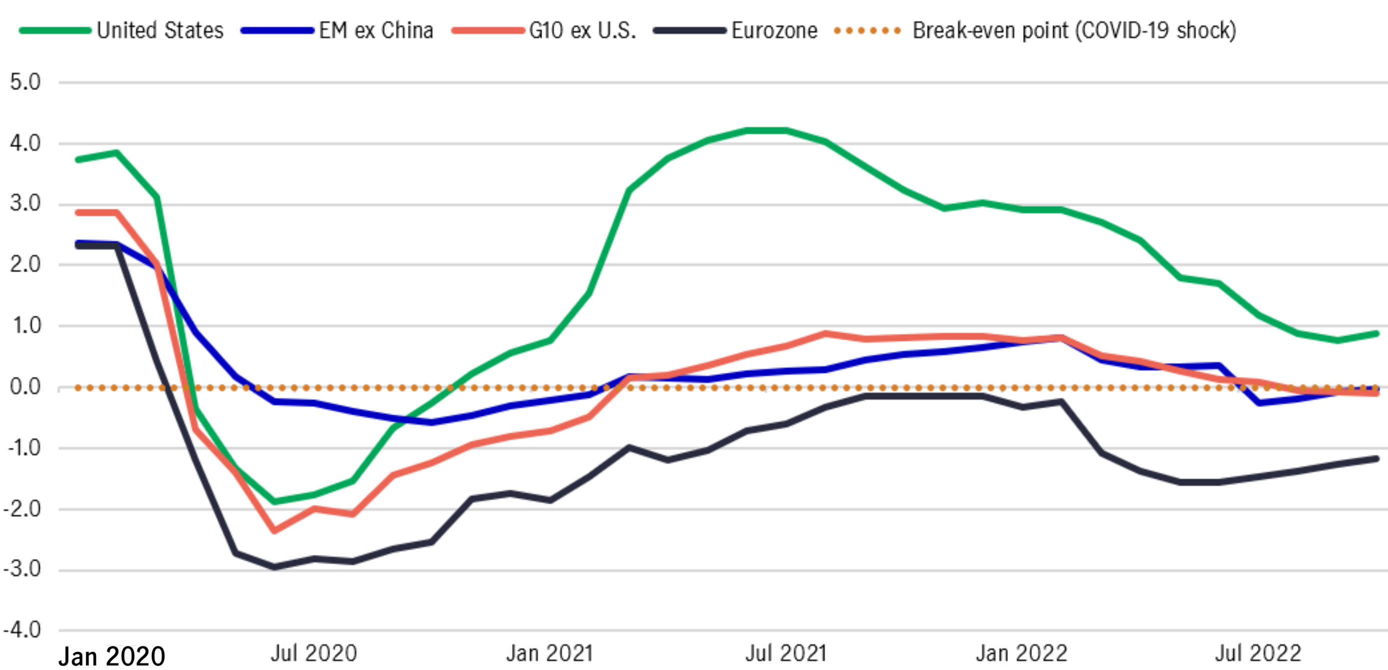
1 *Collapse and Revival: Understanding Global Recessions and Recoveries*, International Monetary Fund, 2015.

Economic weakness will be particularly pronounced in interest-rate-sensitive economies such as Canada, Australia, New Zealand, and the United Kingdom—these economies would almost certainly be confronting downside risks as a result of spillovers from their respective weaker housing markets. In Continental Europe, the growth drag will predominantly stem from particularly large negative terms-of-trade shocks.

Meanwhile, slowing final demand from advanced economies, elevated inflation, and a still-strong U.S. dollar (USD) will likely morph into material headwinds for growth in emerging markets (EM). In mainland China, a bumpy exit from zero-COVID policy, weak external demand, a still struggling property sector, and insufficient policy support look set to extend the country's below-trend GDP into 2024. That said, the prospects for the rest of Asia's economies are a little more mixed: We expect weak foreign demand to weigh on export growth, but North Asia is particularly vulnerable in light of a likely inventory overhang. On the other hand, weakness in ASEAN countries will likely be cushioned by a strong reopening bounce and relatively healthy household balance sheets.

Amid a macro backdrop characterized by elevated global inflation, uncertainty over when Fed rates might peak, and rising odds of a global recession, the first half of 2023 could bear witness to a series of sharper—and longer—bouts of market volatility. Thankfully, the picture does brighten slightly in H2, during which these headwinds are likely to moderate, ushering in more conducive conditions for financial markets.

Cumulative forecast revisions to GDP growth, 2020–2023



Source: Bloomberg, Manulife Investment Management, as of November 26, 2022. EM refers to emerging markets. In this chart, EM represents the combined reading of the following economies: Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, the Philippines, Poland, Russia, South Africa, and Turkey. G10 refers to the group of 11 leading industrial countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

Our base-case expectations

Our base case is that the looming negative demand shock is sufficient to see growth concerns overtake fears about the inflationary backdrop, a development that could pave the path to a dovish policy pivot among central banks, leading to monetary easing in Q4. This is consistent with current market pricing and the historical tendency over the past five decades, where rapid and substantial rate hikes have tightened financial conditions so quickly that the subsequent growth slowdown prompted a sharp turnaround in the Fed cycle from tightening to easing.

While our forecast for the first half of 2023 may seem bearish, it's always helpful to remember that periods of volatility often create opportunities. It's also a period in which active managers can flex their skills and extract alpha. Crucially, there's light at the end of the tunnel, as we expect trading conditions to improve in H2.

Three key risks to our baseline assumptions

1 **Timing of the stagflation trough: stagflationary dynamics may extend into late 2023/early 2024**

The impact that monetary policy has on the real economy typically isn't easily observable until 12 to 18 months later. We're wary that the transmission of the current global tightening cycle has barely begun; historically, the slowdown in growth becomes manifest once the tightening cycle has *ended*. Looking back to the year just past, global financial conditions only moved into restrictive territory in March 2022, a threshold that the United States crossed six months later. Put differently, it could be some time before we get past the most painful part. It's also worth noting that the nature of the current cycle—in which a large component of inflation is supply driven and becoming geopolitically entrenched—is also very different from past cycles. The supply/demand balance remains tight, and commodity constraints are more binding than usual. Crucially, China's reopening may bring commodity constraints back into focus and complicate the monetary policy picture for developed markets.

The rebuilding of commodity reserves such as oil (e.g., the Strategic Petroleum Reserve in the U.S.), gas (as Europe refills its storage after the winter), grains (India may start rebuilding its food grain buffers), strategic commodities (e.g., high-end semiconductors and critical commodities such as hydrocarbons), and the volume of metals needed in the green transition could well push commodity prices higher. In terms of monetary policy, although the Fed is set to raise interest rates at a slower pace, Fed Chair Jerome Powell noted that the end point for the central bank's current tightening cycle may result in a higher terminal rate than previously expected. Meanwhile, several Fed speakers have signaled that rates could remain at an elevated level for a longer period of time before they could even begin to consider easing.

> "We're wary that the transmission of the current global tightening cycle has barely begun; historically, the slowdown in growth becomes manifest once the tightening cycle has *ended*."

Key signposts to monitor

- Global inflation
- Fed policy and statements
- Evolution of China's zero-COVID policy
- Pace of inventory adjustment

2 Mainland China's COVID controls

We maintain our view that the path to reopening will gain further momentum after the National Party Congress in March 2023. The recent call for a whole society push to encourage the elderly to get vaccinated is an important shift, although it remains to be seen whether persuasion alone will increase vaccine take-up or if the rollout will proceed as quickly as planned.

Key signposts to monitor

- Vaccination/fatality rate
- Healthcare infrastructure capacity
- Announcement of a centrally planned top-down structured reopening

3 USD strength: too early to call a peak

A weaker USD is typically associated with an improved global growth outlook and a risk-on environment for risk markets; the converse is also true. Sustained USD depreciation would require global economic growth outside of the United States to outstrip U.S. growth and for interest-rate differentials between the United States and the rest of the world to narrow; however, neither dynamic appears likely for the time being. Additional tailwinds for the USD could arise from EM central banks replenishing their foreign exchange (FX) reserve buffers.

Key signposts to monitor

- U.S. growth
- Interest-rate differentials relative to the rest of the world

Continued U.S. dollar strength could negatively affect global growth prospects

Source: Macrobond, Manulife Investment Management, as of December 13, 2022. The gray area represents recession. It is not possible to invest directly in an index.

Second guessing central banks: when does a policy pivot *count* as a pivot?

This is another factor that we think investors should take into consideration: How *should* we define pivots? In recent weeks, market attention has shifted to forecasting the peak in the global tightening cycle with many references to central bank policy pivots. These four words, from what we can see, have become the phrase du jour to describe just about *any* shift in monetary policy.

Such characterization, however, doesn't adequately capture the nuance in interest-rate cycles, as these pivots invariably involve a high degree of variability in terms of timing and magnitude. Crucially, we aren't just talking about just one central bank but different central banks, each of which operates under different constraints and challenges.

In our view, it could be helpful to think about the sequence of a policy pivot through the following framework:

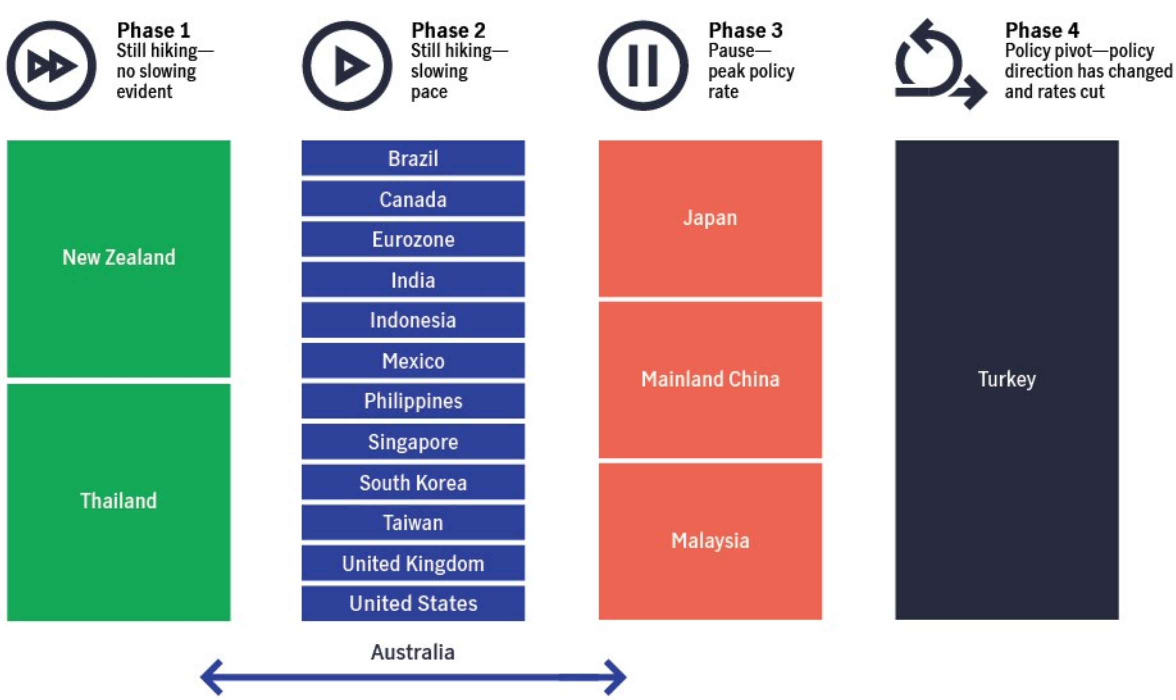
Phase 1 **Active tightening—**Increasing pace/no slowing pace evident

Phase 2 **Still tightening—**Slowing pace of tightening

Phase 3 **Peak policy rate—**Paused

Phase 4 **The pivot—**When policy changes direction and rates are cut

Monetary policy: transitioning from tightening to easing



Source: Manulife Investment Management, as of December 16, 2022. The Reserve Bank of Australia straddles phases one, two, and three: Despite announcing smaller interest-rate cuts recently, minutes and statements from the central bank suggest it wants to maintain optionality for larger hikes in the future.

When viewed through this framework, it's clear to us that very few central banks are really at the point of a *genuine* policy pivot or ready to move from the end of the tightening cycle to the start of an easing cycle. As such, we believe the running debate for the first half of 2023 will be the pace at which central banks in phases one and two will shift into phases three and four.

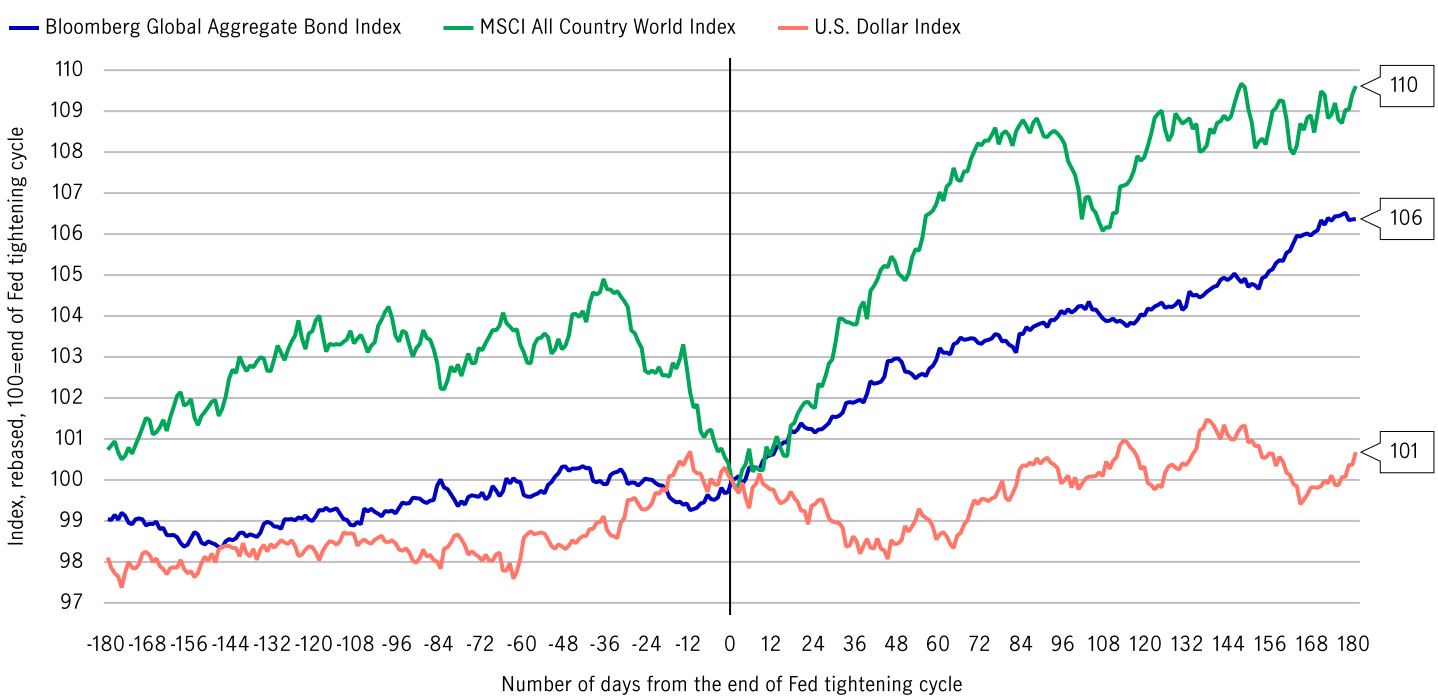
In our view, very few central banks are at the point of a *genuine* policy pivot.

How have asset markets traditionally performed around shifts in the Fed's rate cycles?

Few would dispute that the most consequential central bank policy path for financial markets is that of the Fed's. Since our base-case expectation is for the fed funds rate to peak at close to 5% by the first half of 2023 and for rate cuts to occur before year end as growth concerns overtake worries over the inflationary backdrop, it's worthwhile assessing how risk assets have typically behaved during shifts in the Fed's tightening cycle.

- **Global equities**[2]**—**Since hitting a low in October 2022, global equities have recovered by between 10% and 15%[3] on signals that the Fed could slow its pace of tightening. Our analysis, however, shows that equities tend to bottom only at the end of a tightening cycle, not before. In other words, a slowdown in the pace of rate hikes has historically not been a sufficient condition for equities to bottom.

Market behavior when the Fed's tightening cycle ends



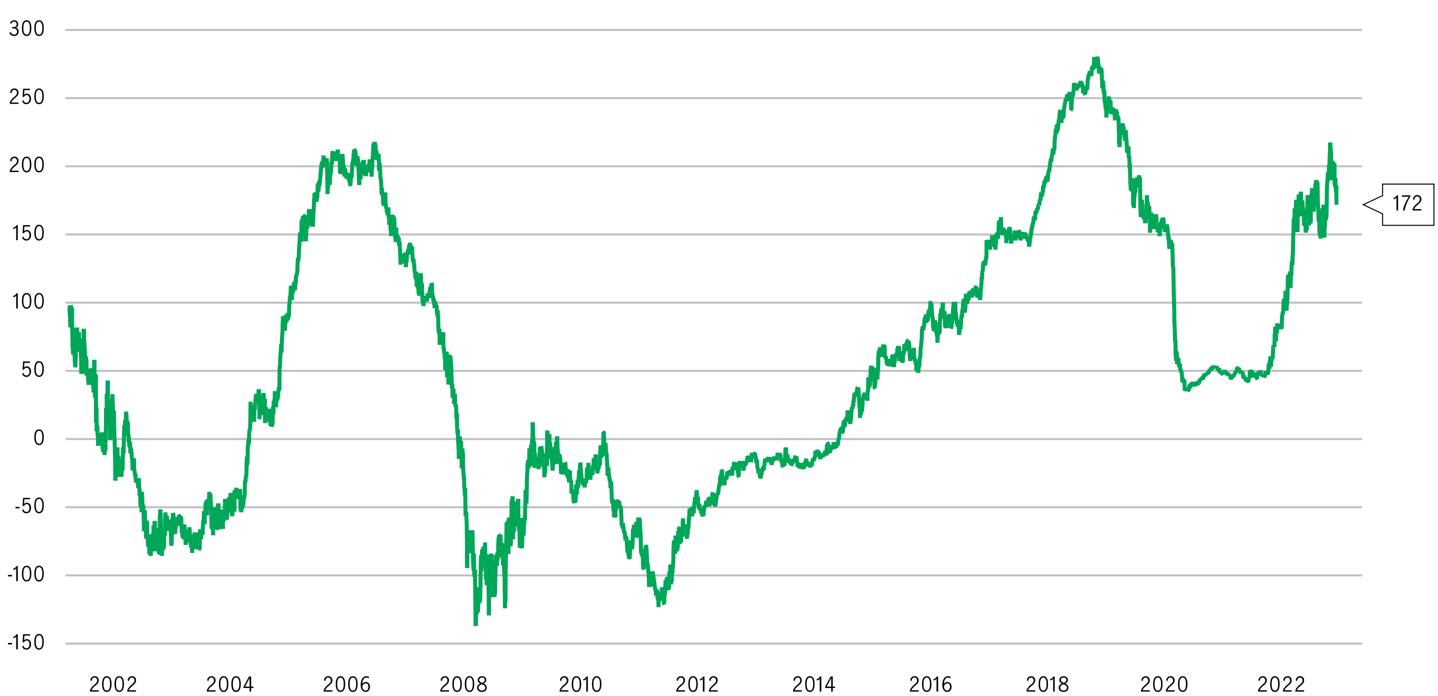
Source:: S&P Dow Jones Indices, U.S. Department of the Treasury, Macrobond, Manulife Investment Management, as of December 13, 2022. Fed refers to the U.S. Federal Reserve. It is not possible to invest directly in an index.

2 We've used the MSCI All Country World Index, which tracks the performance of publicly traded large- and mid-cap stocks of companies in both developed and emerging markets as a proxy for global equities. It Is not possible to invest directly in an index. 3 Bloomberg, as of December 13, 2022.

- **Global bonds**[4]—As with equities, global bonds have recovered from October's sell-off on the slower Fed tightening narrative. Once again, our analysis shows that global bonds have historically bottomed at the end of the Fed's tightening cycle; a slowdown in the pace of Fed rate hikes alone may not be a sufficient condition.
- **FX**—As of this writing, the U.S. Dollar Index, which is a proxy for the USD, has weakened ~8.5%[3] from its late September peak on the belief that the Fed will be slowing the pace of its interest-rate hikes. Market consensus is that the USD has peaked, and the Fed could soon pause interest-rate hikes altogether and begin lowering rates in 2023. While a peak in U.S. yields is a *necessary* condition for the USD to weaken, it isn't a sufficient condition. Sustained USD depreciation would require global economic growth (ex-U.S.) to outstrip U.S. growth and for the interest-rate differential between the United States and the rest of the world to narrow. Neither of these two conditions seems likely to materialize for the time being.

In addition, our analysis shows that, historically, the USD, on average, enters a very short-lived period of depreciation at the end of a Fed tightening cycle that typically lasts 40 days or so; however, the currency has historically managed to reclaim all lost ground within the following 3 months. We don't expect things to be different this time: Regardless of whether the Fed pauses its hiking cycle in 2023, the USD still retains a yield advantage against most other currencies. This perspective is also consistent with the second cyclical driver of the USD—U.S. economic outperformance.

Interest-rate differential: U.S. spread to DXY less U.S. 2-year yield (bps)



Source: Macrobond, Manulife Investment Management, as of December 13, 2022. DXY refers to the U.S. Dollar Index. It is not possible to invest directly in an index. Bps refers to basis points.

4 We've used the Bloomberg Global Aggregate Bond Index, which tracks the performance of global investment-grade debt in fixed-rate treasury, government-related, corporate, and securitized bond markets, as a proxy for global bonds. It is not possible to invest directly in an index.

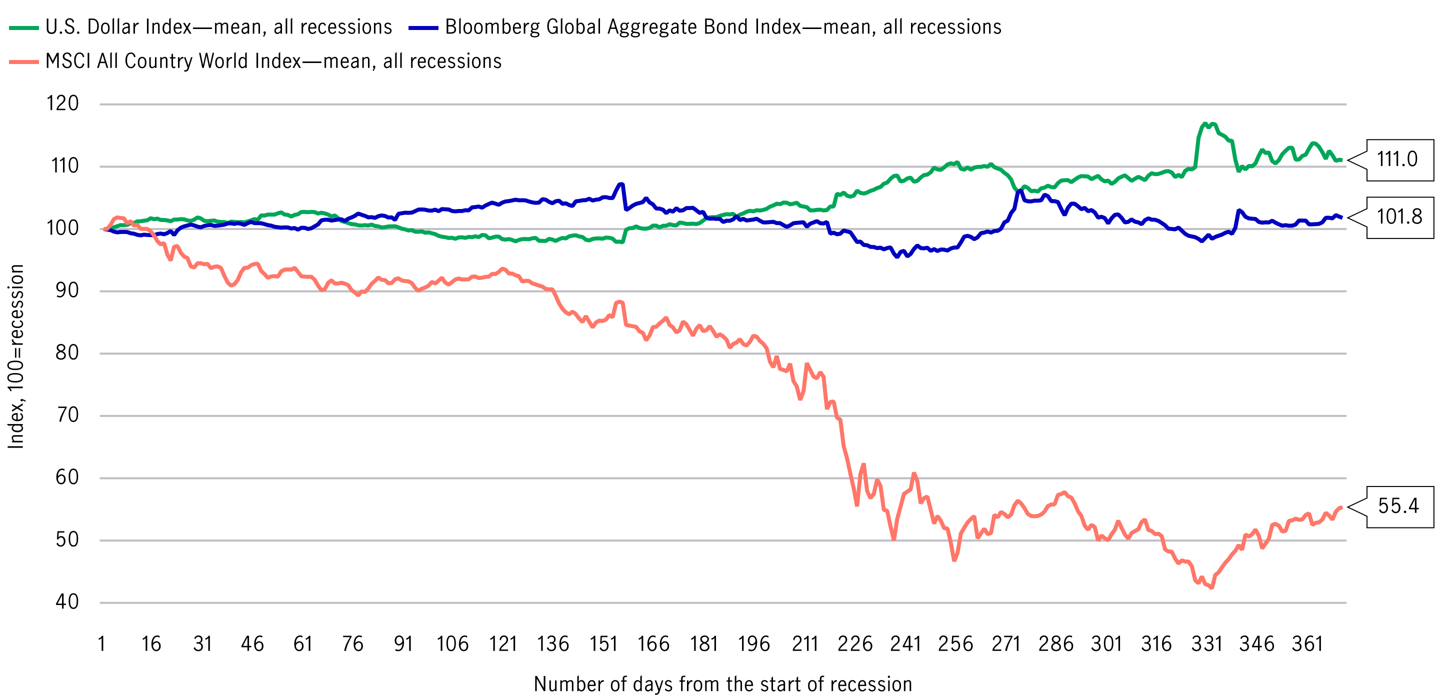
Speculation about a possible global recession mounts

While the market consensus on a global recession has been rising in recent months, it has yet to tip into consensus view, with a probability of below 50%. Notably, the market remains skeptical about the likelihood of a U.S. recession. When we add an additional screen in our analysis of risk asset performance during U.S. recessions, we find that global equities tend not to hit bottom before a recession has begun. The argument that global yields have peaked before the official onset of a U.S. recession, however, is a little more compelling. In regard to the USD, a U.S. recession isn't necessarily USD negative unless the country's economy is leading the world into a global recession. This is the case even when the Fed is cutting more aggressively than other central banks (due to the USD's safe haven status).

> "The key, as always, is to remain cautious and steer clear of confirmation biases and groupthink."

In conclusion, while it might be psychologically inviting to believe that the worst of the market upheavals is over, our analysis suggests otherwise. Policy takes time to work its way through to the real economy, and there's no reason to assume that things could be different this time. That said, experienced investors understand instinctively that market swings can bring about compelling opportunities and that sharp market movements are typically smoothed out over a longer investment horizon. The key, as always, is to remain cautious and steer clear of confirmation biases and groupthink. The way we see it, things will get better, and positive change is on the horizon, but we're just not quite there yet.

How equities, bonds, and the USD behave during previous U.S. recessions



Source: Macrobond, Manulife Investment Management, as of December 13, 2022. USD refers to the U.S. dollar. It is not possible to invest directly in an index.

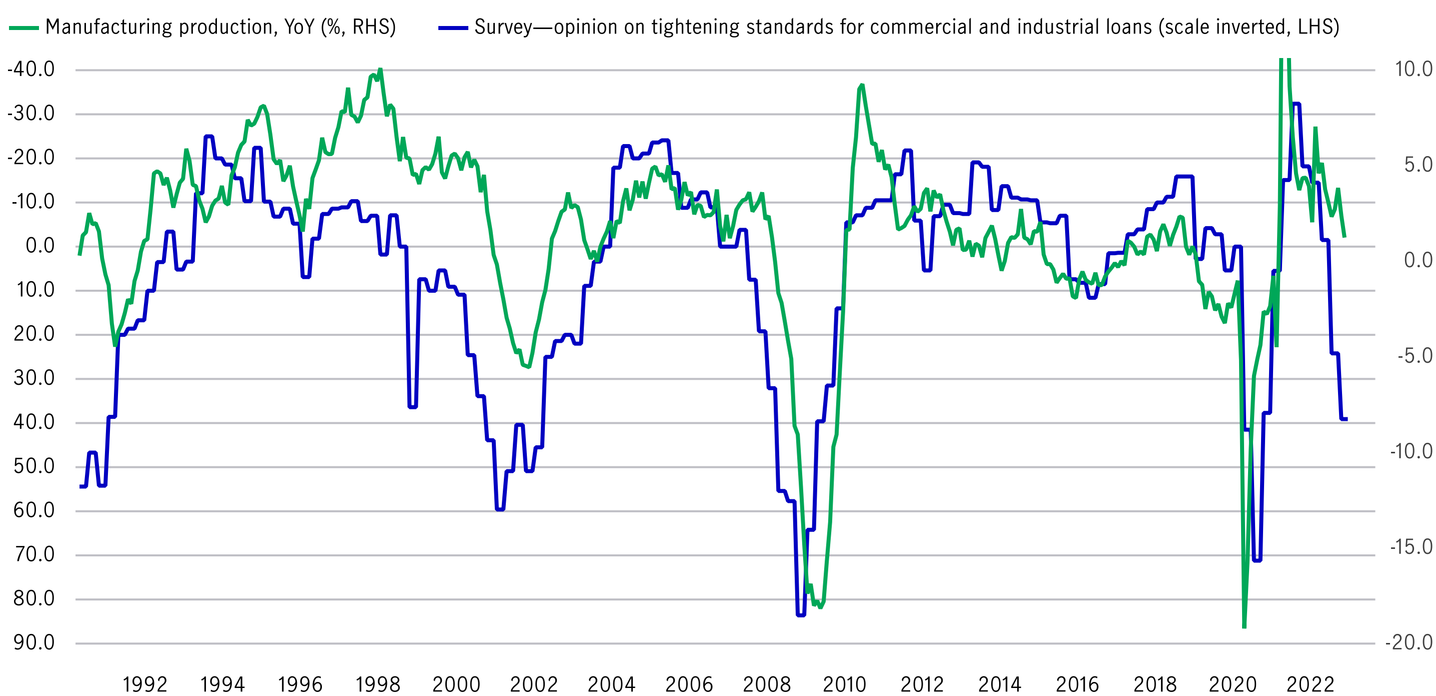
United States

Big picture

We expect the United States' economic outlook to get progressively brighter as the year ahead progresses. 2023 is likely to begin with the United States staring down a recession as the cumulated lagged effects of 2022's monetary policy tightening take their toll on the consumer, employment, and manufacturing activities. Typically, we could have expected fiscal support to cushion the blow, but government spending is also likely to be a headwind to growth within the context of the scale of pandemic relief; a split Congress also makes further material stimulus unlikely. Monetary policy will likely—once again—be a dominant theme, with markets in search of peak fed funds rate and its timing. We expect rates to hit a peak range of 5.00% to 5.25% in March. Beyond that, the focus should shift to the likely timing of the first possible interest-rate cuts, which we believe will take place in Q4 as employment and inflationary pressures weaken enough to justify easier policy.

"Monetary policy will likely—once again—be a dominant theme, with markets in search of peak fed funds rate and its timing."

Tighter policy leads to tighter lending standards, which leads to weaker economic growth (%)



Source: U.S. Federal Reserve, Macrobond, Manulife Investment Management, as of December 12, 2022. YoY refers to year over year. LHS refers to left-hand side. RHS refers to right-hand side.

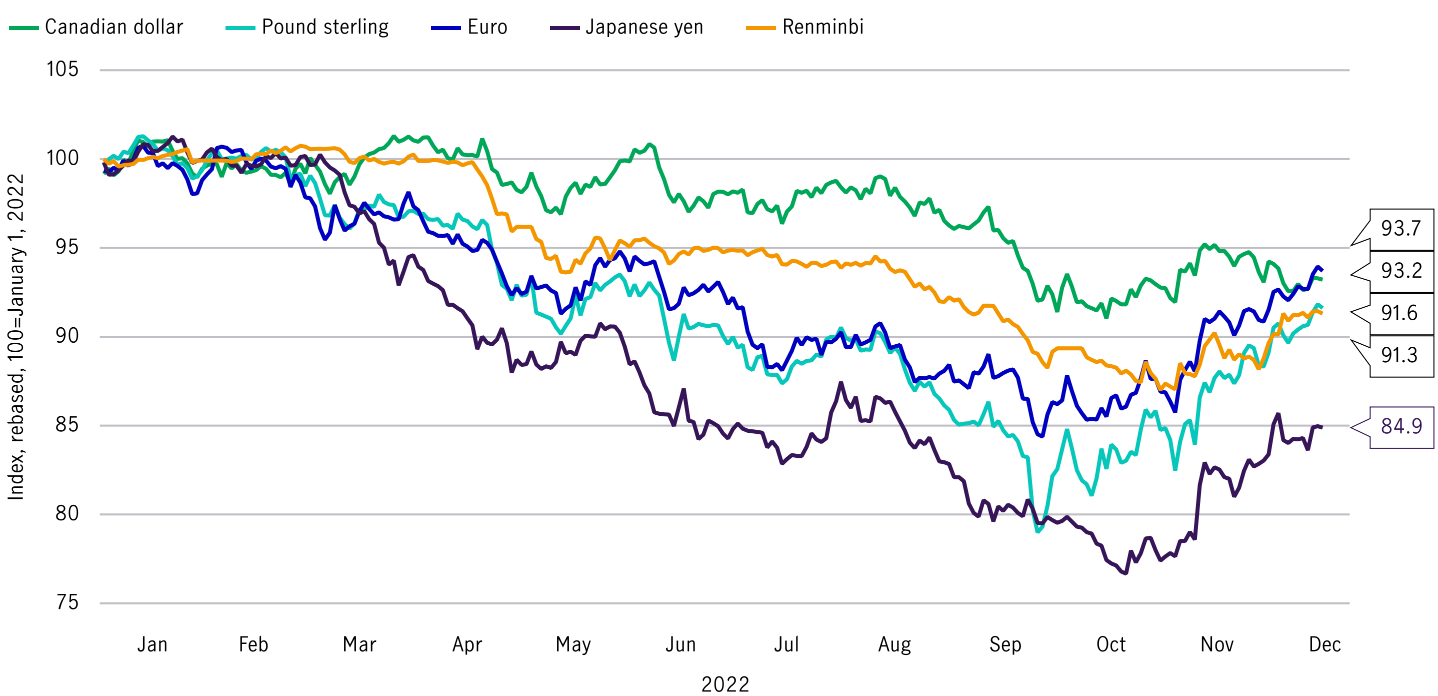
What we're watching

- **The extent of labor market slack—**Whereas inflation was very nearly the singular focus in 2022, we expect more attention will be given to the extent of labor market slack this year. A precondition for Fed easing is deceleration in wage growth—a critical driver of medium-term inflation; however, should the labor market remain stubbornly tight for most of the year, it could delay the policy pivot.
- **The services sector—**While most signs are clearly pointing to a slowdown in the consumption of goods, the services sector remains resolutely strong. We would expect a moderation to materialize over the course of the year.
- **USD—**In our view, any investment in international equities should be at least evaluated through an FX lens.

Key market views

- **Equities—**We remain cautious until it's clear when policy rates might peak and when we're convinced that markets have properly priced in the likelihood of a recession. Consequently, we believe a more defensive tilt to equities into the new year makes sense.
- **Fixed income—**Higher interest rates have erased the search-for-yield narrative that has dominated the past decade as fixed income becomes an increasingly attractive opportunity. As with equities, credit and high-yield spreads haven't reached levels that would typically be associated with a recession; as such, we have a bias toward higher-quality names.

Exchange rates are a key consideration in any investment in 2023



Source: Bloomberg, Manulife Investment Management, as of December 12, 2022.

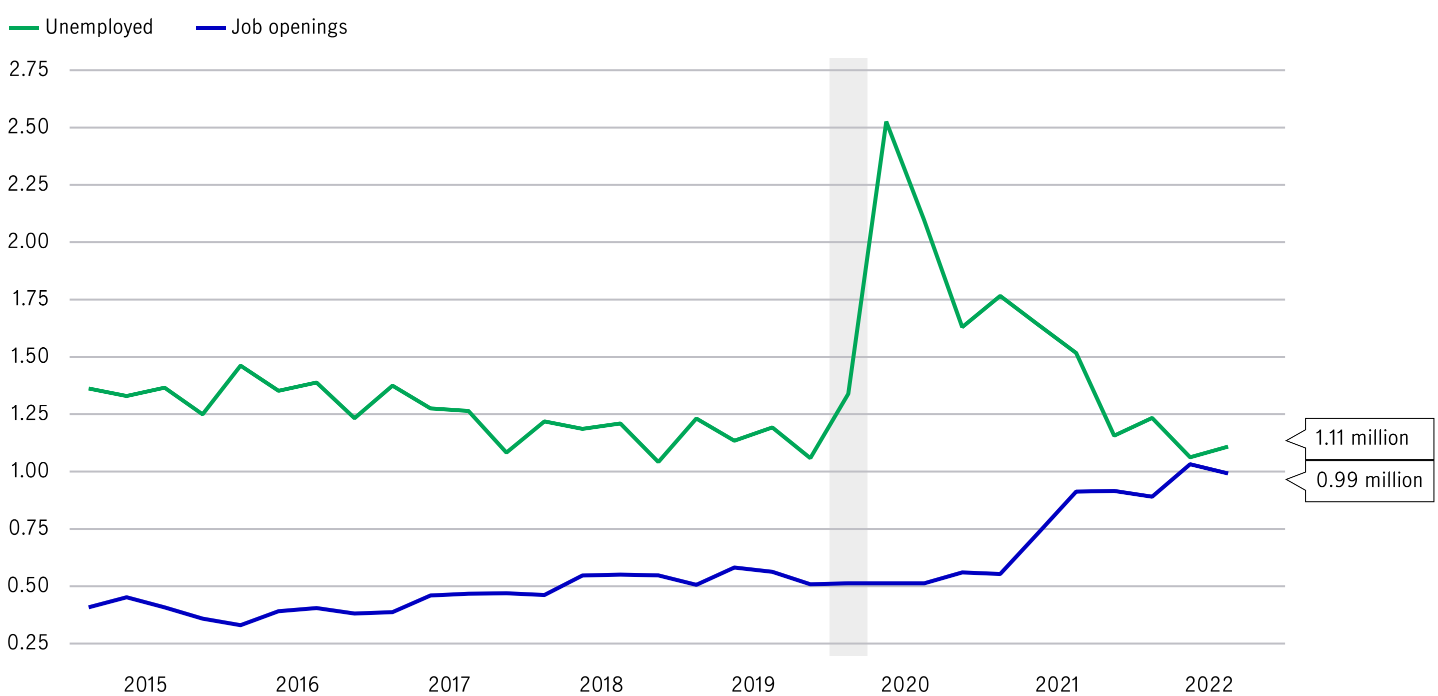
Canada

Big picture

We expect Canada's economic growth to turn negative in 2023. The combined effect of slower consumption growth, a large inventory overhang, and weak global demand is expected to trigger a moderate recession, followed by a shallow recovery. So far, residential investment has been mostly weighed down by a collapse in real estate transactions. A slowdown in new home building should follow, putting additional downward pressure—albeit temporarily—on GDP growth. Meanwhile, given the country's larger share of employment in highly cyclical industries such as construction and manufacturing relative to the United States, the Canadian labor market is somewhat more vulnerable to a global recession. That said, record-high labor shortages across most industries could lead to a smaller-than-usual decline in hours worked in the year ahead. Finally, we expect inflation to continue to ease as the supply side improves alongside softer demand for goods and services.

In our view, record labor shortages across most industries could lead to a smaller-than-usual decline in hours worked in the year ahead.

Acute labor shortages could provide a buffer against unemployment



Source: Statistics Canada, Macrobond, Manulife Investment Management, as of December 13, 2022. The gray area represents recession.

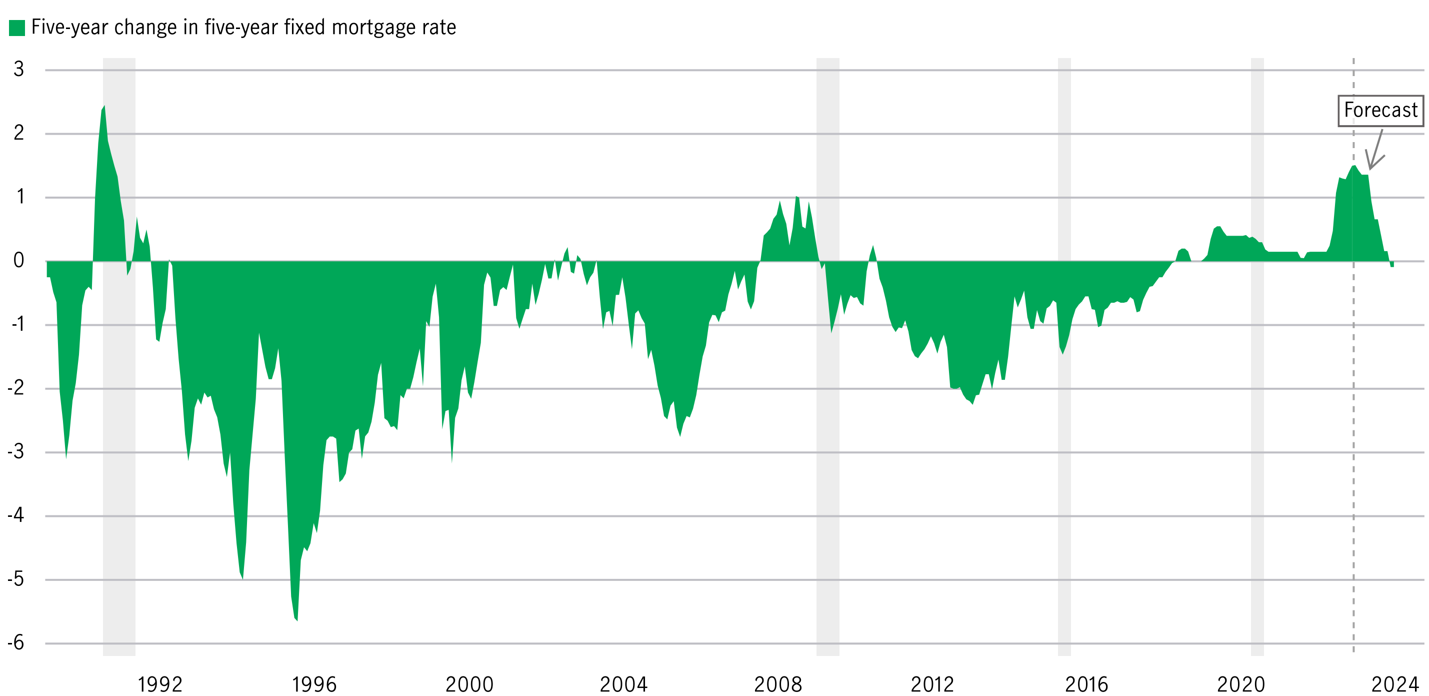
What we're watching

- **Housing activity—**35% of Canadians have a mortgage on their home[5] and, for much of 2023, they'll need to refinance at a significantly higher interest rate. Any sign of financial distress would be worrisome; however, with the Bank of Canada (BoC) being near the end of its tightening cycle, we believe mortgage rates are likely to peak soon.
- **QT—**In 2022, the BoC's balance sheet shrunk by roughly CAD$90 billion[5] as maturing assets (mainly government bonds) weren't repurchased by the central bank. Quantitative tightening (QT) is expected to continue through 2023, putting additional pressure on an already volatile and somewhat illiquid bond market. We'll watch for signs of stress in this important segment of the Canadian financial system.

Key market views

- **Equities—**With a majority of sectors outperforming the S&P 500 Index year to date, the S&P/TSX Composite Index looks to be a reliable defensive strategy in a difficult market environment. That said, as we move into a disinflationary environment in 2023, with commodity prices easing, it may be difficult to repeat the outperformance that we saw in 2022. A housing downturn could also exert pressure on the performance of financial sector firms.
- **Rates and currencies—**We continue to anticipate rate cuts in the second half of 2023 in response to a weak economic environment and lower inflation. Canadian government bond yields are likely to decline in anticipation of these expected rate cuts. Meanwhile, lower commodity prices and a higher-than-usual spread between U.S. and Canadian yields could prevent the Canadian dollar (CAD) from appreciating substantially.

Canada: the steepest mortgage refinancing shock since the 1990s (%)



Source: Bank of Canada, Macrobond, Manulife Investment Management, as of December 12, 2022. The gray areas represent recessions.

5 Bank of Canada, as of December 6, 2022.

Euro area

Big picture

The deterioration in the euro area's economic outlook appears to have stabilized, with expectations of near-zero growth in 2023 followed by a modest expansion in 2024. While the outlook remains disappointing, recent stabilization has delivered a meaningful recovery in European equities on both an absolute and relative basis. We believe the European Central Bank (ECB) will hike an additional 100 basis points (bps) through Q1. While the central bank's tightening cycle has so far avoided a worrisome widening in sovereign yield spreads, markets remain attentive to balance sheet developments as the ECB looks to begin QT in early 2023. The continued challenge for the euro area is the currency bloc's inflation outlook as policymakers keep a watchful eye on ongoing wage negotiations and their implications for broader price pressures. Investor concerns about the energy crisis appear to have moderated, but we remain alert to secondary developments and knock-on effects as they relate to political risk.

"The continued challenge for the euro area is the currency bloc's inflation outlook as policymakers keep a watchful eye on ongoing wage negotiations and their implications for broader price pressures."

The spread between German and Italian 10-year government bonds has tightened (%)

Source: Macrobond, Manulife Investment Management, as of December 6, 2022.

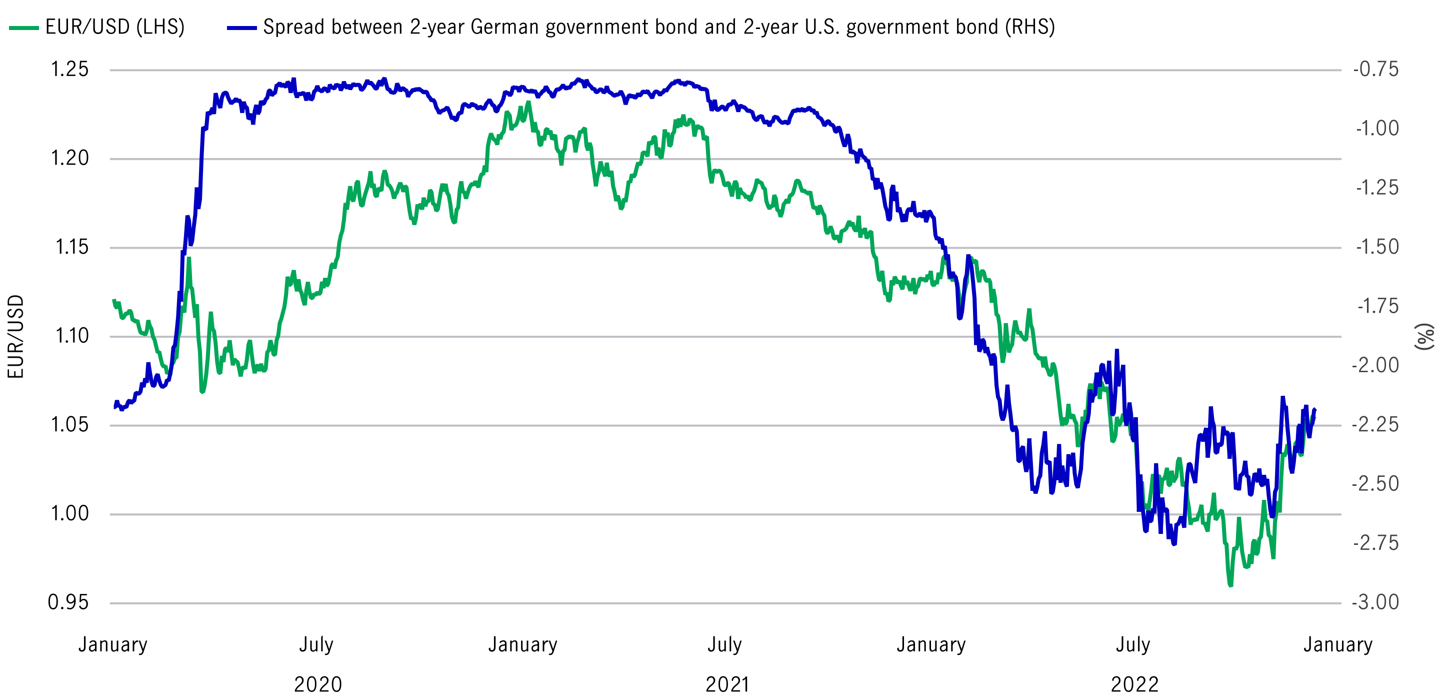
What we're watching

- **Euro area wage growth—**Given the broad rise in wage pressures across the euro area, policymakers are monitoring ongoing wage negotiations very closely as the outcomes of these talks could carry significant risk to the medium-term outlook for inflation.
- **Euro area interest rates—**Benchmark government bond yields and peripheral spreads have been remarkably well contained through the first phase of the ECB's tightening cycle, but the implementation of QT in early 2023 could bring about a disruptive market response.

Key market views

- **Equities—**European equities have staged an impressive recovery on both a relative and absolute basis as market participants have responded to the material moderation in risks related to energy, geopolitics, inflation, and growth. We see scope for continued outperformance through 2023.
- **Currencies—**We expect the euro (EUR) to continue to recover lost ground against the USD this year, moving toward the mid- to lower 1.10 level. Narrowing interest-rate differentials between the United States and the eurozone offer fundamental support to the EUR. We think excessively negative sentiment toward the EUR and existing positioning could also provide scope for further upside as investors reassess their exposure to EUR-denominated assets.

Narrowing interest-rate differentials provide fundamental support to EUR/USD



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 12, 2022. LHS refers to left-hand side. RHS refers to right-hand side. EUR refers to the euro. USD refers to the U.S. dollar.

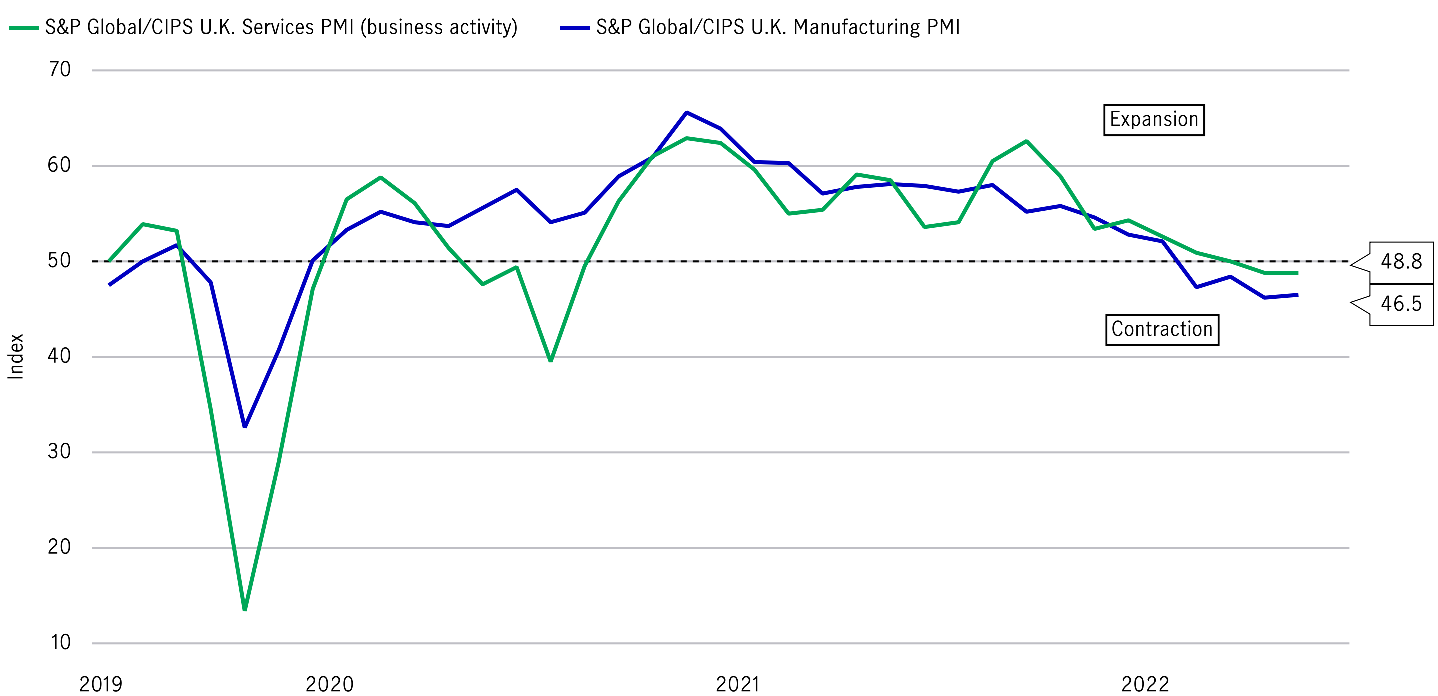
United Kingdom

Big picture

The United Kingdom's economic outlook continues to be challenging given expectations of a contraction through the first half of 2023 and only a modest recovery into the end of the year. Headwinds to economic growth remain broad, as tighter financial conditions are set to affect consumption as well as business and residential investment. The arrival of the new British Prime Minister Rishi Sunak has delivered much-needed relief to markets that had been grappling with uncertainty about the country's fiscal outlook. The Bank of England (BoE) remains hawkish—within the context of double-digit headline inflation—although recent statements from the central bank have dialed down the extent of further tightening that had been priced in by the market. We expect the BoE to reach a terminal rate of 4% in Q1 2023. Political and geopolitical risks appear to have softened considerably, despite ongoing uncertainty around the Northern Ireland Protocol and Scotland's continued attempts to call for a referendum on independence.

"Headwinds to economic growth remain broad, as tighter financial conditions are set to affect consumption as well as business and residential investment."

High-frequency growth indicators have drifted into contractionary territory



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 7, 2022. CPI refers to Consumer Price Index. PMI refers to Purchasing Managers' Index. A reading of above 50 indicates expansion and below 50 indicates contraction. It is not possible to invest directly in an index.

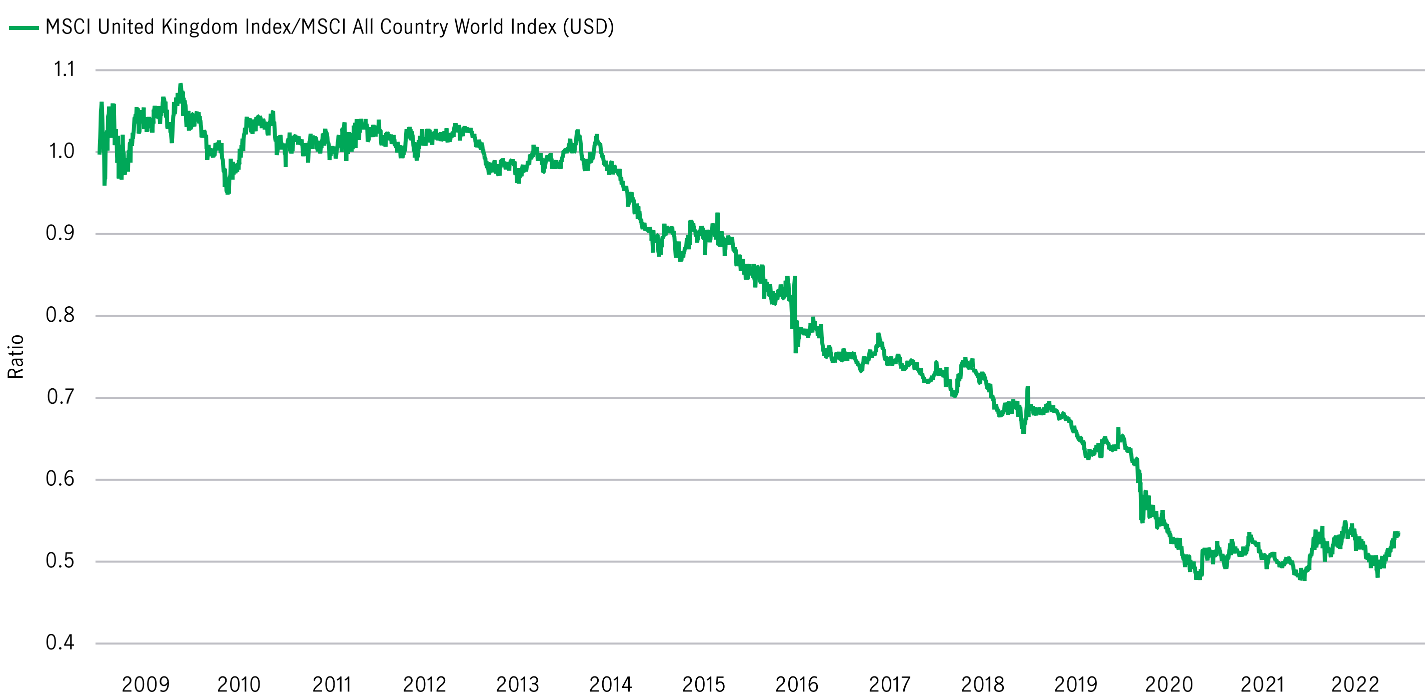
What we're watching

- **U.K. housing—**Higher interest rates have severely affected mortgage demand, and house prices are falling at an accelerated pace. The lagged impact of BoE tightening poses a significant risk for household consumption as fixed-rate mortgage holders look to refinance over the coming years.
- **Evolution of the British labor market—**The market remains exceptionally tight, with the unemployment rate hitting lows not seen since 1974. A reacceleration in wage growth could present a major challenge to the BoE as policymakers look to rein in inflation.

Key market views

- **Equities—**The recent relative outperformance in U.K. equities has been impressive. We think U.K. stocks could hit fresh postpandemic highs should global growth improve through the second half of 2023.
- **Currencies—**Pound sterling (GBP) has staged an astonishing near-20% recovery from its late September low. Prospects remain favorable given extended bearish sentiment and positioning, implying that it wouldn't take a lot of positive developments for the GBP to surprise to the upside.

U.K. equities have recently enjoyed accelerated outperformance



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 7, 2022. USD refers to the U.S. dollar. It is not possible to invest directly in an index.

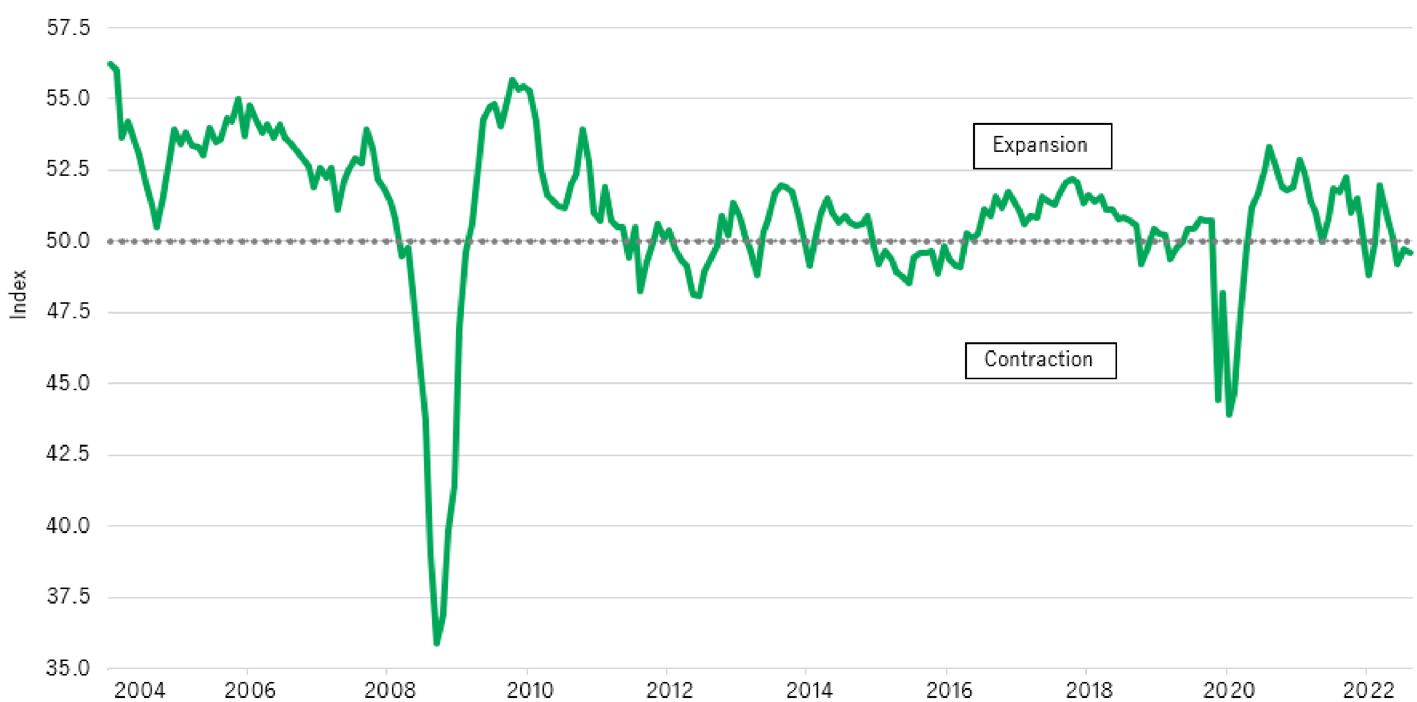
Asia-Pacific

Big picture

It will be difficult for the region to escape the downdraft of a global recession. Consumer spending will also likely be restrained by the recent aggressive interest-rate hikes and elevated inflation. Early signs of a slowing in economic activity were notable in Manufacturing Purchasing Managers' Indexes (PMIs) for November, which fell further into contractionary territory across the region, driven by a sharp decline in the employment index; in addition, there are signs pointing to slowing export growth. The good news is that the reopening of the region's economy and a continued recovery in international arrivals should provide support to growth in established tourist destinations, most notably Thailand. Meanwhile, headline inflation seems to have peaked in many economies and is likely to drop further over the coming months as transport and energy price inflation continues to ease. We also expect central banks in the region to begin to shift their focus from containing inflation to supporting demand. We think most tightening cycles will come to an end around Q1 2023, and we expect some central banks to start cutting interest rates before the end of 2023.

"The good news is that the reopening of the region's economy and a continued recovery in international arrivals should provide support to growth in established tourist destinations, most notably Thailand."

Asia's Manufacturing PMI has slipped into contractionary territory



Source: IHS Markit, Macrobond, Manulife Investment Management, as of December 8, 2022. PMI refers to Purchasing Managers' Index. A reading of above 50 indicates expansion and below 50 indicates contraction. It is not possible to invest directly in an index.

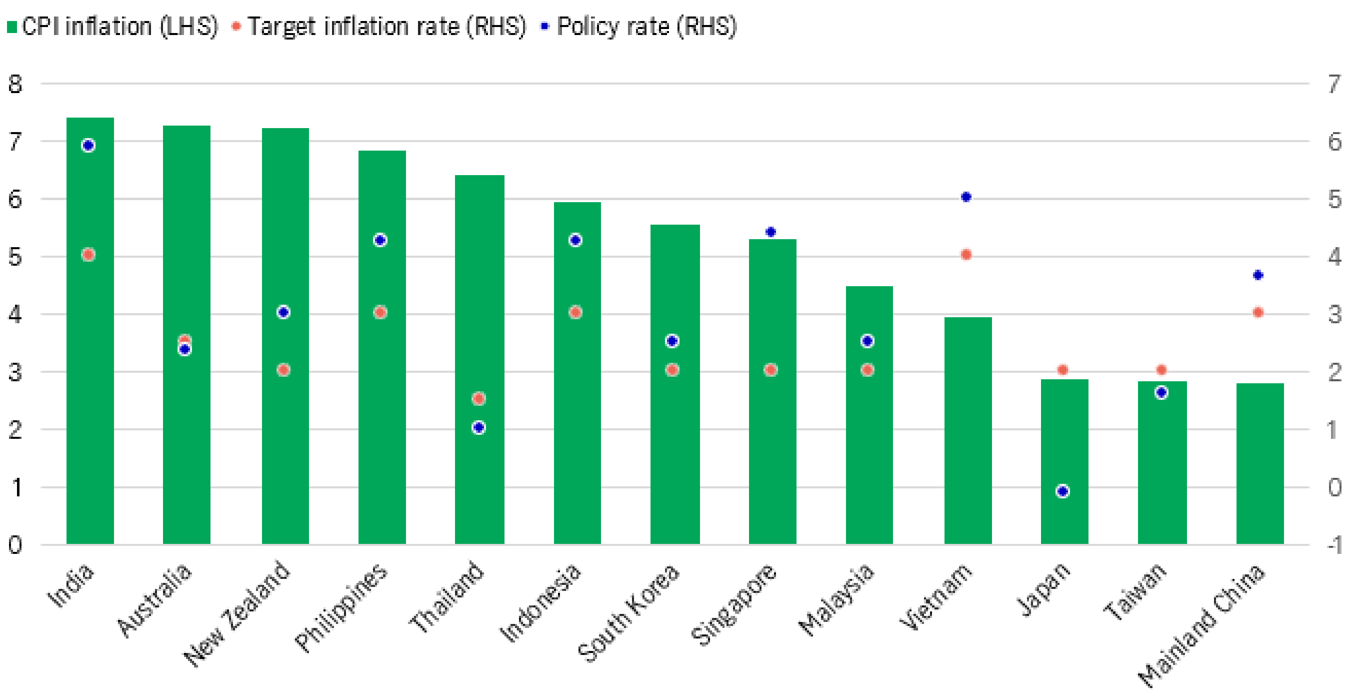
What we're watching

- **Asian export growth slowdown—**The combination of an inventory overhang in Northeast Asia and weakening global demand for Asia's exports would represent the withdrawal of a key source of USD funding and could negatively affect economic growth in the region.
- **Inflation—**While disinflation is broadening in earnest, inflation remains well above target for many, and central banks in the region may not rest easy until they see inflation back within target.

Key market views

- **Equities—**We've previously recommended selective exposure in commodity exporters versus commodity importers, but the rising risk of a global recession unfolding implies higher volatility, continued weakness in global trade, and tighter USD funding, which suggest that an additional screen to assess relative strength in external liquidity metrics could be helpful. We find Indonesia and the Philippines ranked well with the additional liquidity risk screen.
- **Fixed income and currencies—**In our view, regional policymakers aren't likely to match the timing and scale of the Fed's tightening cycle. This suggests likely outperformance in regional bonds and underperformance in local currencies.

Policy rates and CPI inflation vs. target, YoY (%)



Source: National central banks and statistics offices, Macrobond, Manulife Investment Management, as of December 2, 2022. CPI refers to Consumer Price Index. It is not possible to invest directly in an index. YoY refers to year over year. LHS refers to left-hand side. RHS refers to right-hand side.

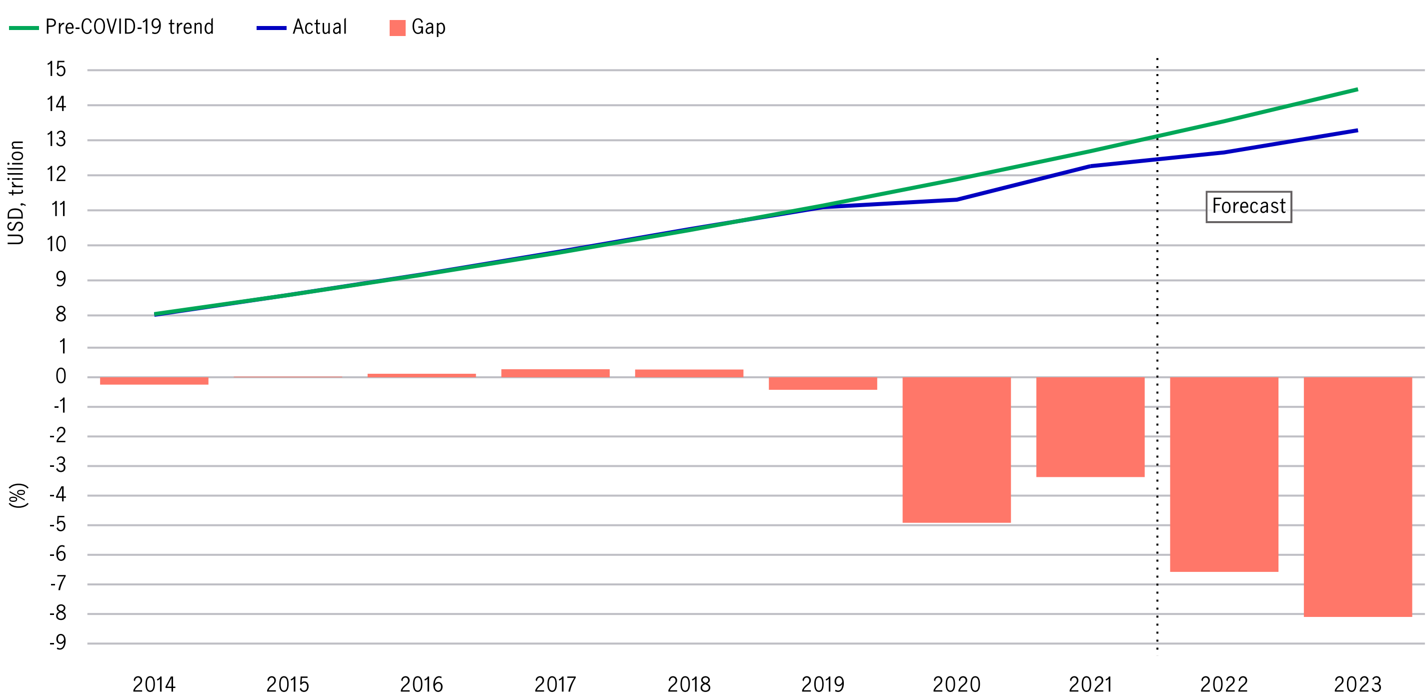
Mainland China

Big picture

Optimism has soared amid a raft of headlines indicating a relaxation of various zero-COVID measures. These include several cities easing requirements for negative tests in public spaces and scaling back testing stations, along with reports of a vaccination target of 90% for the elderly by the end of January. These are very encouraging signals; however, uncertainties remain: High-risk areas accounting for ~50% of GDP are still subject to lockdowns, and it remains unclear if the vaccination rollout can proceed as planned and whether the lighter-touch approach will succeed in quashing current outbreaks. Crucially, if these measures don't work, it's unclear what measures might be adopted in response. We've maintained a baseline forecast for meaningful reopening occurring after the National Party Congress in March. Indeed, most analysts have retained their forecast for the expected reopening despite recent developments. Senior officials are reportedly debating a GDP growth target of ~5.0% for 2023. With GDP growth estimated at 3.2% in 2022, this would leave the Chinese economy ~8.0% below its pre-COVID-19 trend (2014–2019).

"We've maintained a baseline forecast for meaningful reopening occurring after the National Party Congress in March. Indeed, most analysts have retained their forecast for the expected reopening despite recent developments."

China: 5% growth in 2023 would leave the economy 8% smaller than its pre-COVID-19 trend



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 9, 2022. USD refers to the U.S. dollar.

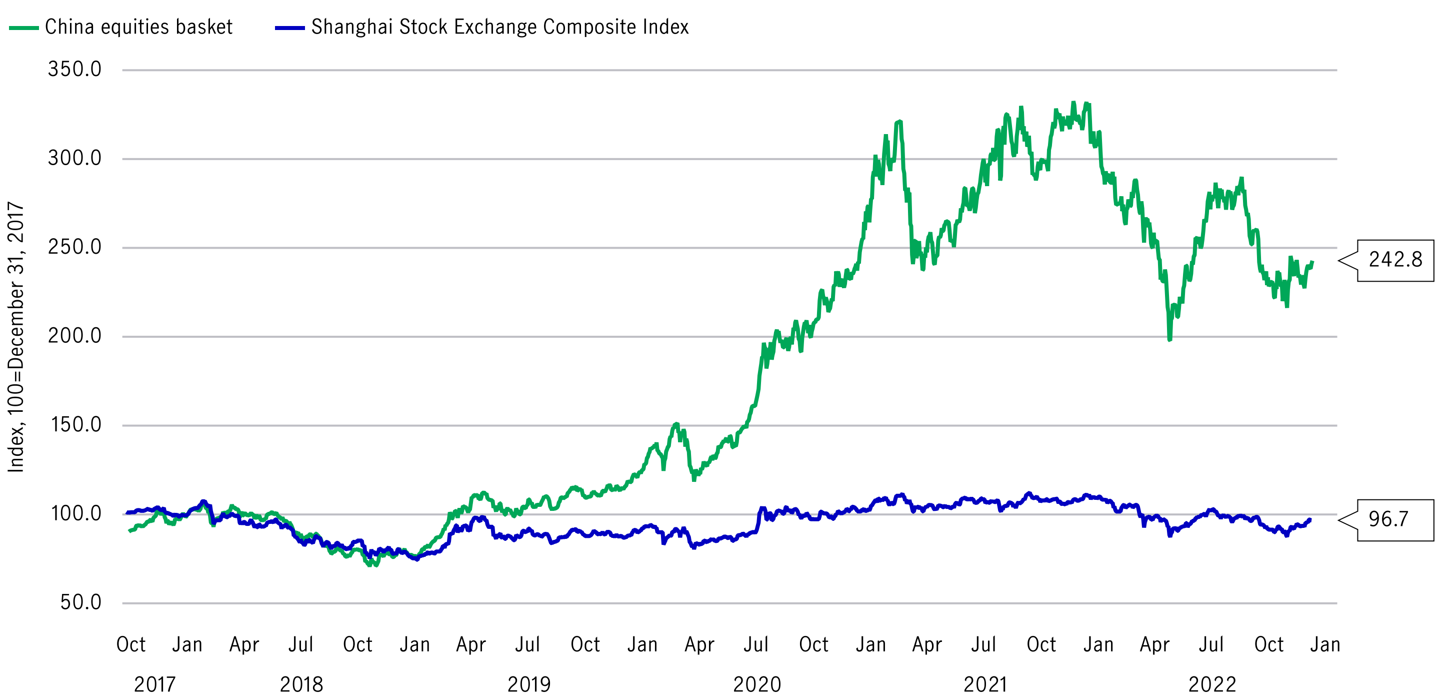
What we're watching

- **Vaccination rate, fatality rate, and healthcare infrastructure capacity—**These are key signposts that, in our view, will determine whether mainland China's path to a full reopening stays on track for the end of Q1 2023.
- **Cyclical momentum—**The transition from zero-COVID to living with COVID-19 could be disruptive (over a 1- to 3-month investment horizon) as infection rates rise and restrictions are needed to ring-fence the healthcare system. Many households are likely to minimize in-person interactions as infection fears come to the fore, keeping a cap on mobility rates and consumption. Once hospitalization and mortality rates stabilize and become less concerning (likely in Q2), mobility levels and consumer consumption should recover. Policy measures to provide additional financing to property developers are accumulating, but land and housing sales remain anemic, reducing the pipeline of construction for next year.

Key market views

- **Equities—**A stagflationary global economic backdrop remains particularly challenging for Chinese equities. We're also mindful of the risk that the expected delisting of Chinese companies from U.S. exchanges could be brought forward. Yet there remain selective strategic opportunities, and we continue to have a favorable view of equities leveraged to the renewable energy sector, the digital economy, high-value global manufacturing, advanced technology, and consumption upgrade.
- **Fixed income—**We expect Chinese government bond yields to fall further as growth continues to disappoint and the People's Bank of China maintains an easing bias.

Selective strategic opportunities in Chinese equities



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 9, 2022. The basket of Chinese equities referenced in the chart comprises Chinese firms with exposure to renewable energy, innovation, and consumption. It is not possible to invest directly in an index.

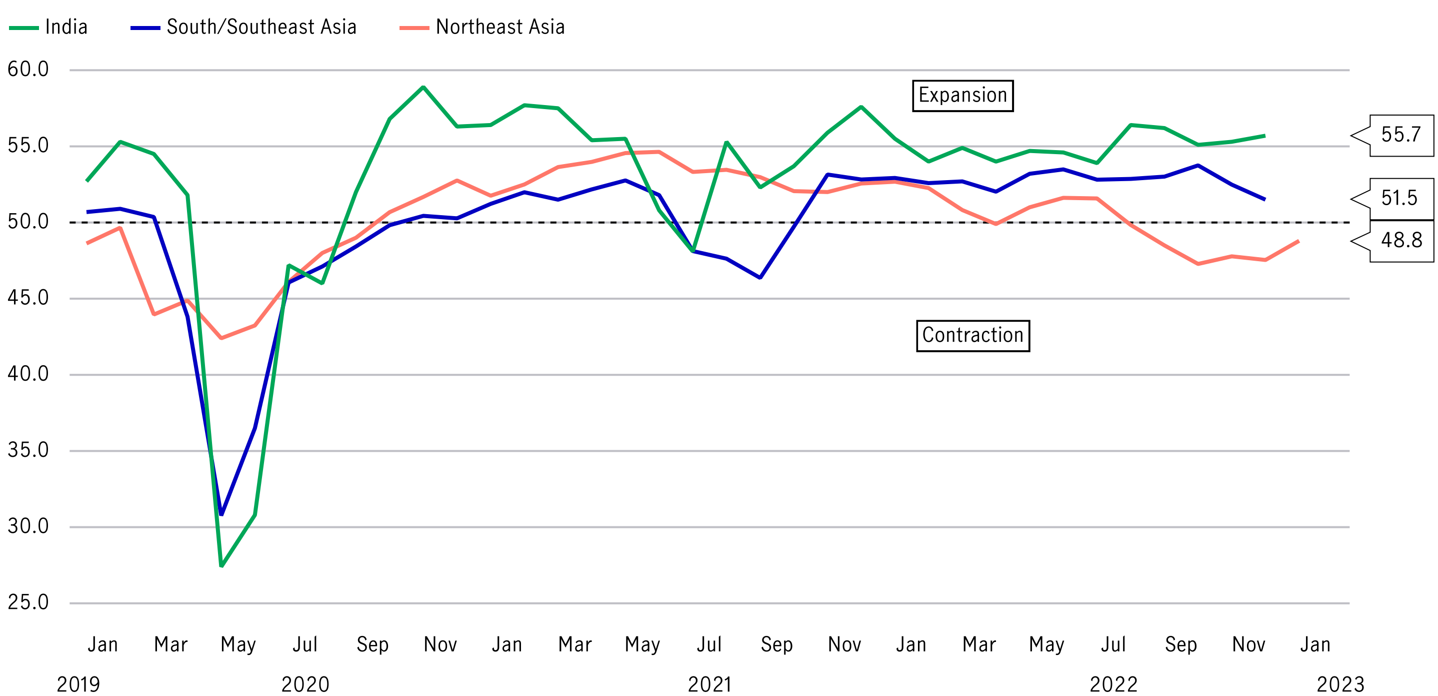
India

Big picture

The Indian economy has stayed on track with its reopening in 2022 and has since emerged as one of the regional outperformers in terms of economic growth and financial markets. Inflation fell back within the Reserve Bank of India's (RBI's) 2% to 6% target range in November, thanks to cooler commodity prices, a tighter fiscal stance, and base effects. With inflation having moved past its peak and domestic demand showing signs of softening, the central bank's rate-setting committee slowed the pace of monetary tightening with a 35bps hike to the country's repo rate at the conclusion of its December meeting. We believe the RBI's rate hiking cycle is likely to end soon. Meanwhile, India's structural growth story remains intact thanks to the government's continued multi-year push to build up domestic manufacturing capacity and increase capital spending as part of its goal to become a US$5 trillion economy by 2026/2027 (and US$10 trillion by 2033/2034), from around US$3.4 trillion in 2022.

> "The Indian economy has stayed on track with its reopening in 2022 and has since emerged as one of the regional outperformers in terms of economic growth and financial markets."

Manufacturing PMI: India is outperforming its regional peers by a wide margin



Source: IHS Markit, Macrobond, Manulife Investment Management, as of November 30, 2022. PMI refers to Purchasing Managers' Index. A reading above 50 represents expansion and below 50 indicates contraction. It is not possible to invest directly in an index.

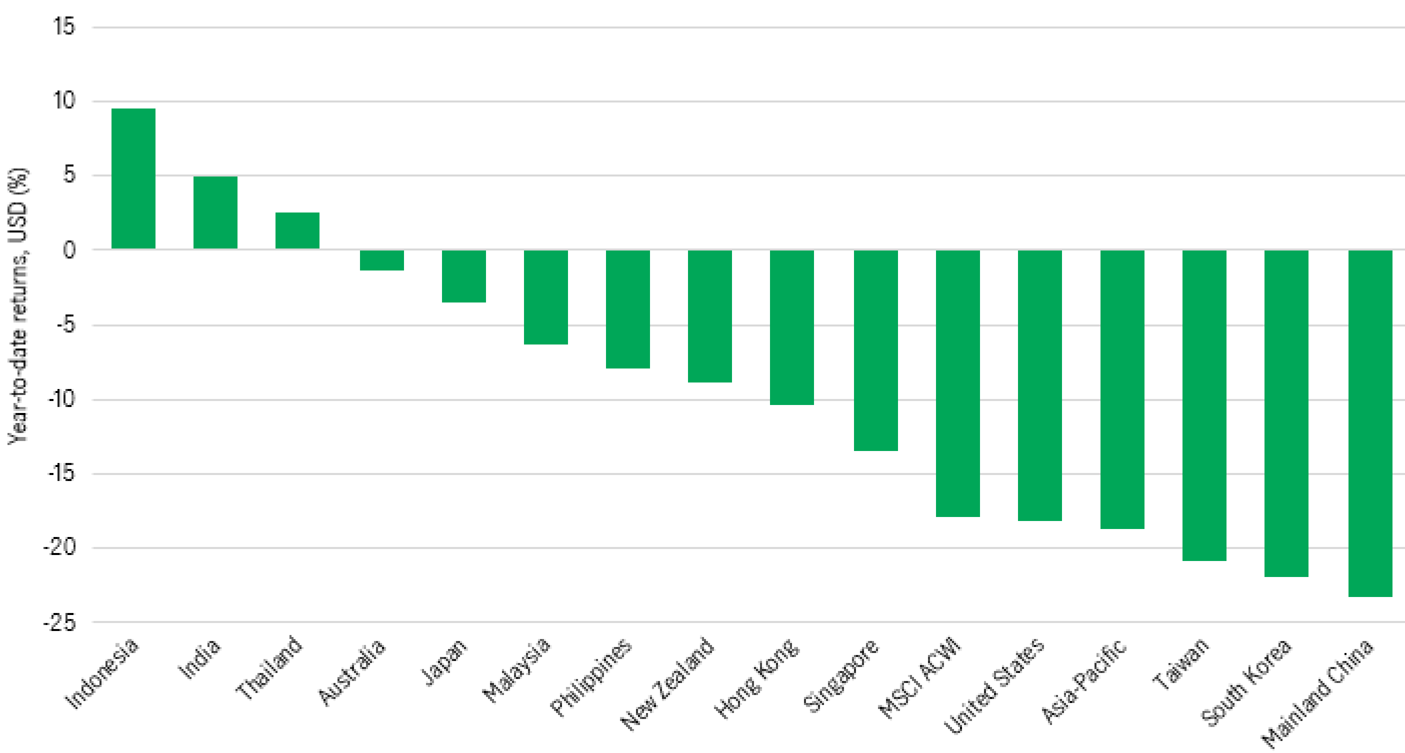
What we're watching

- **RBI policy and inflation—**RBI Governor Shaktikanta Das leaned hawkish in December, noting that inflation remains high and broad based and may remain higher than the 4% mid-target for the next 12 months. Stickier inflation at elevated rates may compel the RBI to extend its tightening cycle and/or delay any expected easing.
- **2023 Union Budget of India—**This is expected to be presented by the country's Finance Minister Nirmala Sitharaman either in or before February 2023. We expect a pro-growth bias to remain, which is consistent with the government's preference for supply-side support to infrastructure and manufacturing.

Key market views

- **Equities—**Indian equities have held up relatively well in the face of challenging global crosscurrents. We think that's a testament to the fundamentally positive backdrop and expect relative outperformance within the region to continue.
- **Rates—**RBI Governor Das announced the country's statutory liquidity ratio (known as the reserve ratio for commercial banks in many countries) for hold-to-maturity issues at 23% of net deposits will be extended to March 2024 and then restored in phases from June 2024. Having initially been set to expire in March 2023, this may be positive for the fixed-income market as it should translate into reduced selling pressure in the near term.

Indian equities: one of the regional outperformers in 2022



Source: MSCI, Macrobond, Manulife Investment Management, as of December 8, 2022. MSCI ACWI refers to the MSCI All Country World Index. It is not possible to invest directly in an index.

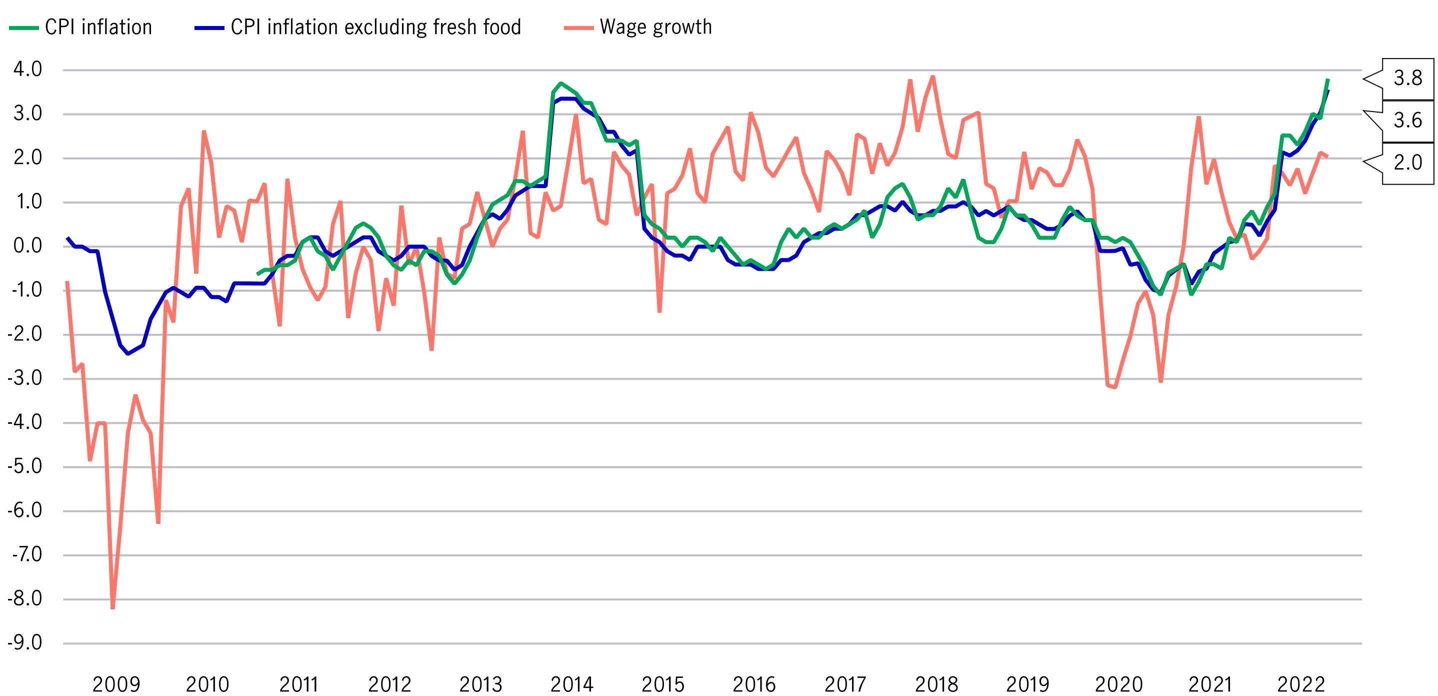
Japan

Big picture

The Bank of Japan (BoJ) surprised the market with a tweak to its yield curve control (YCC) policy in December by widening the yield band for the 10-year Japanese government bond (JGB) from +/–25bps to +/–50bps. The central bank's target on the yield of around 0% and the short-term interest rate of –10bps was unchanged. The announcement came earlier than expected—the consensus view in the market was that a change to the YCC would coincide with the expected change in BoJ leadership in April. While the announcement would have been traditionally regarded as a hawkish policy pivot, a simultaneous increase in quantitative easing tempered the impact. The BoJ said it would significantly increase its bond purchases to JPY￥9 trillion (~US$67.5 billion) a month, up from JPY￥7.3 trillion as had been originally planned as it would enhance the sustainability of its monetary easing actions. Overall, we don't think the policy adjustment will derail the country's economic recovery. Japanese wage growth continues to lag overall inflation; moreover, some inflation relief is expected in January when government subsidies for electricity and gas bills kick in.

The BoJ surprised the market with a tweak to its YCC policy by widening the yield band for 10-year JGB from +/–25bps to +/–50bps; however, a simultaneous increase in quantitative easing tempered the hawkishness of the policy shift.

Japanese wage growth has lagged overall inflation, YoY (%)



Source: Japanese Statistics Bureau, Japanese Cabinet Office, Macrobond, Manulife Investment Management, as of December 6, 2022. CPI refers to the Consumer Price Index. It is not possible to invest directly in an index. YoY refers to year over year.

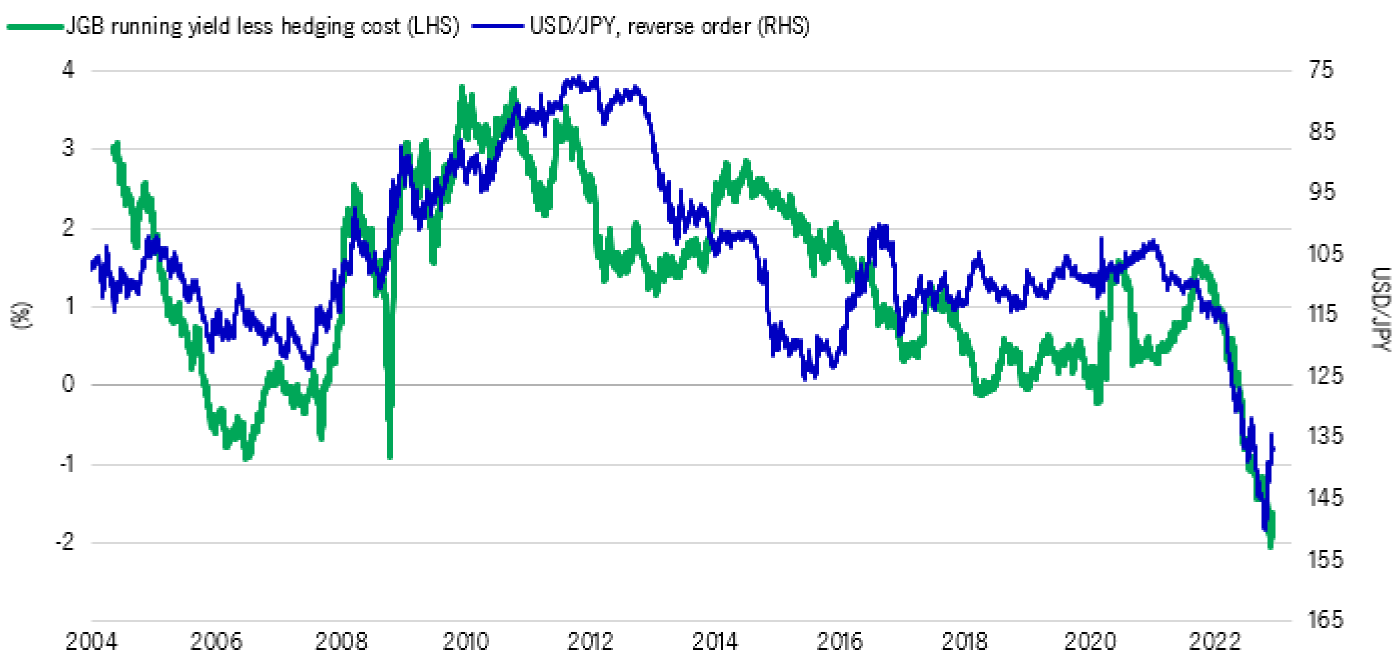
What we're watching

- **The annual wage negotiations in February/ March—**Japan's largest federation of trade unions recently said it will ask for a [3% rise in base pay] in the annual round of wage negotiations. The BoJ has stipulated that stronger wage growth is a [precondition for policy normalization].
- **BoJ leadership change in April—**Our base case is for Japan Prime Minister Fumio Kishida to pick a new BoJ governor with strong technocratic expertise (from the existing pool of incumbent and former deputy governors) to ensure a smooth transition, policy continuity, and market stability. Stronger wage negotiation results and a more hawkish (incoming) BoJ governor could result in earlier-than-expected monetary policy normalization.

Key market views

- **Equities—**The MSCI Japan Index has been a relative outperformer versus global equities year to date and over the past three months.[3] Looser monetary and fiscal conditions have supported positive earnings revisions in stark contrast to much of the rest of the world. As we head into a more challenging macro environment, we have a preference for stocks with more defensive qualities and those that are likely to benefit from reopening for the time being.
- **Currencies—**Consensus toward the Japanese yen (JPY) is bullish against the USD on expectations of tighter monetary policy from the BoJ in 2023; however, a 25bps increase in Japanese government bond yields needs to be balanced against a near-500bps increase in the cost of hedging USD assets.

Cost of FX hedging existing stock of U.S. Treasuries vs. running yield suggests uptrend in USD/JPY remains intact



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 6, 2022. JGBs refer to Japan government bonds. FX refers to foreign exchange. JPY refers to the Japanese yen. USD refers to the U.S. dollar. A more negative differential implies a higher cost of FX hedging, meaning that Japanese investors are more likely to reduce hedges on their existing stock of U.S. assets, a development that's likely to lead to less USD selling from this investor base. LHS refers to left-hand side. RHS refers to right-hand side.

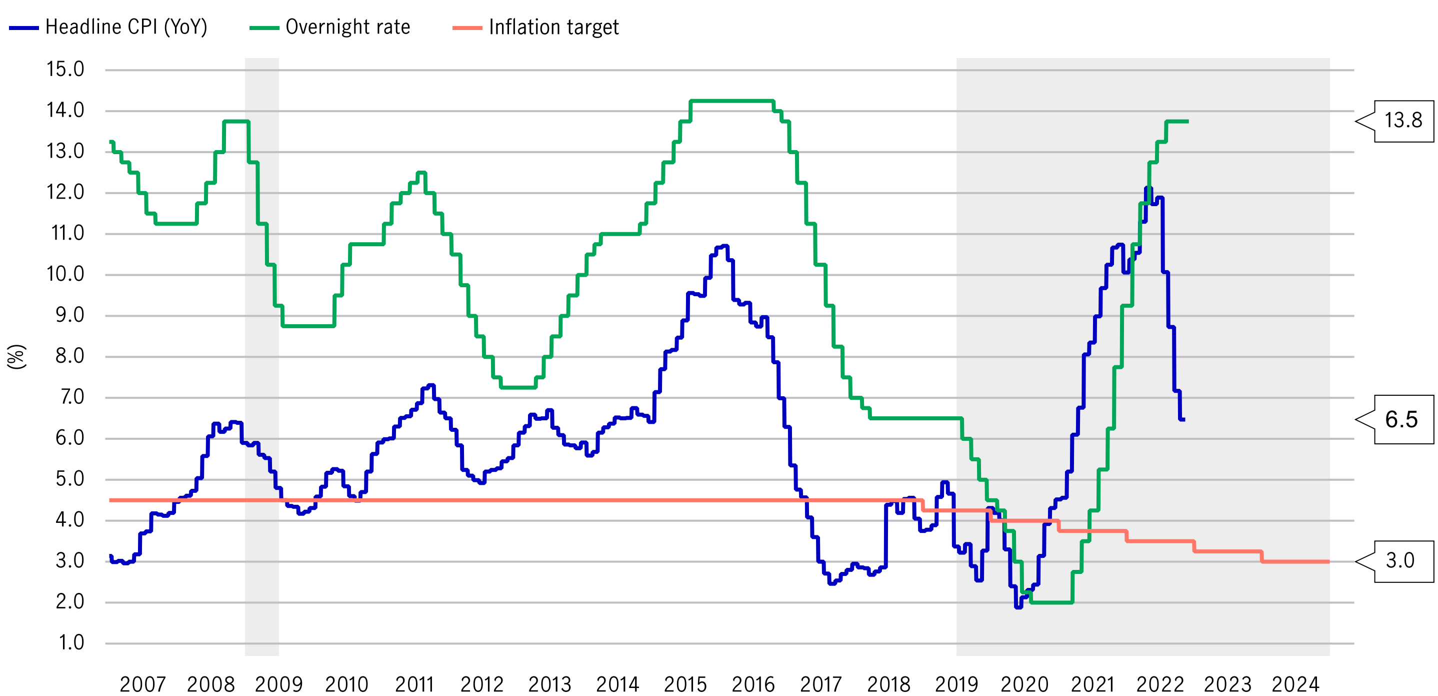
Brazil

Big picture

While Brazil's macro prospects will likely soften in 2023 given the lagged effects of monetary tightening, there are areas of strength that should support Brazilian assets relative to their global peers. For instance, Brazil's terms of trade should be underpinned by the country's leverage to still-tight agriculture and energy markets. Meanwhile, consumption—which represents approximately 70% of Brazil's economy—will be supported by strong real economic activity, a robust employment backdrop, and fiscal expansion. In terms of policy, Banco Central do Brasil (BCB) was one of the first central banks to engage in a tightening cycle, and we expect it to maintain its current level of restrictive policy rates in H1, with the likelihood that it could tighten further if inflation pressures don't abate. There's some fiscal policy uncertainty associated with structural tax reform—an erosion in the fiscal outlook could prompt the BCB to move interest rates further into restrictive territory, a development that could place the existing fiscal surplus at risk.

"BCB was one of the first central banks to engage in a tightening cycle, and we expect it to maintain its current level of restrictive policy rates in H1, with the likelihood that the bank could tighten further if inflation pressures don't abate."

Inflation is declining but still above the BCB's target of 3.25%



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 13, 2022. BCB refers to Banco Central do Brasil. CPI refers to the Consumer Price Index. It is not possible to invest directly in an index. YoY refers to year over year. The gray areas represent recessions.

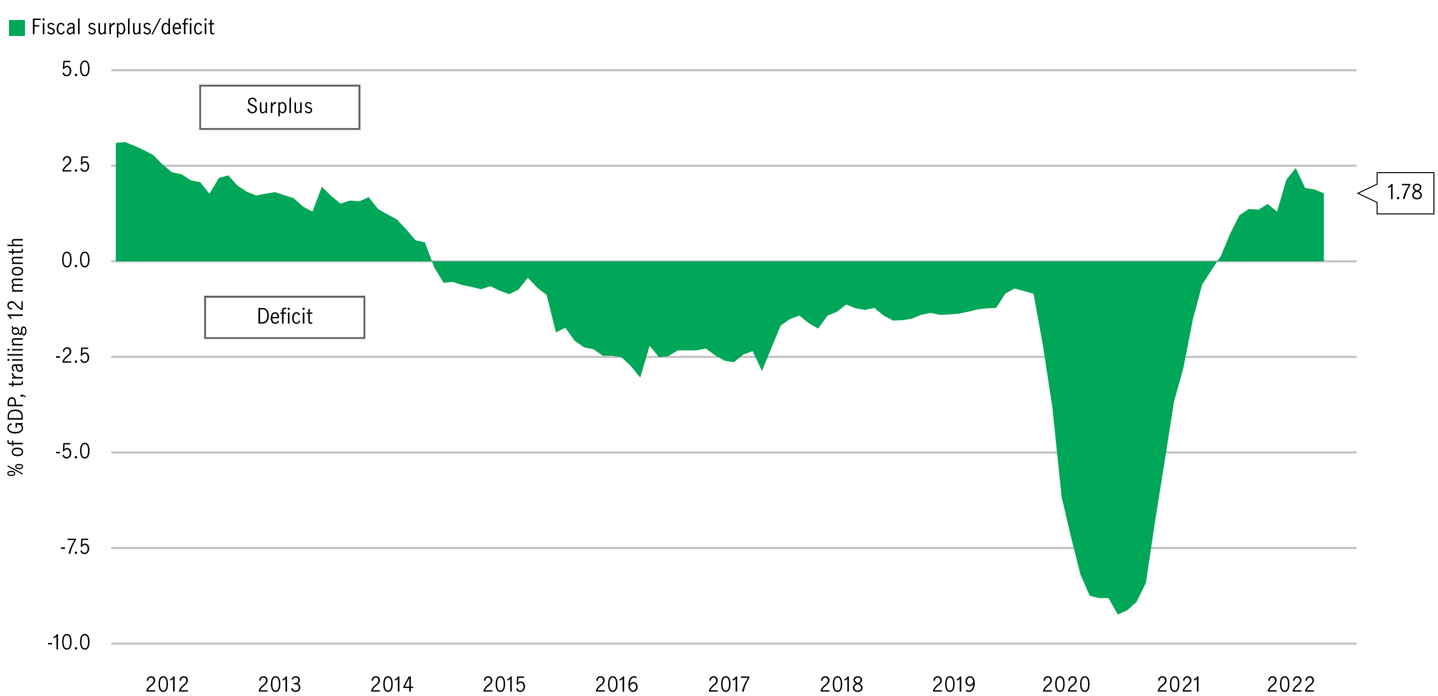
What we're watching

- **Fiscal outlook—**At of this writing, President Luiz Inácio Lula da Silva's fiscal plan for 2023 remains uncertain and we expect spending to increase, contributing to an uncomfortable deficit; however, political gridlock in Congress will likely put a cap on any major fiscal expansion.
- **Flows and sentiment—**International demand for Brazilian assets remains a major driver of the Brazilian real (BRL). The relatively high level of yields on offer has attracted global inflows to a broadly underowned asset class. That said, the market continues to be primarily driven by sentiment; as such, sudden and forceful swings in either direction are possible. In addition, negative global risk sentiment translates to a headwind to the market given the high beta nature of Brazilian assets.

Key market views

- **Equities—**In our view, the fundamentals of the MSCI Brazil Index remain remarkably strong; index metrics such as forward profit margins and dividend yields remain elevated. From a valuation perspective, Brazilian equities compare favorably against their emerging- and developed-market counterparts. The cyclical nature of the index also means it could benefit from the current shortage in global commodities supply; however, the asset class can be prone to sharp swings given its sensitivity to the still-evolving geopolitical backdrop.
- **Currencies—**The BRL's trend has been volatile and risks continue to tilt to the downside in 2023. Global growth risks and domestic fiscal risks remain elevated, but Brazil's positive terms of trade could mitigate some of these headwinds. We expect the BRL to trade within a range of 5.0 to 5.6 against the USD.

Brazil's fiscal surplus is likely to turn into a deficit in 2023



Source: Bloomberg, Manulife Investment Management, as of December 5, 2022. YoY refers to year over year.

Mexico

Big picture

The economic outlook for Mexico remains weak. That said, deterioration in the country's growth prospects appears to have taken a breather, with expectations of slightly positive growth in 2023. Inflation expectations are also stabilizing as headline CPI inflation eases from recent multidecade highs. Banco de México (Banxico) is expected to reach its terminal rate in Q1, keeping pace with the timeline of Fed tightening. High-frequency economic indicators reveal impressive resilience as growth drivers shift from reopening-related sectors to manufacturing and agriculture, helping economic activities recover to prepandemic levels. The Mexican peso (MXN) remains remarkably stable—the USD/MXN pair has been unable to stay above the psychologically important 20.00 level for long. The level of political stability we're seeing in Mexico remains impressive relative to its regional peers—implying it could offer the prospect of sentiment-driven upside for Mexican equities through 2023.

"The level of political stability we're seeing in Mexico remains impressive relative to its regional peers—implying it could offer the prospect of sentiment-driven upside for Mexican equities through 2023."

Mexico's GDP has recovered to prepandemic levels

Source: Macrobond, Manulife Investment Management, as of November 30, 2022.

What we're watching

Core inflation—Unsurprisingly, Banxico's expected policy pivots look set to be driven by the usual suspect: the outlook for core inflation. An earlier sense of reassurance has been followed by renewed concern. The trajectory of core inflation in the coming months will therefore be critical for market participants as they look to assess how the central bank might recalibrate its monetary policy in terms of both the terminal rate and the length of time—in the rate-setting committee's view—in which rates will need to remain elevated.

Key market views

- **Equities—**Mexico's relative political stability should allow for continued outperformance on both an absolute and relative basis given significant regional concerns across a number of its Latin American peers.
- **Currencies—**The MXN has remained remarkably stable in the past year, with USD/MXN unable to stay above the psychologically important 20.00 level for an extended period of time.

The trajectory of core inflation in Mexico remains critical to Banxico, YoY (%)

Source: Bloomberg, Macrobond, Manulife Investment Management, as of November 30, 2022. CPI refers to the Consumer Price Index. It is not possible to invest directly in an index. YoY refers to year over year.

Manulife Investment Management

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Manulife Investment Management

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