Manulife Asset Management™

# Asset Allocation View

THIRD QUARTER 2017

September 2017

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A stable global macroeconomic environment continues to provide a supportive background for various asset classes. Equities and bonds both posted positive gains since June, with commodities performing particularly strongly. Attractive valuations drive opportunities in Asia and Europe; we also remain constructive on Greater China due to strong earnings revisions and capital flows. Overall, the drop in market correlations this year presents us with opportunities "below the surface" to add value in terms of individual countries, styles, and sectors. Our portfolio maintains its bias for equities and credit relative to bonds, though we see potential for increased market volatility moving forward.

## Tactical asset allocation view[1]

### (3 to 12 months)

CAUTIOUS NEUTRAL OPTIMISTIC

**Greater China Equities:** We remain constructive. We expect some deceleration in China's economic activity, but not a material slowdown. Policymakers continue to emphasise stability in the near term ahead of the landmark 19th Party Congress. Greater China equity valuations are attractive relative to their own history and peers. China and Hong Kong stocks are experiencing strong relative earnings revisions, with Hong Kong-listed stocks also benefiting from strong southbound flows via Stock Connect. However, despite recent outperformance, our analysis suggests that many global investors remain sceptical and underweight.

**European Equities:** Economic activity in Europe continues to improve along with the political backdrop thanks to several investor-friendly election results this year. The euro's recent strength has paused equity market gains in local terms. However, we believe the currency move is likely to further limit or delay the European Central Bank's (ECB) ability to remove policy accommodation. The valuation gap versus US equities has narrowed somewhat, but the corporate earnings base still remains depressed relative to the US, with more scope for a recovery in margins.

**Asian Equities:** The macro environment remains positive – we see positive growth and a soft US dollar. The region's fiscal/monetary policy settings remain favourable with growth generally stable or accelerating. Meanwhile, disinflation and currency stability suggest a lack of significant upward pressure on domestic rates. In general, Asian forward price-to-earnings valuations appear cheap relative to most developed markets, whilst pay-outs are generally lower. This offers scope to raise dividends as companies increasingly focus on shareholder returns.

[1] Source: Portfolio Solutions Group, Manulife Asset Management, September 2017. The tactical view is by no means, reflective of Portfolio Solutions Group's current positioning. Projections or other forward-looking statements regarding future events, targets, management discipline or other expectations are only current as of the date indicated. There is no assurance that such events will occur, and if they were to occur, the result may be significantly different than that shown here. Information about the portfolio's holdings, asset allocation, or country diversification is historical and is not an indication of future portfolio composition, which will vary.

# Review[2]

Stocks and bonds have both produced positive returns since the end of June, with global equities rising 3.7% in US dollar terms, and global bonds 2.6%. The macroeconomic environment has been one of stronger growth (the global developed Purchasing Managers' Index, or PMI, is the highest since 2011); solid corporate earnings releases; continued disinflation; and ongoing accommodative policy by the major central banks. This has been very supportive for risk assets such as equities and credit.

At the same time, geopolitical risk has risen driven by the ongoing travails of the Trump administration as well as heightened tensions on the Korean peninsula. Inflation releases continued to surprise to the downside globally and, despite the strength of the US labour market, there is still no sign of any significant wage pressures. These factors helped drive money into government bonds, with yields falling in almost all geographies and maturities, reducing market expectations of further rate rises by the Federal Reserve.

The US dollar continued to weaken (-3.3% in trade-weighted terms) driven by several factors. These include lack of progress and continued scepticism around the Trump administration's ability to deliver pro-growth economic policy, as well as reduced expectations of rate rises. Interestingly, the dollar did not prove a "safe haven" during the recent brief risk sell-offs associated with missile tests from North Korea, with investors instead flocking to the euro and yen.

## Equities

Virtually all the stock markets in our universe produced positive returns in US dollar terms, with the major highlights as follows:

- Emerging markets were the out-performers (+8.8%), led by a recovery in the commodity-heavy Latam markets (e.g. Brazil +23.6% in US dollars).
- Asia ex Japan also performed well (+7.2% in US dollars), led by China (+14.8%).
- The S&P500 rose 3.1% but was once again out-gunned by Nasdaq, which rose 5.2%.
- European stocks rose 4.6% in US dollar terms, though there was a wide distribution of returns amongst the major markets – e.g. Italy rose 11.2%, but the UK only 2.4%.
- Japan underperformed, rising only 2.9% in US dollar terms.
- There has been relatively little dispersion in terms of sector performance, except for technology which continued to perform strongly (+7.9%).
- In terms of US equities, "growth" continued to outperform "value" (by 3.9%) and large caps continued to outperform small caps (by 2.1%).

## Bonds

Bonds also made gains during the period – the Barclays Global Aggregate Index returned 2.6%. The US 2- to 10-year Treasury yield curve bull flattened, with the 10-year yield reaching a nadir of 2.01% in early September, before rebounding modestly at the time of writing. Globally, the best returns for a US dollar investor were found in the eurozone and China, helped by the strength of the euro and renminbi respectively. Credit outperformed government bonds, with high yield also outperforming investment grade.

## Commodities

In general, non-agriculture commodities performed exceptionally strongly – oil (WTI) rebounded by 7.1%, and iron ore rebounded by 17.9%. Precious metals continued their positive performance, with gold up 6.5%.

The drop in market correlations this year presents us with opportunities "below the surface" to add value in terms of individual countries, styles and sectors.

[2] Source: Bloomberg, 1 July 2017 to 13 September 2017. Indices used: MSCI (Country/Regional, Technology), Bloomberg Barclays Global Aggregate Total Return Index, US dollar index, Russell (Growth, Value, Large/Small Caps).

# Outlook

The global macro environment remains supportive – we note decent economic growth, limited inflationary pressures, and major central banks not inclined to aggressively tighten policy. We expect global growth to remain positive and close to trend over the next 12 months. We expect the US economy to continue to rebound from its first quarter soft patch and the eurozone to continue accelerating. There will be a modest slowdown in China in the next 6 to12 months as the property market decelerates and re-stocking runs its course. There is likely to be a pick-up in US inflation in the coming quarters, driven by rising import prices and the rebound in energy. However, we do not expect a significant sustained rise in inflation given the secular backdrop.

That said, we feel rates markets are currently under-pricing the Fed's determination to continue normalising policy (in terms of further rate rises), particularly given the recent loosening in financial conditions. Ultimately though, a key driver of the pace, magnitude, and terminal rate for federal funds will be US wage growth, which so far has remained well contained.

In terms of bonds, we expect US Treasury yields to meander around current levels, with some upward bias near term given long investor positioning, further rises in short rates, and the beginning of the shrinking of the Federal Reserve's balance sheet. We expect low returns and, with elevated duration risk, we maintain a tactical short duration position across our portfolios. Our base case is that US 10-year yields remain in the 2 to 2.5% range over the medium term. An upside break-out is only likely if there is a significant positive surprise in terms of US fiscal policy, where it only took investors less than a year to swing from optimism to near pessimism.

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Our portfolios remain pro-risk. We maintain our bias for equities and higher credit relative to government bonds. We do not see any of the usual warning signs to make us materially reduce risk: an inverted yield curve, a sharp sell-off in credit spreads, aggressive tightening by central banks, extreme valuations, or broad-based investor complacency. This time around, more specific issues we are monitoring are US government bond yields (a significant move in either direction would be problematic), a material acceleration in US wages, a sharp deceleration in Chinese activity, and a complete impasse between Congress and President Trump on tax reform leading to a breakdown in cooperation.

Although we expect equities to continue to outperform over the next 6 to 12 months, we recognise that markets have

already travelled a long way. Further gains will therefore likely be accompanied by a pick-up in volatility, with market dips becoming larger and more frequent. Within equities, we maintain our preference for non-US equities over US ones, though this view has moderated as we recognise that US equities are likely to outperform during a period of market volatility/consolidation. The drop in market correlations this year presents us with opportunities "below the surface" to add value in terms of individual countries, styles, and sectors.

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