Manulife Asset Management

Monthly Macro View

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For retail use, January 2018

Markets continue rally into the New Year

2018 promises to be a year of opportunities and challenges for investors. After a banner 2017, synchronized global economic growth and positive corporate earnings are slated to continue. However, elevated valuations in some asset classes may augur greater volatility and, in some cases, a correction.

In the initial Monthly Macro View of 2018, Senior Asia Strategist Geoff Lewis examines the key issues that investors should follow in the new year. In particular, he looks at how historic tax reform in the US is likely to boost its economy and have a positive spill over for Asia.

Review: Equity markets in 2017

Few would disagree that 2017 was a "banner year" for global investors and one of the best on record. For equity investors, the synchronised global upturn delivered a strong recovery in earnings, coupled with stable or rising price-to-earnings (PE) ratios in all major markets including the US. Global equities returned 25% last year, with earnings growth contributing 18.0%, dividends 3.0% and higher valuations 3.6%[1]. For fixed income investors, the absence of inflation coupled with only modest tightening steps by central banks meant that bonds did not spoil the party for equity investors, as many had feared. There was enough left in the liquidity punchbowl to allow global bonds to post positive returns of 7 to 10%[2].

At the start of last year, the advice we gave clients was that poor politics would likely give precedence to robust economies from a financial market perspective. We urged Asian investors to ignore the financial media negativity and stay invested, on the understanding that only rarely do geo-political issues translate into a deep or sustained equity correction. Time and again last year, investors were rewarded if they simply stayed calm during periodic bouts of market nerves arising from geopolitics. Investors as the year progressed appeared to learn to stay put, fight the urge to de-risk, and stay invested.

A New Year Begins: Equities in January 2018

Political risks remain, e.g. with slow negotiations to form a new government in Germany, upcoming elections in Italy, and unfinished business in Catalonia. There are also concerns around stalled NAFTA negotiations and President Trump's potentially more combative approach to trade with China. But many of these issues are likely to provide more short-term distraction than a fundamental signal to investors.

Global equity markets continued to rally hard in the first half of January. So much so that sentiment barometers like the AAII bull and bear index and short-term chart technicals now look stretched. A market correction now would inevitably generate considerable media angst, with predictions that overpriced markets have finally brought the period of low volatility to an end. Whatever the short-term disruption, a 10% correction now could be a healthy development regarding the longer-term market evolution. 2018 can still be a decent year for investors, albeit one with lower returns than last year.

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[1] Absolute Strategy Research Weekly Wrap, 12 January, 2018. Global equities are represented by MSCI All Country World Index.
[2] Bloomberg and Manulife Asset Management, as of 31 December 2017. Bonds' returns are represented by Barclays Global Aggregate and High Yield indices. Total returns in US dollar. Past performance is not indicative of future results.

Investment Strategy in 2018

Our views on investment strategy for 2018 are set out in full in the latest "Global Intelligence" report, Manulife Asset Management's flagship quarterly publication, published on 18 December 2017.[3]

In the current environment, we continue to see above-trend economic growth and a healthy earnings uptrend, and have maintained a reasonably large equity overweight going into 2018 despite concerns related to valuations, interest rates, and inflation. That said, fixed income also plays an invaluable role for downside protection and diversification over time. Being nimble will be key.

We expect (on a structural basis) global economic growth and inflation rates will stay modest in absolute terms and relative to past business cycles. As such, in our base case outlook for 2018, yields are unlikely to rise sharply enough to trigger a major bear market in bonds that in turn would spell an end to the secular rally in equities.

Tax reform in the US

On 20 December 2017, the House of Representatives passed the revised version of the tax reform bill; two days later, President Trump signed the bill into law. The bill's passage represents America's most sweeping tax reform enacted since 1986. Implications of the new legislation include:

- We envisage that this round of tax reform will have positive implications for Asian export-led economies in 2018 via increased growth prospects of the US economy.
- Business expectations of future market growth are unlikely to be increased enough by the tax cuts to boost investment significantly, but accelerated depreciation allowances have historically had some success in bringing capital expenditure forward.
- With more new technologies just starting to be introduced, some firms may be feeling they need to invest in technological upgrading to keep up with the competition. If enough US firms respond to 100% investment allowances with new orders, the current uptrend in business investment could persist.

Downside risks for the US in 2018 are manageable

- Although much analysis has focused on the upside implications of tax reform, some potential downside risks remain for the US economy after its implementation.
- One key risk is the return of a strong US dollar in the first half of 2018 as corporations repatriate a significant share of their profits held overseas, which could be a direct threat to buoyant emerging and Asia markets.
- Tax reform could lead to inflationary pressures, potentially forcing the Fed to become more hawkish in the pace of its monetary tightening.

Conclusion

Although not large, the passage of the US tax reform has more positive than negative implications for Asia in the short term. An increase in US economic growth may lead to increased demand for Asian

[3] "Global Intelligence Outlook 2018", Manulife Asset Management, 18 December 2017.

exports, especially if US corporations bring forward their capital expenditure plans in response to the new tax incentives and competitive pressures. While potential downsides remain regarding its longer-term consequences, we feel the recent US tax reform is likely to be a marginal net positive for the US and Asian export-based economies in 2018.

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