

---

# MONTHLY MACRO VIEW

## Goldilocks escapes the bears—for now

THE ASSET ALLOCATION TEAM

April 2019

As markets enter the second quarter of 2019, the reemergence of the Goldilocks economy—moderate economic growth, low inflation, dampened market volatility—should underpin asset classes globally. We expect that accelerating growth in the US and China, coupled with dovish central bank policy, should bolster the Goldilocks scenario in upcoming months. However, it will also face challenges from US-European Union trade friction and investors' overoptimistic expectations of China's economic rebound.

In this edition of Monthly Macro View, Asset Allocation's Macro Strategy Team explains the investment themes that will dominate markets over the next quarter: accommodative central bank policy, a rebound in US economic data, continued deterioration in European economic sentiment, and a focus on economic stabilisation in China. Goldilocks is set to stay—for now—but how long can she keep the bears at bay?

## Index

P.02

---

**01** | Market Overview:  
Goldilocks escapes  
the bears – for now

P.03

---

**02** | An Overview  
of our Q2  
Investment  
Themes

P.07

---

**03** | This Month's  
FAQs

## 01 Market Overview: Goldilocks escapes the bears—for now

Most asset classes continued to grind higher over the last month, as ongoing central bank support and price momentum managed to edge out—albeit modestly—weakening investor sentiment over deteriorating macroeconomic conditions. In our view, concerns were driven by a combination of factors: weak manufacturing surveys out of Europe, a shockingly weak US payrolls headline figure, and central bank jawboning, which all contributed to an inverted US yield curve. Given that yield curve inversion is typically considered an excellent lead indicator for recessions, the negative feedback loop in the market briefly became self-reinforcing, until subsequent business surveys around the world surprised to the upside. A more benign US employment report confirmed that the earlier payrolls number was an aberration and that the labour market was in fact still in good health. Consequently, the often-referenced Goldilocks environment reestablished itself, providing support to asset classes worldwide.

- Equity indexes worldwide rose over the last month. The S&P 500 Index continued its upward march, peering through the fog of messy economic data to the point where it's once again flirting with new all-time highs<sup>1</sup>; similarly, most European markets appreciated modestly. The month of March was marked by periods of volatility, as concerns around further weakness stemming from manufacturing surveys gave way to optimism around signs of stabilisation in Asia, whose trade activity is central to economic activity in the region. Unsurprisingly,

an incrementally positive Chinese outlook had a pronounced effect on countries in the Pacific Rim, with emerging markets (EM) in Asia, Japan, and Australia all performing strongly during the month.

- In fixed income, the modest downward pressure on yields intensified during the month, with the aforementioned central bank dovishness and weak data briefly inverting the yield curve. However, subsequent economic prints that painted a more positive picture of the US economy helped to stabilize rates, albeit at lower levels than the narrow range established at the start of the year.
- Foreign exchange rates have remained a picture of stability this year, with the US dollar remaining generally unchanged against other major currencies<sup>1</sup>.

As we've previously outlined, we expect the uncertainty we've seen since the beginning of the year to give way to increased investor confidence in the coming weeks. However, we believe that this emerging sense of optimism (which should build up over the second quarter) could be marked by short-term volatility around trade uncertainty with Europe. Ultimately, we expect the upbeat sentiment to be replaced by concerns of a US slowdown in 2020, which will in turn lead to a rerating of asset classes in the autumn. We continue to believe that nimble positioning remains the order of the day for 2019.

<sup>1</sup> Bloomberg, as of 11 April 2019.

## 02 An overview of our Q2 Investment Themes

The first quarter of the year was marked by a sizable bounceback in equities, an important decline in global bond yields, and what we consider to be a long list of distortions in economic data. Generally speaking, we expect the current risk-on sentiment to continue as we enter the second quarter, bookended by a rebound in economic growth in the United

States and China, combined with supportive monetary policy. However, we remain cautious on two fronts: First, investors appear to have priced in a good deal of expected good news in the China/EM narrative, and second, Europe has yet to produce a believable trough in deteriorating economic data.

### Theme 1: Central banks are sidelined

Most major developed-market central banks adopted a much more dovish tone in the first quarter, led by the US Federal Reserve (Fed), which has signaled that it will be leaving interest rates unchanged in 2019<sup>2</sup>. Our current forecasts reflect no change in policy rates in 2019 or 2020 from any major central bank, and we now assign a higher probability of an interest-rate cut as opposed to a hike next year, even though neither is our base case<sup>3</sup>.

Why the change in tone from the Fed? In our view, the pivot had less to do with a change in the US economic outlook and more to do with its ability to react to the weak inflationary picture. Indeed, the inflation picture in the United States is deteriorating. We expect disinflationary forces to be at play for most of 2019, and we don't expect to see personal consumption expenditures—an inflation indicator that the Fed monitors closely—to be able to consistently remain above 2% by year end. This is particularly problematic, given that the Fed appears to be shifting to a new regime in which

it targets an average 2% inflation over the cycle<sup>4</sup>. Not only would 2019 fail to provide the overshoot needed to rectify many years of missed targets, but it would likely add to the aggregate discrepancy.

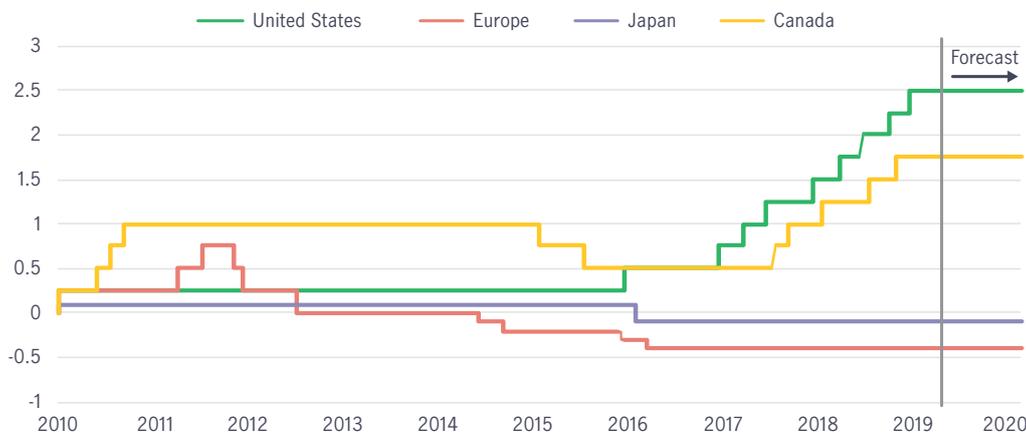
Most other major central banks—including the European Central Bank, Bank of Canada, the Reserve Bank of Australia, and the Bank of Japan—have taken a similar approach to interest rates, opting to leave rates unchanged with a bias toward trimming rates. Where equity markets are concerned, this will be seen as a positive because it means improved economic fundamentals can be celebrated without the fear of rate hikes. However, markets have already priced for a no-hike outcome in 2019 and even a 50% chance of a rate cut by December<sup>1</sup>. In our view, this may be too dovish—it's entirely possible that the market-based probabilities of interest-rate hikes could rise and fall in the months ahead, particularly if US economic data reaccelerates in the second and third quarters.

<sup>2</sup> "Fed holds line on rates, says no more hikes ahead this year," CNBC.com, 20 March 2019.

<sup>3</sup> Manulife Asset Management's Asset Allocation Team, March 2019.

<sup>4</sup> "Fed to keep open mind in review of strategy, tools, Clarida says," Reuters, 22 February 2019.

**Chart 1: Central bank main policy rates (%)**



Source: Bloomberg, Manulife Asset Management, as of 21 March 2019. The main policy rates for the central banks are represented by the following respective policy rates: US = Federal funds rate; Europe = deposit facility rate; Japan = short-term policy interest rates; Canada = overnight rate target.

**Theme 2: A roller coaster ride of US economic data**

We’ve noted previously that the 2019 US economic calendar would progress in three acts. Act One, which was mostly contained to Q2, included substantial distortions to economic data that have made it difficult to get an accurate reading of the underlying pulse of the economy. These distortions include the weather, December’s US government shutdown, delayed tax receipts, heightened geopolitical tensions, and the confidence shock as US stocks flirted with bear market territory at the end of last year. The Atlanta Fed’s GDPNow forecast for Q1—which tracks expected GDP in real time—has been particularly volatile over this period, underscoring the amount of uncertainty that the US economy is facing.

We now expect US economic data to stage a firm reacceleration in Q2 and Q3, driven by a stronger US consumer, better housing activity, and improved corporate confidence and spending. We also believe that the next two quarters will be characterised by a softening of geopolitical risks, although it’ll continue to percolate in the background. This should support risk-on sentiment.

We continue to caution, however, that 2020 will be a difficult year for the US economy, with technical recession being a tail risk that’s worth monitoring (although not our base case expectation). A resurgence of growth fears could dampen investor sentiment in Q4.

**Chart 2: US economy: a volatile first quarter**

US GDP NowCast



Source: Thomson Reuters, Manulife Asset Management, as of 31 March 2019

**Chart 3: Lower mortgage rates mean more home sales**



Source: Thomson Reuters, Manulife Asset Management, April 2019

### Theme 3: No bottom in Europe—yet

After peaking in late 2017, most major European economic data has been deteriorating. Industrial production, which closely tracks equity index earnings and performance, has been affected by a combination of slower demand for European exports, the usual dose of political uncertainty on the Continent, and a series of one-off factors that have distorted the data. Most business surveys, which lead economic activities, have also been weak.

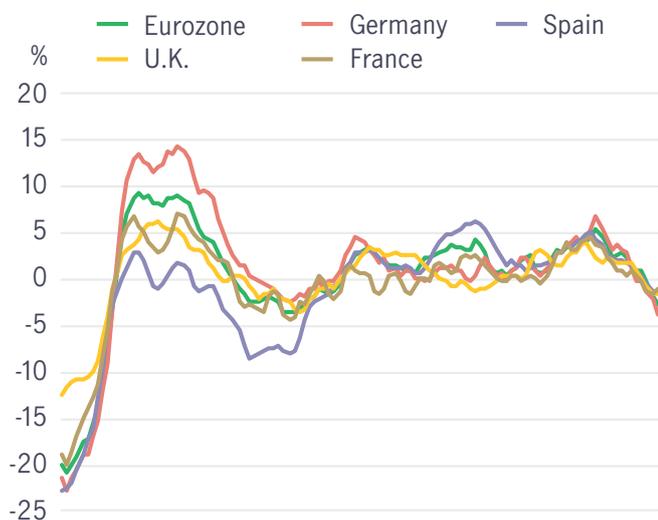
While the region’s economic prints paint a bleak picture, there are bright spots, first among them, the dramatic improvement in employment rate—low unemployment rates (including record lows in Germany) should continue to support domestic demand. The improvement in economic conditions that we’ve seen in Asia could also provide some

support, given how intertwined the two continents have become economically.

However, until we see a full bottoming in European economic data, it’s difficult to become more positive about Europe; we’re also hesitant due to elevated geopolitical tensions. In addition to what now seems like permanently entrenched uncertainty around Brexit, the United States has until mid-May to act on the US Department of Commerce’s investigation into whether European auto imports constitute a threat to US national security. The economic impact could be sizable and, depending on how the report is worded, could see consensus growth forecast for Europe trimmed by up to 0.5 percentage points.

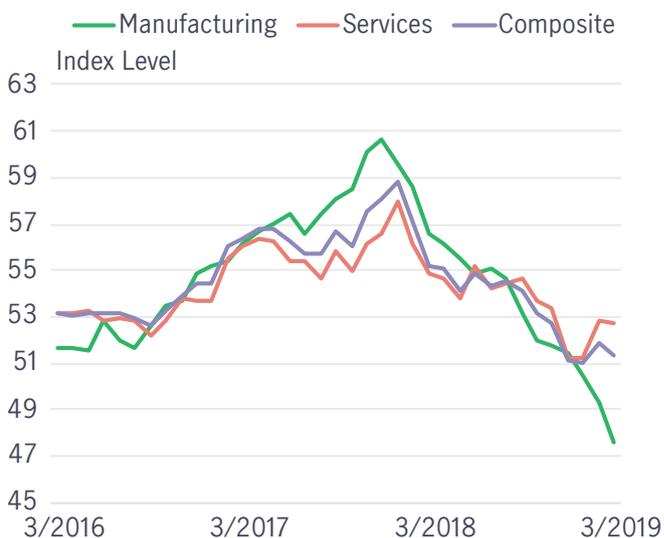
**Chart 4: European industrial production has yet to hit bottom**

Industrial production (year-on-year change, 3-month moving average)



Source: Thomson Reuters, Manulife Asset Management, January 2019

**Chart 5: European PMIs have continued their slide**



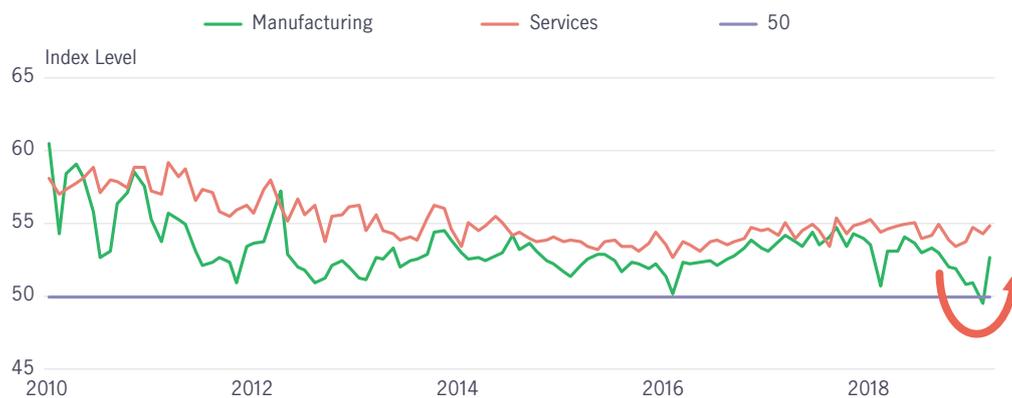
Source: Thomson Reuters, Manulife Asset Management, March 2019

## Theme 4: China's stabilisation versus rebound

The positive effects of China's sizable fiscal and monetary stimulus, including a reserve requirement ratio (RRR) cut in early January, are beginning to show up in economic data. Critically, China's manufacturing PMI is now back above the critical 50 level, signaling expansion<sup>5</sup>, and in doing so, appeasing global growth fears, if at least temporarily. We view China's fiscal stimulus program, particularly individual and corporate tax cuts, to be the most effective form of the most recent stimulus, and believe it'll help to offset some of the negative effects arising from deleveraging and derisking efforts undertaken in the past year. While we continue to expect additional RRR cuts to take place in 2019, we believe policy focus will continue to be on stimulating economic activities through the more effective fiscal channel.

That said, we remain concerned that the positive sentiment toward China might be running ahead of demand. In particular, we have yet to see a bottoming in leading indicators of Chinese exports (such as South Korean exports), the profits of firms in China's industrial sector remains soft, and global trade is likely to continue weakening for several months. While fiscal stimulus could provide some support, we doubt that we'll see the rebound that we witnessed in 2016 repeated this year. Policy uncertainty may limit the effectiveness of the government's stimulus programs, and a US-China trade deal might not emerge until around June.

**Chart 6: China's purchasing manager's index has bounced back above the 50 level**



Source: Thomson Reuters, Manulife Asset Management, March 2019

## Theme 5: Cautiously optimistic about EM

Last year was marked by pronounced EM underperformance, as a slowdown in China, trade war concerns, and overall market volatility wreaked havoc on EM equity returns. The first three months of this year, however, brought about a drastic turnaround. What's changed?

The answer, in our view, is relatively straightforward: reduced volatility, dovish turns from global central banks and diminishing trade tensions. The relatively steady US dollar has also fostered a sense of stability. These are positive

developments for EMs, and we've generally become more constructive on the space.

However, there are three ongoing issues that we feel merit monitoring and, depending on how things develop, could limit our enthusiasm. First, we expect global trade to continue to deteriorate for a few more months, which will weigh on EM. Second, as noted earlier, while we believe that the Chinese economy will stabilise, it's unlikely to stage a significant rebound. It's also worth noting that the stimulus

<sup>5</sup> Thomson Reuters, March 2019.

programs prescribed so far this year are largely consumption based, so any expected feedthrough effect to EM through trade may be more limited than in the past. Third, a great deal of the underperformance in EMs has been unwound,

and we're cautious that the expected good news is already reflected in the price of those equities. While we may still see upside, it's likely to be more limited than what we saw in the past quarter.

**Chart 7: Relative returns: MSCI Emerging Market Index/MSCI World Index (weekly)**



Source: Thomson Reuters, Manulife Asset Management, as of 1 April 2019.

## 04 This month's FAQs

### 1. Which asset class in the EM universe do you prefer?

We have a general preference for EM debt over EM equities, both from a short-term and a structural perspective. We expect EM central banks, particularly those in Asia, to embark on a notable monetary easing exercise. Specifically, we expect authorities in China to continue to introduce both monetary and fiscal initiatives, which will have a positive effect on this asset class. A more stable or weaker US dollar should also support EM assets, as will the recent dovish turn from the Fed. Longer term, we believe the quality of EM debt has been improving on a structural basis, and we view the asset class as a higher-quality credit compared with US high-yield and loans. It also offers attractive carry.

**2. How has the recent yield curve inversion affected your investment outlook?** The recent 5-day inversion of the 3-month, 10-year US Treasury yield curve<sup>1</sup> has sparked a flurry of commentaries, with some noting that the brevity of the inversion suggests its irrelevance, to others, who were deeply concerned that it could signal an imminent recession. Our view is somewhere in the middle: We don't think it would be prudent to ignore the flatness and temporary inversion of the yield curve, while arguing that

the occurrence needs to be analysed within the broader context of today's markets and economy. We recognise that the yield curve isn't a perfect indicator of impending recession—the lead time between an inversion and a recession is inconsistent, and it's important to note that term premium is distorted by unconventional monetary policy. Additionally, a shortage of safe assets is likely to have pushed more funds into US Treasuries, creating further distortions. Equally important is the fact that the inverted yield curve has historically not been a reliable predictor of recession outside the United States. Finally, this inversion is uncommon in two respects: First, the Fed typically continues tightening through a yield curve inversion. This time, however, the Fed opted to pause and signaled that the rate hiking cycle might have ended. Second, in modern yield curve inversions, it's always the 2-year, 10-year segment of the curve that inverts first; this time, only the 3-month, 10-year portion have inverted. In our view, this has muddied the signal somewhat. Ultimately, the extremely flat yield curve is consistent with our view that we're at end cycle and there's limited medium-term growth or inflationary pressures, and that 2020 poses some low but nonnegligible recession risk.



# Manulife Asset Management

---

## Disclaimer

Manulife Asset Management is the asset management division of Manulife Financial. The information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable but Manulife Asset 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 hereof or the information and/or analysis contained herein. Neither Manulife Asset 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 herein.

This material was prepared solely for educational and informational purposes and does not constitute a recommendation, professional advice, an offer, solicitation or an invitation by or on behalf of Manulife Asset Management to any person to buy or sell any security. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. The economic trend analysis expressed in this material does not indicate any future investment performance result. This material was produced by and the opinions expressed are those of Manulife Asset Management as of the date of this publication, and are subject to change based on market and other conditions. Past performance is not an indication of future results. Investment involves risk, including the loss of principal. In considering any investment, if you are in doubt on the action to be taken, you should consult professional advisers.

Proprietary Information – Please note that this material must not be wholly or partially reproduced, distributed, circulated, disseminated, published or disclosed, in any form and for any purpose, to any third party without prior approval from Manulife Asset Management.

These materials have not been reviewed by, are not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the following Manulife entities in their respective jurisdictions.

Indonesia: PT Manulife AsetManajmenIndonesia. Malaysia: Manulife Asset Management Services Berhad. Thailand: Manulife Asset Management (Thailand) Company Limited. Singapore: Manulife Asset Management (Singapore) Pte. Ltd. (Company Registration Number: 200709952G). Vietnam: Manulife Asset Management (Vietnam) Company Ltd. Australia, South Korea and Hong Kong: Manulife Asset Management (Hong Kong) Limited in Hong Kong and has not been reviewed by the HK Securities and Futures Commission (SFC). Philippines: Manulife Asset Management and Trust Corporation Japan: Manulife Asset Management (Japan) Limited. Taiwan: Manulife Asset Management (Taiwan) Pte. Ltd. (Investment is not protected by deposit insurance, insurance guaranty fund or other protection mechanism in Taiwan. For the disputes resulted from the investment, you may file a complaint to the Securities Investment Trust & Consulting Association of the R.O.C. or Financial Ombudsman Institution. License No. 106 Jin-Guan-Tou-Xin-Xin-008 "Independently operated by Manulife Asset Management (Taiwan) Co., Ltd." /6F., No.89, Songren Rd., Taipei, Taiwan 11073, Tel: (02)2757-5999, Customer Service: 0800-070-998.)