Manulife Asset Management™

Monthly Macro View

2018 Outlook

For retail use, December 2017

2018: Markets build on momentum to ring in the New Year

"All good things come to an end", as the saying goes. It's time to wrap up 2017, a year marked by strong equity performance and global economic growth all year. With the new year around the corner, many investors are wondering: will the "blue skies" continue and provide more fireworks?

2018 will likely face strong challenges to surpass this year's performance, although it will have the existing momentum to build on: accelerating, synchronized global growth may propel company earnings higher, but will it be enough to satisfy investors, given lofty valuations? We also expect some increase in inflation, even as Developed Market central banks both raise official interest rates and scale back QE. Indeed, investors would be best served by keeping a close watch on inflation, wages, corporate earnings and also sectoral performance (will IT continue to lead?), even with positive returns likely to continue in early 2018.

1. 2017 outperformed investor expectations by a wide margin. Is this a hard act to follow? Should investors stick with equities over bonds? Where is the value?

We think 2018 will be a less exciting year for investors, but one that can still provide decent returns for some asset classes, notably non-US equities. Our preference for global equities is driven by:

- Earnings yields being well above bond yields in most cases.
- Almost all economies being in expansion mode which supports earnings forecasts and revisions.
- Sentiment and positioning indicators have yet to reach extremes.

Global equities will continue to perform in 2018

We see limited scope for risk assets to provide consistently high returns now that the long and profitable period of disinflation that characterised much of the 35 years is coming to an end. For equity investors, it was always going to be “better to travel than to arrive”. But recognising that an investment era is ending does not necessarily mean that 2018 is the inflection point at which we enter the “half return” world. Our advice is thus to stay invested, stay long stocks over bonds, and enjoy the fruits of the global synchronised expansion for as long as you can.

Selective opportunities in fixed income

The economic backdrop described earlier is one that is likely to remain a benign environment for corporate credit in 2018, and the default rate is projected to stay low. Nevertheless, we wish to remind investors that although high yield bonds may appear especially attractive in such a low yield environment, they are not a close substitute for the low risk component of portfolios.

It is investment grade and sovereign bonds that are more likely to cushion the portfolio against some of the potential late cycle volatility in stocks. The best-case scenario for high yield bonds over the next 12 months may be positive returns of 5%–7%, while the potential downside in the event of an equity correction could be -10% to -15% i.e. high-yield may exhibit “equity-like volatility” with “fixed income returns”. We therefore no longer believe the risk/reward ratio favours overweighting US or European high yield and would scale positions back to neutral at best.

2. Will emerging markets (EM) continue their run in 2018?

World Bank senior economist Ayan Kose wrote in a recent blog for the Brookings Institute that he believes in future the global business cycle will be driven primarily by the seven largest EM economies or EM-7. They are: China, Russia, India, Brazil, Turkey, Mexico, and Indonesia[1]. He argues that together, these countries will assume a role akin to that of the G-7 economies – France, Germany, Italy, Japan, the UK, Canada and the US – in the business cycles of the 1950s up until the 1990s.

[1] See 'Big emerging market economies versus the G-7: Which group will drive the upswing in global growth?' www.brookings.edu,14 July 2017.

EM will likely continue posting gains in 2018 on the back of strength in the 'EM-7'.

Kose forecasts that by 2019, the EM-7 will account for 50% of world economic growth. In contrast, the G-7's share will be in the minority, around 25% of the total. Regardless of the accuracy of any specific forecast, the key point is that the EM-7 is as important to the global economy today as the G-7 countries were twenty years ago.

In the absence of a significant improvement in DM productivity, it is the momentum of the EM-7 economies that in future is likely to drive sustained global expansions and hence the cycle in corporate profits, earnings and share prices. We at Manulife Asset Management believe that this shift in the balance of economic power from DM to EM merits a strategic rebalancing of global equity portfolios embodying a significant increase in the weight of EM equity markets, which are currently grossly under-represented in key benchmark indices.

3. Synchronised global cyclical upswing – will it continue in 2018?

No single aggregate economic time series has a precise one-for-one relationship with the real economic activity and the global business cycle. Nevertheless, when so many of the most popular global economic gauges are so closely aligned, our confidence is greatly increased. Moreover, the global economy is a bit like an ocean tanker – it takes a long time to build up real momentum, but once that happens, it takes a big shock to bring the tanker to a halt or change its course.

Synchronised global growth — Stronger for Longer

Four-quarter rates of change in GDP have risen in the third quarter for the US, Japan, Germany, France, and Italy. Thus, Organisation for Economic Co-operation and Development (OECD) growth in the third quarter will have increased from the second quarter's 2.4% rate, which was the best outturn since the third quarter of 2015. Since troughing in the first half of 2016, the OECD's Leading Indicator for the DM economies has risen continuously, and continued to improve in September. With so many of the most-watched economic activity measures in the fourth quarter pointing to further expansion, we can expect another year of synchronised global growth in 2018 with some confidence.

4. What about earnings in 2018? Will cyclical sectors continue to lead the way?

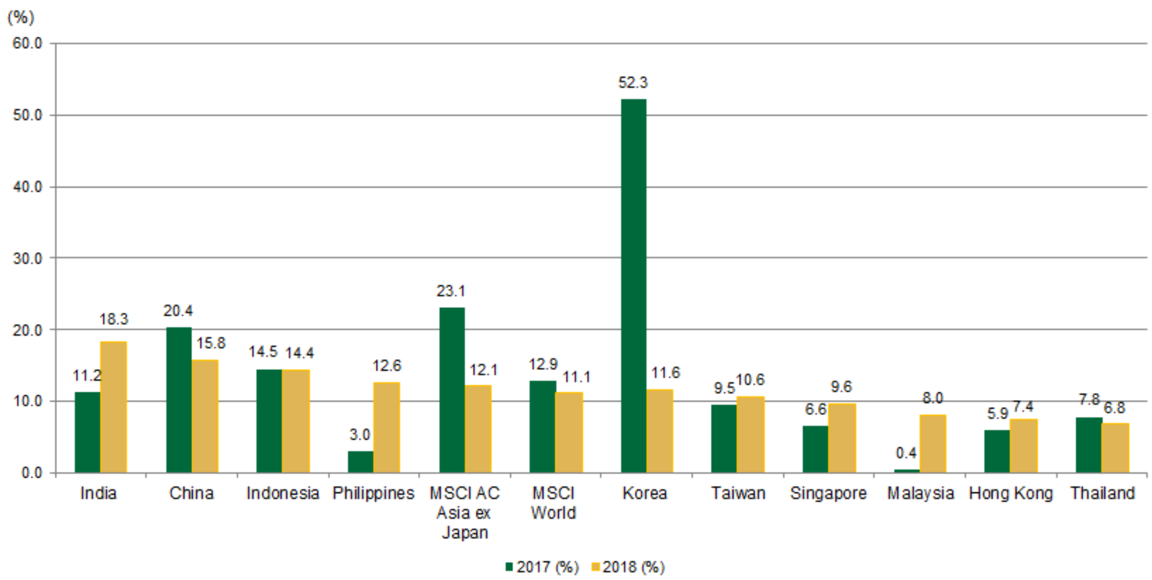
Earnings comparisons will naturally be harder in 2018 after such a strong rebound this year. Moreover, the profits of listed companies cannot continue to exceed the growth in nominal income indefinitely – at some point, the world of "low numbers" or "half returns" will make its presence known. From that perspective, 2017 has been a jubilee year for risk assets that may not be repeated for a long time to come.

Positive if less elevated earnings prospects

There is a significant gap between bottom up earnings forecasts for 2018, which are clustered in the low double digits, and the forecasts from the models of top down equity strategists, which are less rosy. Risk of earnings disappointment is probably something more for the second half of 2018. That said, we still expect to see positive, if less elevated, earnings-per-share (EPS) growth next year, given our base scenario of sustained and above-trend growth amid ample global liquidity.

A silver lining to profits peaking is that we expect the greater dispersion in stock returns so evident this year to persist in 2018. That should prove a boon for bottom up stock pickers, less so for passive funds. Cyclicals should do well in 2018, as should financials and energy stocks, while the IT sector may provide fewer fireworks than in 2017, though underlying trends in the demand for IT products are expected to remain robust.

Figure 1: Asian 2018 EPS forecasts – In many cases, better than this year[2]



5. **Oil prices have risen. Headline CPI inflation should rise as a result. Is this a big concern?**

Short answer: probably not. Understandably, inflation is the number one concern for investors in 2018. We think the price of crude oil has moved up into a new higher range. Thus, there will be some impact on headline inflation in the first quarter of 2018, but it will not be a large impact. Inflation expectations may also increase; at a minimum they should stop falling. This could be a catalyst for a period of higher volatility and a correction in risk assets, but oil prices at US$60 per barrel alone are not enough to cause an inflation panic, and central banks including the Fed are likely to “look through” the data and not alter their course on account of oil. A comparison of producer price index (PPI) with CPI suggests that there is already some “pipeline” inflation building.

Marginal increase in inflation: wages are main inflation focus in the US

All things considered, US wages are a bigger inflation risk factor that could prompt the Fed to become more hawkish. Wage costs have replaced jobs as the key labour market focus. While a resurgence of inflation represents a major potential threat to bonds and equities, our base case scenario is that inflation only rises gradually in 2018, gently approaching central bank targets in the US and eurozone. Inflation will be restrained by global disinflationary forces and the fact that DM growth has only

[2] FactSet, I/B/E/S, MSCI and Goldman Sachs Global Investment Research, consensus estimate based on bottom-up median estimate, as of 24 November 2017.

recently exceeded the trend rate, while inflation responds to the output gap with a considerable lag of at least twelve months.

Should we be wrong, and inflation accelerates earlier and faster than expected, that would pose a cruel dilemma for asset allocators. Under a rising trend inflation scenario, equities and bonds would be positively correlated, with negative absolute returns for both asset classes. Thus, there is a need for investors to stay vigilant on inflation as 2018 unfolds.

6. The US dollar is currently staging a rebound. What are the implications for markets?

We see the US dollar as experiencing a technical, counter-trend rebound, which could persist until the middle of next year, buoyed by US overseas profit repatriation, as happened in 2004. But the conditions for the return of dollar strength and secular appreciation are missing, in our view. Nevertheless, a rising as opposed to a firm US trade-weighted or real effective exchange rate (REER) remains one of the key risks for investors in 2018. A rise in the DXY (Dollar Index) exchange rate basket in 2018 could prove particularly painful for EM and non-US dollar assets generally.

7. China – have 'Hard Landing' risks really gone away?

We see China continuing a relatively stable trajectory in 2018, with the main risk being a conscious decision by Beijing to sacrifice short term growth in pursuit of financial stability. China's outlook is still subject to considerable uncertainty. Recent surveys of international fund managers, for example, still attach roughly a 40% chance of a "hard landing" for the Chinese economy in 2018.[3]

China continues on a stable economic trajectory in 2018

They see the risk of a pronounced slowdown as having risen, after heavy reliance on debt-fuelled growth over the past decade. But China's economic situation is unique in many ways and we think forecasting a downshift to much weaker growth is difficult to justify. With per capita income less than 1/4 of that of the US, there is still considerable scope for China to match what are now lowered expectations.

Conclusion

2018 will in many senses be a continuation of 2017: global growth is slated to accelerate; most markets are expected to move higher on positive earnings. At the same time, 2018 will likely witness many of the events that did not occur this year: a return of marginally higher inflation and increasing interest rates in Europe and possibly Japan. With this rapidly shifting environment, investors should remain focused on the interplay between fundamentals and valuation.

[3] ASR Global Investment Strategy, 31 October 2017.

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