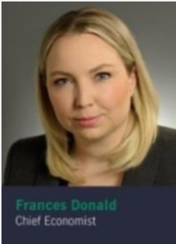
Manulife Investment Management

Market Note

15 Oct 2020



With rising geopolitical tensions and a fading fiscal impulse—the coming weeks could prove to be challenging for risk assets. Our Chief Economist Frances Donald shares her latest market outlook.

Market outlook: uncertainty returns

In mid-August, we noted that the global economy had entered the second phase of the recovery, which we call the stall out and highlighted six key macro themes that we believe would shape the financial markets during the next two to three months—particularly in the United States.

Given the level of uncertainty we're facing and the pace at which events are unfolding, it shouldn't surprise anyone that our views on these tactical themes have evolved. As such, it makes sense to provide an update and explain how our perspective has changed.

In our view, the coming weeks will be characterized by:

- A market environment that will continue to be challenging for risk assets
- A pause in U.S. dollar weakness, with the likelihood that the greenback could strengthen ahead of the election
- A temporary unwinding of the inflation trade

1) We're firmly in the stall out phase of the recovery

What we wrote in August: *As the rush of stellar week-over-week/month-over-month economic prints fade, anxiety will creep back in, creating an obstacle to general risk appetite. This implies that gains in risk assets will likely slow relative to what we saw between April and July.*

Our current view

It's important to note that we're not expecting to see a double-dip recession or a W-shaped recovery. Rather, we continue to believe that the current phase will be defined by stalling economic improvements, where upside economic surprises—which kept investors cheerful—would fade during this phase of the recovery. The vast majority of high-frequency data as well as many traditional economic prints have confirmed our views.

In the past month, however, we've also noted that the stall out is taking the shape of the letter K. By that we mean we expect to see a bifurcation in the recovery where the manufacturing sector, which is far less hampered by social distancing requirements, continues to improve while the services sector not only slows, but weakens. This is particularly relevant to the stock market, which is far more weighted toward manufacturing than services. Indeed, we believe a K-shaped recovery is likely to exacerbate the perception of a divide between the stock market and the economy that could put a floor under how far global stock market indexes can fall.

Market implications

We expect to see continued misses in global economic data exacerbated by concerns relating to a second wave of a COVID-19 outbreak and other volatility-inducing macro events. As a result, we expect risk assets to trade within a relatively tight range, with greater probabilities for periods of risk aversion.

2) A growing fiscal air pocket

What we wrote in August: *The United States has hit a fiscal air pocket and the global fiscal impulse will now wane. This will challenge growth and could distort data.*

Our current view

In hindsight, it now appears that even our somewhat downbeat views in August—which was out of consensus—were too optimistic. Our base assumption has now evolved from a short-term air pocket to the view that Congress is unlikely to pass a phase four fiscal package before November's election, worsening the fiscal cliff drag on the recovery related to the expiration of unemployment benefits. We expect this to accentuate the stall out nature of economic data between now and year end, which could also weaken inflation expectations.

This said, it's clear that the United States' fiscal impulse is fading far faster than most of the developed world and we're now more focused on this policy problem as a primarily U.S. issue.

Market implications

Absent a new fiscal package, we see more scope for downside misses on economic data, pressuring general risk sentiment.

3) Inflation has been priced in, for now

What we wrote in August: *We expect the market to become at least temporarily preoccupied with stagflation concerns as the second derivative on most inflation statistics begins to turn.*

Our current view

Our view was that inflation expectations could rise above 2.0%, and indeed, it did rise to a level consistent with markets expecting over 2.0% inflation. However, the factors that led us to that view—large fiscal spending, a weakening of the U.S. dollar, and stronger commodities—have now partially unwound. While we still believe that inflation will rise to 2.0% to 3.0% over the next 12 months and that there is opportunity in inflation protection on that horizon, for now, the focus will likely turn back to deflation. See our note, "In focus: U.S. inflationary forces," which talked about how we'll go through alternating periods of inflation and deflationary concerns in the market.

Market implications

Inflation protection trades are likely to take a breather, while curve steepener trades could unwind in the absence of fresh fiscal stimulus in the United States.

4) Reacceleration in central bank activity—less so in the United States, but more so elsewhere

What we wrote in August: *A sudden spike in rates and a slowdown in growth will likely usher in a reacceleration in central bank action in the coming months, particularly from the Fed and the European Central Bank (ECB). Should they act as expected, it'll help to contain nominal rates as real rates continue to fall.*

Our current view

A divergence has occurred between the U.S. Federal Reserve (Fed) and most other major central banks. The Fed has moved toward average inflation targeting, signaling that rates will be low for a prolonged period. However, comments from Fed Chair Jerome Powell at the September 16 meeting—along with various communications from several Fed officials in the following week—suggest the bar for the Fed to ease *further* from here on is quite high and the Fed itself has yet to work out what *exactly* average inflation targeting means in practice, muddying policy signals. While the Fed could quickly change its tune, this suggests to us that the Fed is far less likely than we initially expected to move forward with any additional easing, absent a major shock.

Conversely, there is evidence that several other major central banks are keen on being more active on the policy front. Notably, the ECB is rightfully concerned about the disinflationary impact of the exchange-rate pass-through from a stronger trade-weighted euro and has been quite vocal about it. In our view, the ECB could deliver additional stimulus as soon as December, although Q1 2021 seems more likely. The

Bank of England is also likely to announce more easing measures early next year as economic challenges mount post-Brexit. Comments from the Bank of England suggest negative policy rates remain a possibility in the United Kingdom.
In the Pacific region, the Reserve Bank of Australia is also likely to deliver a marginal downward adjustment to its policy rate, inching toward the effective lower bound, and the Reserve Bank of New Zealand seems interested in moving *below* the lower bound.

Market implications

The growing divide in policy direction—a Fed that's on pause versus other major central banks that are ready to act—suggests there's room for the U.S. dollar to, at a minimum, halt its recent weakness. The evolution of U.S. political and global geopolitical events offer the potential for the greenback to strengthen in the near term, which would have an impact on other macro themes as well.

5) Heightening geopolitical risks

What we wrote in August: *Global geopolitical concerns will likely become a larger market focus in the next few months, with various issues—ranging from a U.S.-China decoupling to November's U.S. election, and turbulence in select key emerging markets such as Turkey—coming into focus.*

Our current view

Our view in August was that geopolitical tensions would become more problematic and extend beyond the U.S.-China relationship. Indeed, we've seen a growing list of geopolitical issues that could exacerbate uncertainty and challenge risk. They include:

- Problematic developments with Brexit as the British government threatened to unilaterally overwrite sections of last year's EU-U.K. withdrawal agreement, thereby injecting more uncertainty into the region's economic and policy outlook.
- Tensions between the EU and Russia following the poisoning of the Russian opposition politician Navalny.
- The contested Belarusian election, which revealed additional fissures within the EU's diplomatic establishment.
- An unexpectedly challenging EU-China summit during which Europe stepped up its demands on market access. Arguably, this has set the stage for a potentially important theme that could shape 2021—a unified U.S./EU front to extract agreements/concessions from China.

Most importantly, a rising probability that the winner of the upcoming U.S. election won't be known until after November 3. Plus, we believe that markets have underpriced the likelihood of a second-term for President Trump and that the Republicans could retain control of the Senate.

Market implications

In our view, markets have been preoccupied with examining the impact of fiscal and monetary policies and haven't paid enough attention to the surge in global geopolitical risks—we believe these *global* geopolitical risks are currently underpriced.

6) Non-U.S. assets could be more attractive relative to U.S. assets

What we wrote in August: *U.S. growth and market outperformance will likely be challenged as non-U.S. assets become more attractive in this environment.*

Our current view

We had expected the stall out phase of the recovery to inflict more damage on services-based economies versus manufacturing-based economies, thereby hurting the United States and the United Kingdom more than the industrial economies of northern Europe and north Asia. The fiscal cliff was an added feature that was expected to weigh on the U.S. economy in particular. In our view, both these narratives remain intact and have contributed to U.S. assets being hit relatively harder in recent weeks.

However, while we continue to prefer non-U.S. assets over U.S. assets in the tactical term, we're cognizant of the fading tailwind offered by a weaker greenback.

We're anticipating a one to two quarter pause in the greenback's longer-term trend, with the potential for strength in response to political uncertainty.

Market implications

We continue to believe that U.S. assets are overvalued relative to their peers and will keep this theme in our tactical outlook. However, the fading tailwind provided by the U.S. dollar implies this trade is likely to be less appealing than it was a month ago.

Disclaimer

A widespread health crisis such as a global pandemic could cause substantial market volatility, exchange trading suspensions and closures, and affect portfolio performance. For example, the novel coronavirus disease (COVID-19) has resulted in significant disruptions to global business activity. The impact of a health crisis and other epidemics and pandemics that may arise in the future, could affect the global economy in ways that cannot necessarily be foreseen at the present time. A health crisis may exacerbate other preexisting political, social, and economic risks. Any such impact could adversely affect the portfolio's performance, resulting in losses to your investment

Investing involves risks, including the potential loss of principal. Financial markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. These risks are magnified for investments made in emerging markets. Currency risk is the risk that fluctuations in exchange rates may adversely affect the value of a portfolio's investments.

The information provided does not take into account the suitability, investment objectives, financial situation, or particular needs of any specific person. You should consider the suitability of any type of investment for your circumstances and, if necessary, seek professional advice.

This material, intended for the exclusive use by the recipients who are allowable to receive this document under the applicable laws and regulations of the relevant jurisdictions, was produced by, and the opinions expressed are those of, Manulife Investment Management as of the date of this publication and are subject to change based on market and other conditions. The information and/or analysis contained in this material has been compiled or arrived at from sources believed to be reliable, but Manulife Investment 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 of the information and/or analysis contained. The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline, or other expectations, and is only as current as of the date indicated. The information in this document, including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Manulife Investment Management disclaims any responsibility to update such information.

Neither Manulife Investment 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. All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment, or legal advice. Clients should seek professional advice for their particular situation. Neither Manulife, Manulife Investment Management, nor any of their affiliates or representatives is providing tax, investment, or legal advice. This material was prepared solely for informational purposes, does not constitute a recommendation, professional advice, an offer, or an invitation by or on behalf of Manulife Investment Management to any person to buy or sell any security or adopt any investment strategy, and is no indication of trading intent in any fund or account managed by Manulife Investment Management. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Diversification or asset allocation does not guarantee a profit or protect against a loss in any market. Unless otherwise specified, all data is sourced from Manulife Investment Management. Past performance does not guarantee future results.

Manulife Investment Management

Manulife Investment Management is the global wealth and asset management segment of Manulife Financial Corporation. We draw on more than a century of financial stewardship to partner with clients across our institutional, retail, and retirement businesses globally. Our specialist approach to money management includes the highly differentiated strategies of our fixed-income, specialized equity, multi-asset solutions, and private markets teams, along with access to specialized, unaffiliated asset managers from around the world through our multimanager model.

These materials have not been reviewed by and 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. Additional information about Manulife Investment Management may be found at manulifeim.com/institutional.

Australia: Hancock Natural Resource Group Australasia Pty Limited, Manulife Investment Management (Hong Kong) Limited. **Brazil:** Hancock Asset Management Brasil Ltda. **Canada:** Manulife Investment Management Limited, Manulife Investment Management Distributors Inc., Manulife Investment Management (North America) Limited, Manulife Investment Management Private Markets (Canada) Corp. **China:** Manulife Overseas Investment Fund Management (Shanghai) Limited Company. **European Economic Area and United Kingdom:** Manulife Investment Management (Europe) Ltd.**,** which is authorized and regulated by the Financial Conduct Authority**;** Manulife Investment Management (Ireland) Ltd., which is authorized and regulated by the Central Bank of Ireland **Hong Kong:** Manulife Investment Management (Hong Kong) Limited. **Indonesia:** PT Manulife Aset Manajemen Indonesia. **Japan:** Manulife Investment Management (Japan) Limited. **Malaysia:** Manulife Investment Management (M) Berhad (formerly known as Manulife Asset Management Services Berhad) 200801033087 (834424-U). **Philippines:** Manulife Asset Management and Trust Corporation. **Singapore:** Manulife Investment Management (Singapore) Pte. Ltd. (Company Registration No. 200709952G). **South Korea:** Manulife Investment Management (Hong Kong) Limited. **Switzerland:** Manulife IM (Switzerland) LLC. **Taiwan:** Manulife Investment Management (Taiwan) Co. Ltd. **United States:** John Hancock Investment Management LLC, Manulife Investment Management (US) LLC, Manulife Investment Management Private Markets (US) LLC, and Hancock Natural Resource Group, Inc. **Vietnam:** Manulife Investment Fund Management (Vietnam) Company Limited.

Manulife Investment Management, the Stylized M Design, and Manulife Investment Management & Stylized M Design are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates, under license.

523799