Manulife Investment Management

Outlook 2022 | Global Macro Outlook

Moving from stagflation to growth

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Global overview

Big picture

Historically, when we construct a forecast for the year ahead, we begin by laying out a road map detailing how varying headwinds and tailwinds can affect the economy and try to work out which among them will dominate at different points in time. Once that's done, we have these expectations incorporated into our economic forecasting models and firm up assumptions that we've made about policy responses.

As we set out to do this for 2022, our road map suggested a fairly stark year of two halves. A long list of macro headwinds implies that the first half of 2022 looks problematic, particularly when compared with 2021: Price pressures look as though they might ease, but inflation could remain uncomfortably high for the first few months of the year—particularly in light of the emergence of the Omicron variant—while global growth looks like it could disappoint.

This is a continuation of the stagflationary narrative that persisted in the second half of last year; however, prospects for the second half of 2022 look better, as we expect inventory rebuilds and the unwinding of supply chain disruptions to fuel a more sustainable recovery than the pent-up rebound of 2021. An improved growth picture and slower inflation should bring us back to a Goldilocks regime, which should be far better for market returns and general risk assets.

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What 2022 could look like—key drivers and factors

Key macro drivers	H1 2022 Stagflationary conditions	H2 2022 Goldilocks returns
Primary global macro tailwinds	• Reacceleration of global auto sectors • Household and business credit expansion • Continued strength in U.S. housing activity	• Global inventory rebuilds • Capital expenditure improvements • Alleviation of supply chain disruptions • More fulsome return-to-office initiatives • Real wage growth • Assumed dovish pivot from central banks
Primary global macro headwinds	• Liquidity deceleration • Global fiscal tightening • Supply chain disruptions that limit inventory rebuilds • Purchasing Managers' Index could slip globally • Lagged impact of China growth shocks filters into real economy • Slowdown in U.S. consumer goods spending • Ongoing economic impact of COVID-19, particularly on non-U.S. economies	• Liquidity deceleration • Global fiscal tightening
Inflation outlook	Inflation will likely exceed most central bank targets for the first half of the year	A sharp deceleration in headline prices as goods prices unwind sharply; it's likely that headline inflation in year-over-year terms falls back to a level that's consistent with most central bank targets by year end

Source: Manulife Investment Management, December 16, 2021.

In our view, this year-of-two-halves scenario is a good base case for 2022 and will serve us well as a traditional macro year-ahead outlook. Yet, as we make assumptions about 2022, we find ourselves having to do far more guesswork than we've typically done in the past, even in 2021.

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Many of the key questions central to our outlook—and, for that matter, almost everyone else's—are new to us. Notably, many of these questions relate to policy choices that require less data analysis and more political insight, which isn't exactly a quantifiable variable that economists can use in their modeling work.

While it isn't particularly fashionable or click-worthy to admit that we have less confidence in our base-case projection than normal, we believe it's important to acknowledge the highly uncertain environment that we're in as we head into a year dominated by a very long list of known unknowns.

The four known unknowns

1 COVID-19 and associated global policy responses

In our base case, a fifth wave of coronavirus outbreak will primarily affect the global economy in the first quarter of the year, albeit in an uneven manner.

As of this writing, it remains unclear just how much more transmissible and/or severe this next wave will be, but when it comes to COVID-19 and the economy/financial markets, there are some basic tenets that have become clearer to us in the past 18 months.

COVID-19 can affect the global economy in two key ways. First, through resulting changes in household/ business behaviors (demand-side developments). There isn't a strict formula for this—different economies have different demand-side responses, and vaccination rates may become increasingly relevant. In general, we assume that each subsequent wave will have a relatively smaller impact on these behaviors. However, the second channel of impact is at once more powerful and less predictable: government responses in the form of restrictions on economic activity, social mobility, or trade (supply-side developments).

While it isn't particularly fashionable or click-worthy to admit that we have less confidence in our base-case projection than normal, we believe it's important to acknowledge that there's a high level of uncertainty in the environment that we're operating in.

Problematically, there isn't really any robust way to forecast these responses—different leaders in different jurisdictions have reacted differently with varying results. While we can try to model a relationship between the severity of a COVID-19 variant and ensuing official responses, it isn't a constant and, crucially, it wouldn't be particularly reliable.

A fifth wave (or subsequent outbreaks) that's less severe and leads to limited government responses and behavioral responses is consistent with our base-case outlook for 2022. But lockdowns, supply chain disruptions, and/or a pullback in activity from households and businesses will likely exacerbate the stagflationary environment that we experienced in the second half of 2021.

2 Global supply chain disruptions

In our base-case scenario, we've already endured the worst of the disruptions in global supply chains. Stresses around port activity appear to be easing, global trade pricing has improved, and companies have been reporting major improvements in supply chain bottlenecks. If we're correct, then price pressures in the manufactured goods space should ease throughout the first half of the year, and global companies should be able to restore depleted inventories, thereby contributing to growth through inventory rebuilds and extended capital expenditures. In many ways, the ability to identify *when* global supply chain disruptions will ease is probably the most critical macro call for 2022, in terms of both growth *and* inflation.

Once again, our ability to model how quickly supply chain bottlenecks will dissipate and whether a new COVID-19 variant will produce additional supply disruptions through policy responses or other mechanisms is limited.

"In many ways, the ability to identify *when* global supply chain disruptions will ease is probably the most critical macro call for 2022, in terms of both growth *and* inflation."

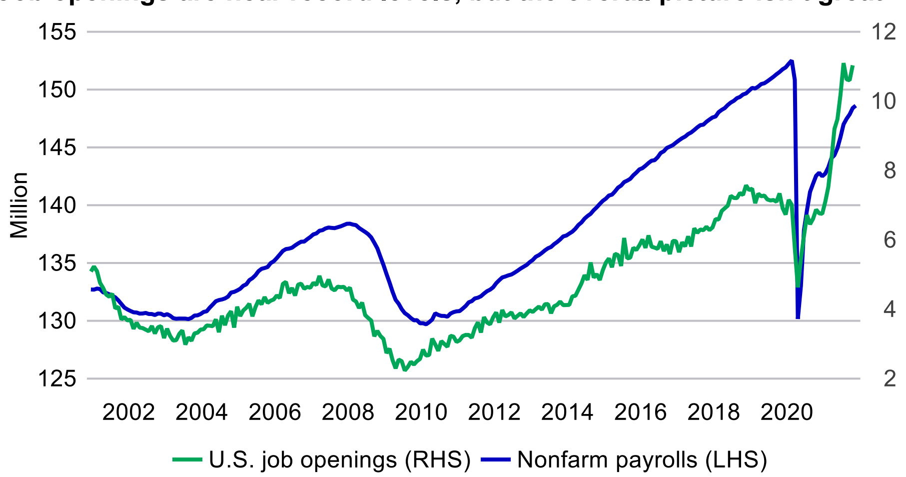
3 The return of U.S. labor force participation

In our base case, U.S. labor supply trickles back into the jobs market throughout 2022. We have a pretty good grasp of why the United States endured the biggest one-off drop in labor supply in modern history—it's a potent mix of a myriad of issues: fear of contracting COVID-19, direct government assistance, pressures associated with virtual school (for working parents), slower immigration, and early retirement.

However, the U.S. labor force participation rate barely budged in the second half of 2021, even after several of those factors subsided (e.g., taking into account retirees who aren't likely to return to the job market). Why is it taking so long for the U.S. labor supply to return to prepandemic levels? Are we missing the bigger picture? Like so many other economic questions of the past two years, we're in uncharted waters, meaning there isn't a robust forecasting model that we can turn to for a sense of how the labor force will behave in the coming year—we can assume, but we won't know for sure.

A return of the U.S. labor force is key to not just the U.S. outlook, but also to global growth. If U.S. workers decide to stay home, wage pressure is likely to continue to rise—a development that's likely to have an uncomfortable impact on businesses in some sectors. It could also translate into a more protracted period of elevated prices and fuel inflation expectations, which could, in turn, lead to a more hawkish U.S. Federal Reserve (Fed).

Job openings are near record levels, but the overall picture isn't great



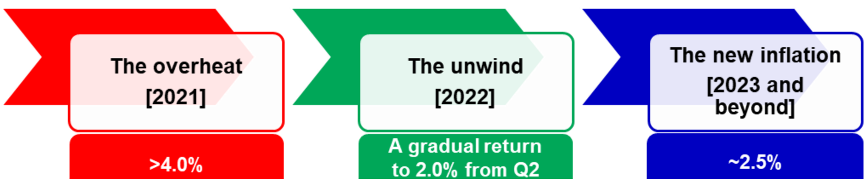
Source: U.S. Bureau of Labor Statistics, Macrobond, Manulife Investment Management, as of December 6, 2021. LHS refers to left-hand side. RHS refers to right-hand side.

"A return of the U.S. labor force is key to not just the U.S. outlook, but also to global growth."

4 Policy responses to higher prices but lower growth

In our base case, the Fed and other major central banks will effectively undergo two phases in 2022. In the first instance, we expect them to pursue a tightening bias in the first few months of the year, when price pressures will remain high. In all likelihood, it will take a few months for the weak global macro environment to be reflected prominently in upcoming economic data, thereby providing some justification for central banks to withdraw support. This tightening bias is likely to produce a further flattening of global yield curves—a key investment theme for the first quarter of the year.

Our views on U.S. inflation remain unchanged



Source: Macrobond, Manulife Investment Management, as of December 6, 2021.

Once inflationary and growth pressures ease, however, we expect global central banks to make a dovish policy pivot, which should create conditions that will allow for an extension of the economic growth cycle.

Forecasting central bank policy is always a mix of art and science but, more often than not, the uncertainty usually has to do with the timing of a policy decision as opposed to its direction of travel. That's less the case in 2022.

First, while we expect uncomfortably high levels of inflation in the first half of the year, they're likely to be driven by global supply issues, which aren't particularly sensitive to interest-rate policy.

"Forecasting central bank policy is always a mix of art and science but, more often than not, the uncertainty usually has to do with the timing of a policy decision as opposed to its direction of travel. That's less the case in 2022."

It's also worth noting that different central banks have taken a different approach to managing inflation: The European Central Bank (ECB) has consistently downplayed its ability to effectively address supply-side-driven inflation, while the Bank of Canada (BoC) has said it believes it can and will keep inflation under control. Same data, different responses.

Second, we expect that global labor markets will still have room for improvement throughout 2022, and central banks with dual mandates (such as the Fed) will have more subjectivity than those with other mandates (e.g., the Bank of England's (BoE's) mandate is price and financial stability).

Third, there will be compositional changes at central banks in 2022, particularly at the Fed, where three seats on the decision-making committee need to be filled. This makes it even *more* challenging to read central bank perspectives.

It's entirely possible (although not our base case) that central banks worldwide will remain hawkish in 2022 and that the Fed will raise interest rates more than two times. Such a development will weaken the likelihood of a Goldilocks reemergence; however, at this point, that remains *not* to be our base-case scenario.

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United States

Big picture

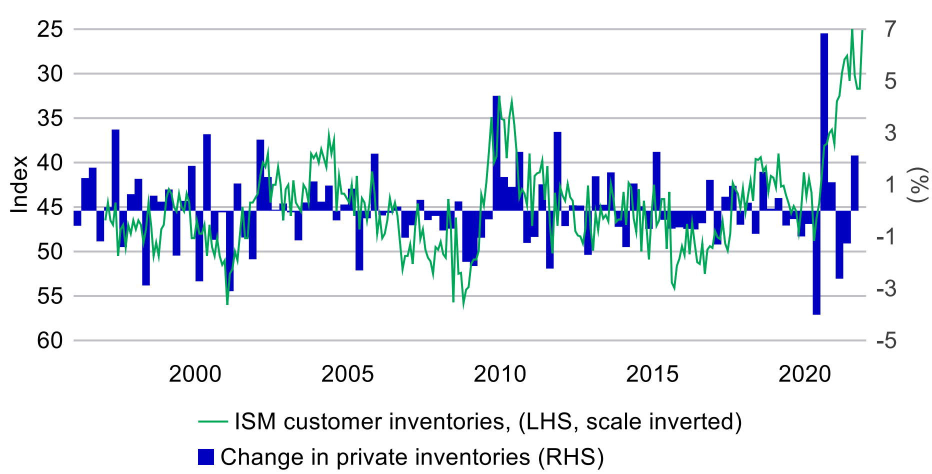
Pandemic or endemic? Transitory or systemic? Hawkish or dovish? Shortages or restocking? Employment surge or shortage?

The coming year is likely to provide clarity to questions such as these, which have muddied the waters for most of the last two years. The problem is that many of the answers are likely to only come in the latter half of the year, meaning that both the macro backdrop and financial markets might be headed for a choppy couple of quarters before establishing a clear direction.

Indeed, we expect the year to begin with the uncomfortable combination of sticky, high inflation and a moderation in growth before transitioning to a higher growth profile with more moderate levels of inflation in the second half of the year.

Despite the headwinds created by monetary and fiscal policy withdrawal in 2022, there are parts of the U.S. economy that we expect will continue to perform well: Manufacturing production, capital expenditures, and business spending still look strong for the next several quarters.

U.S. inventory buildup should continue to support production



Source: Institute for Supply Management (ISM), Macrobond, Manulife Investment Management, as of December 6, 2021. LHS refers to left-hand side. RHS refers to right-hand side.

We expect the year to begin with the uncomfortable combination of sticky, high inflation and a moderation in growth before transitioning to a higher growth profile with more moderate levels of inflation in the second half of the year.

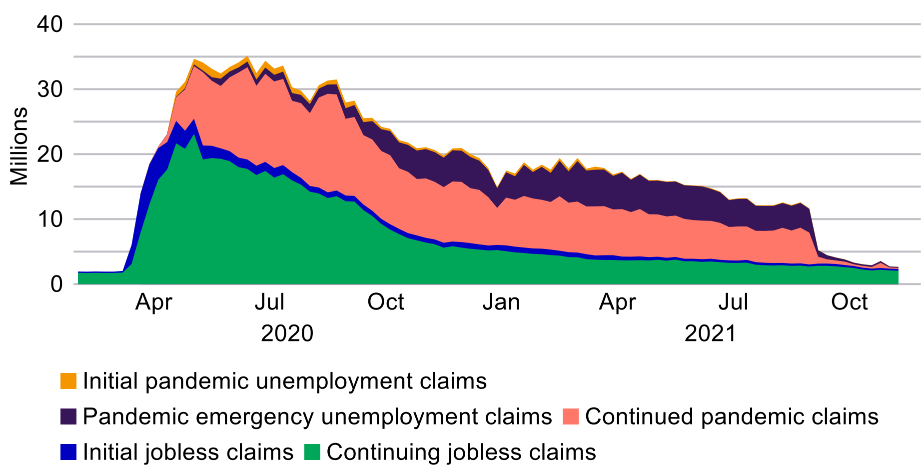
Business surveys so far remain unambiguously positive, and while we'd expect a deterioration in these leading indicators in the coming months, their lagged effects generally imply a brisk pace in the sector and would be supported by a few quarters of inventory rebuilding.

Similarly, the housing market remains at very tight levels—rising personal incomes, still-low interest rates, and consumer behavior all indicate that the existing dynamic is likely to persist for several months to come.

Intuitively, many of the questions that we have are related to the pandemic. In our view, direct government intervention around pandemic-related restrictions will remain minimal, which should, in theory, mean a muted impact on domestic growth. Moreover, international restrictions such as China's COVID-zero policy and reduced mobility may continue to disrupt global supply chains and, by extension, inventory levels and prices. This, in turn, could have potential monetary policy implications as the Fed grapples with how transitory inflationary measures might be.

A separate, more domestic source of uncertainty is the ongoing labor shortage. Employment dynamics were distorted by extended unemployment benefits for the last two years, which created a dearth of labor as the economy reopened. As these benefits rolled off, affected claimants should reenter the job market.

U.S. jobless claims have fallen significantly in recent weeks



Source: U.S. Department of Labor, Macrobond, Manulife Investment Management, as of December 6, 2021.

"In our view, direct government intervention around pandemic-related restrictions will remain minimal, which should, in theory, mean a muted impact on domestic growth."

What we're watching

- **Inflation—**We continue to believe inflation will ease toward 2% by year end, but ongoing supply chain disruptions will likely mean stickier prices, particularly for the first half of the year. Problematically for the Fed, supply-side-driven inflation is far less sensitive to interest-rate policy.
- **Employment—**With the wind-down of enhanced unemployment benefits last autumn, over 8.5 million people lost unemployment benefits. How quickly and how broadly this might translate into an uptick in employment will be crucial for labor supply mismatches and, potentially, consumption.

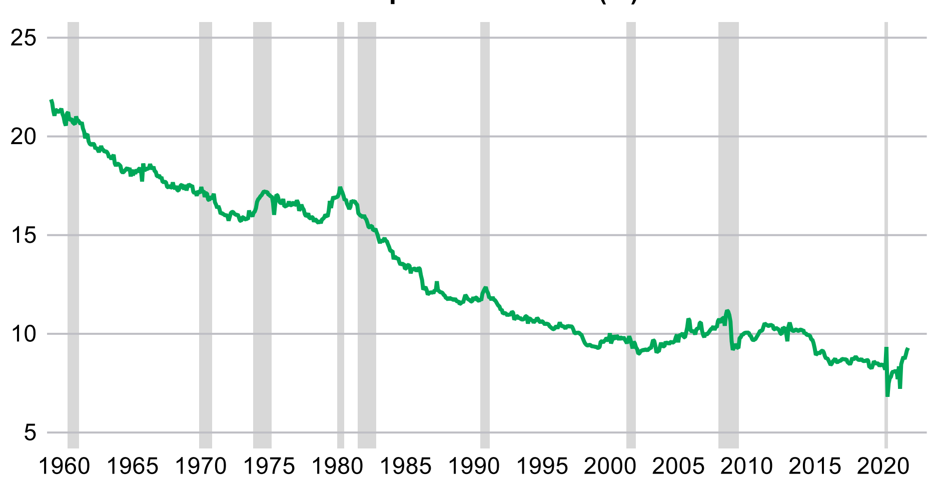
Key market views

- **Equities—**While we remain optimistic about the country's medium-term outlook, short-term uncertainties and lower liquidity levels (as a result of central bank normalization) temper our optimism somewhat. Although we still expect U.S. equities to produce positive returns, we could see increased volatility due to these factors.
- **Rates—**We expect U.S. 10-year yields to finish 2022 modestly higher as uncertainty subsides, when a clearer picture around the Fed's tightening cycle could emerge.

Risks to our view

- **Supply chain issues—**Supply chain disruptions could continue to weigh on the economy in terms of both availability and prices, thereby constraining growth.
- **Impact of inflation on consumption—**Higher prices could derail a bright consumer story. While food and gas prices as a share of disposable income have so far appeared manageable, the metric is beginning to rise toward uncomfortable levels that could force a more discernable shift in consumption patterns.

Gas and food as a share of disposable income (%)



Source: Macrobond, Manulife Investment Management, as of December 6, 2021. The gray areas represent recessions.

"We expect U.S. 10-year yields to finish 2022 modestly higher as uncertainty subsides, when a clearer picture around the Fed's tightening cycle could emerge."

Canada

Big picture

Canada is entering 2022 with a bevy of advantages, particularly relative to its neighbor to the south. Employment has more than recovered from the COVID-19 shock, fiscal policy remains relatively supportive, and vaccination rates are high. And yet, with inflation hitting 4.7% in November, the BoC—which has a single mandate of price stability—isn't left with many excuses to hold off on tightening; indeed, the central bank has indicated quite plainly that it expects to hike interest rates in mid-2022. Meanwhile, the market has gone ahead and priced as many as five rate hikes for Canada as we head into the new year.[1] We too have had to bring forward our rate hike expectations and now believe that we could see one or two interest-rate hikes in 2022. That is, however, still a far more dovish outlook than the market is penciling in.

Canada won't be immune to the many global macro challenges that are expected to affect most economies in the first half of 2022. Another COVID-19 wave, weaker global trade and manufacturing activity, decelerating global liquidity, the lagged impacts of tighter Chinese policy, and a global fiscal cliff—all of these issues are relevant to Canada both directly and indirectly through the global growth impulse.

It's also important to note that Canada continues to face other challenges that are unique, not the least of which is the Canadian economy's relative sensitivity to rate hikes given its dependence on housing activity and leverage. Devastating floods in British Columbia are also likely to limit how quickly supply chains can return to full operating capacity in this recovery.

With a single mandate of price stability and inflation running near 5%, the BoC is left with few reasons to refrain from tightening—interest -rate hikes in 2022 now appear entirely plausible.

1 Bloomberg, as of December 10, 2021.

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What we're watching

- **Canada's property sector—**Housing activity continues to be an important focal point and poses a potential risk to Canada's broader economic outlook. Our concerns in regard to this issue have broadened beyond financial stability to also include the likelihood that structurally high property prices could dampen corporate competitiveness, encourage cost-push inflation, and drive immigration flows into—and out of—Canada.
- **Central bank—**The BoC seems optimistic, but the central bank's glass-half-full approach could create room for policy errors that might be followed by a policy pivot. While we believe interest rates will need to rise in Canada, they'll likely have to rise more slowly than its global peers to avoid sharp declines in growth.

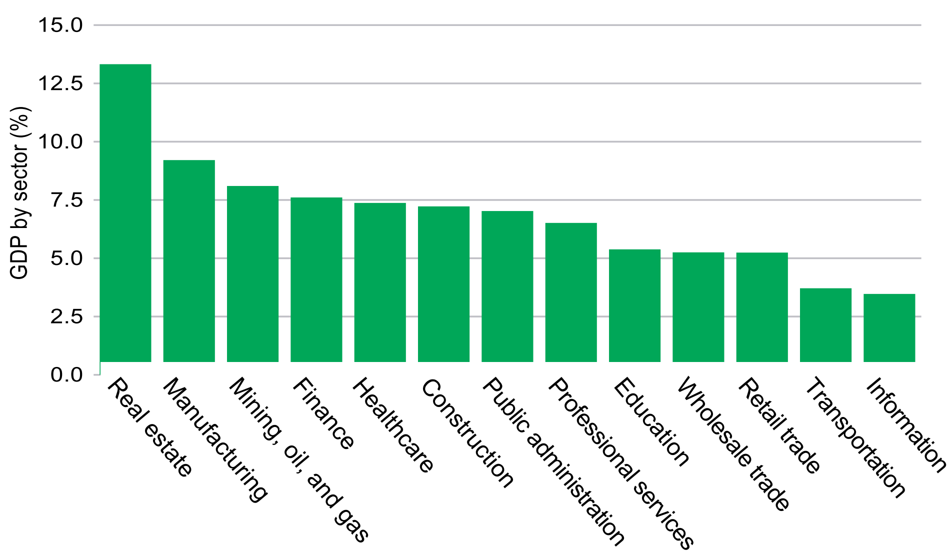
Key market views

- **Currencies—**The CAD remains well supported by high energy prices and relative central bank policy, given that the outlook for the BoC remains relatively more hawkish in relation to the Fed. However, the magnitude of anticipated CAD strength has been tempered by the unexpectedly hawkish shift in Fed policy, which should limit the extent of the currency's strength in 2022. As such, we expect modest weakness in USD/CAD toward the midpoint of the 1.20 to 1.25 range.
- **Rates—**We believe the market will eventually have to reduce its expectations on the number of rate hikes in 2022; however, that change in perception isn't likely to happen until growth and inflation data moderates significantly (as we expect) in Q2. Until then, Canadian rates are likely to follow the global trend and continue to flatten.

Risks to our view

- **Upside risk—**The energy sector remains a key economic driver for Canada, and rising energy prices are likely to bolster the CAD, support investment, and drive more growth than we're currently expecting.
- **Downside risk—**COVID-19 remains an important risk to the Canadian economy, as lockdowns have tended to be more prevalent in Canada than its developed-market peers, and the country has been slower to roll out booster shots compared with the United States and Europe. Should a fifth or sixth wave take hold, it will weaken the path of Canadian growth even more than our base case suggests.

Canada's economy is highly sensitive to monetary policy tightening



Source: Macrobond, Manulife Investment Management, as of December 10, 2021.

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Euro area

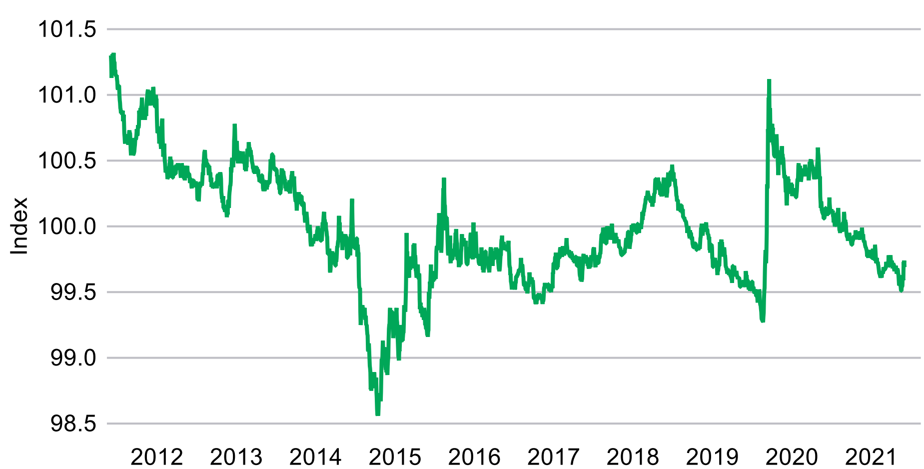
Big picture

The euro area's outlook remains solid as high-frequency indicators hint at impressive levels of economic expansion while medium-term growth expectations continue to be revised upward. Near-term challenges relate to the evolution of the pandemic and individual member countries' (varying) approach to containment—most notably the strict policies deployed in Austria and Germany.

Financial conditions remain supportive of growth; however, a reversal in trend seems likely, and we're watching intra-European bond spreads closely as ECB officials debate the future of the central bank's asset purchase program in the context of hotter-than-expected inflation.

The ECB is enjoying considerable success with its forward guidance so far as markets abstained from pricing in a normalization of policy rates, which remain in the negative territory, thereby delivering a clear divergence in relation to the Fed. Political risk in the first half of 2022 will likely be dominated by the French presidential election, as incumbent Emmanuel Macron is challenged by a resurgence in support for traditional parties as well as popular figures on the far right of the political spectrum.

Euro area financial conditions index



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 6, 2021.

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What we're watching

- **Inflation and the ECB—**Higher-than-expected inflation is creating a considerable amount of uncertainty around the outlook for the ECB's balance sheet policy as hawkish members of the central bank push for a prompt end to asset purchases.
- **Intra-European bond spreads—**Uncertainty around the outlook for the ECB's balance sheet policy has generated a widening in bond spreads, most notably in Italy. Should spreads widen significantly, it could rekindle the debate regarding core versus periphery member states, a scenario that the region's policymakers would no doubt prefer to avoid.

Key market views

- **Rates—**In our view, front-end rates remain low. The ECB is having considerable success with its forward guidance, and this is helping to maintain an important anchor for bond yields at the front end of the curve.
- **Currencies—**A renewed divergence in the outlook for relative central bank policy is likely to keep the EUR/USD pair trading defensively through the first half of 2021 as traders prepare for lift-off at the Fed while also respecting the ECB's conditional forward guidance, which implies limited near-term risk of interest-rate increases.

"Higher-than-expected inflation is creating a considerable amount of uncertainty around the outlook for the ECB's balance sheet policy as hawkish members of the central bank push for a prompt end to asset purchases."

Risks to our view

- **Financial conditions—**The trend of steady economic improvement (established since March 2020) is being threatened as investors assess the outlook for the ECB's balance sheet policy and its impact on a wide variety of risk premia, including sovereign bond spreads. In our view, forward guidance provided by the ECB remains an important offset, helping to underpin interest rates at the front end of the curve.
- **Political risk—**The upcoming French presidential election will likely dominate the European political conversation in the first half of 2022 as President Macron battles against traditional parties as well as popular figures from the far right.

10-year spreads: Italian and French vs. German sovereign bonds (%)

Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 6, 2021. LHS refers to left-hand side. RHS refers to right-hand side.

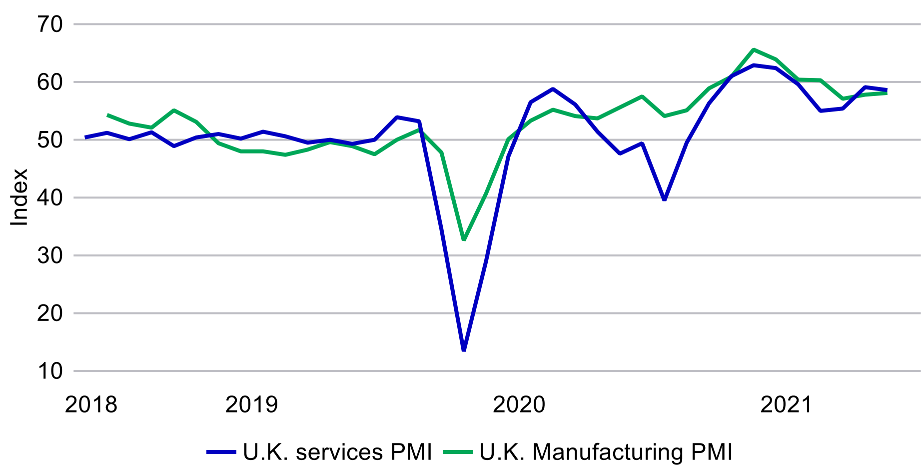
United Kingdom

Big picture

The United Kingdom's medium-term growth outlook remains solid, with healthy levels of growth expected in 2022 and improving prospects for 2023 despite ongoing uncertainties. High-frequency activity indicators such as Purchasing Managers' Indexes (PMIs) are holding up remarkably well. Near-term risk will be tied to how the next phase of the pandemic plays out and its impact on consumption—specifically, consumer spending on services. Inflation remains a threat to real consumption; however, both goods and commodities inflation is expected to moderate heading into the second half of 2022. Services inflation should receive increasing support from a tighter labor market that seems to be adjusting to the end of the government's furlough scheme.

We're keeping an eye on the official policy rate, with 50 basis points (bps) being a key level. Should it rise above that level, the BoE—based on its previous communication—could tighten monetary policy by opting not to reinvest proceeds from maturing debts on its balance sheet. The upcoming gilt maturity schedules suggest the BoE may have an opportunity to do so in March. If this were to happen, it could have important implications on growth prospects.

U.K. PMIs: manufacturing vs. services



Source: Bloomberg, Manulife Investment Management, as of December 6, 2021. A Purchasing Managers' Index (PMI) above 50 indicates expansion.

"Near-term risk will be tied to how the next phase of the pandemic plays out and its impact on consumption—specifically, consumer spending on services."

What we're watching

- **Central bank policy—**Market expectations for the United Kingdom's interest-rate path remain aggressive despite the BoE having caught investors off guard by keeping rates on hold after weeks of hawkish statements. That said, investors continue to expect the the central bank to take an aggressive approach to rate normalization, and we're watching the 50bps level very closely.
- **Inflation—**Price levels in the United Kingdom have risen to a 10-year high, and inflation breakevens, a market-based measure of inflation expectations, remain elevated at levels last sustainably seen in the early/mid-1990s. Official estimates are also being marked up in a manner that we find concerning.

Key market views

- **Equities—**In our view, U.K. equities are undervalued and continue to underperform their peers owing to ongoing uncertainties related to what the U.K.-EU relationship would ultimately look like. Within that context, any positive development—no matter how marginal—could offer significant upside to the asset class's performance.

Risks to our view

- **Central bank policy normalization—**Monetary policy is now a key source of uncertainty to the U.K. economic outlook as investors reevaluate to what extent they can rely on official guidance from the BoE. The central bank's stance has been inconsistent, having swung from dovish to aggressively hawkish between Q2 and Q3 2021 before opting to leave rates unchanged.
- **Inflation—**Prices have hit a 10-year high, and inflation breakevens are at levels last sustainably seen in the early/mid-1990s. Official estimates are being marked up in a manner that we find concerning.

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Asia-Pacific overview

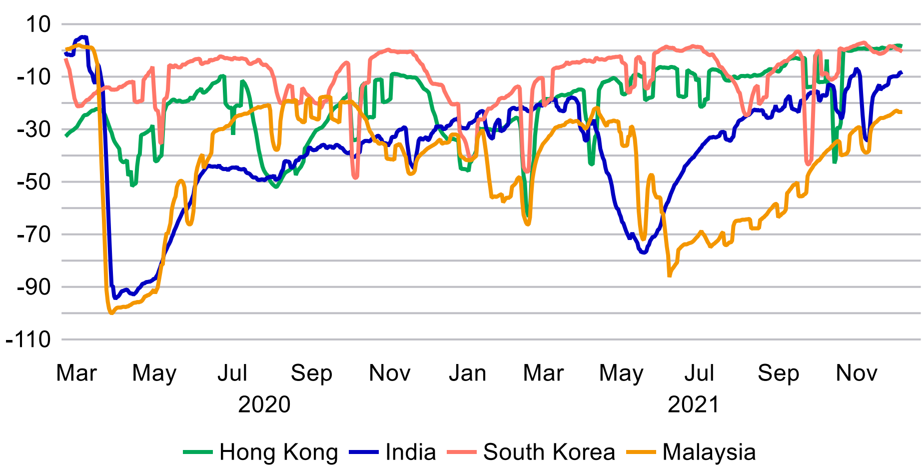
Big picture

Just as the worst of the Delta wave was passing and regional activity was rebounding in earnest, it's fair to say the uncertainty presented by the emergence of Omicron has come at an inopportune time. While many key aspects of the latest COVID-19 variant are as yet unknown, such as immune escape and lethality, it's already dealing a fresh blow to the region's tourism and services sector as border restrictions reemerge.

What's concerning for the region is that supply chains are already stretched and inventories are lower relative to past virus waves. Should Omicron turn out to be as challenging as feared, Asia's ability to leverage foreign demand as a growth driver will be less successful than in the past two years. We suspect economic recovery will lose momentum going into early 2022, and the latest developments reinforce our view that the key to sustainable recovery hinges on supporting domestic demand.

"Should Omicron turn out to be as challenging as feared, Asia's ability to leverage foreign demand as a growth driver will be less successful than in the past two years."

Mobility diffusion index: Omicron variant emerges at an inopportune time (%)



Source: Google's COVID-19 Community Mobility Report, Manulife Investment Management, as of December 6, 2021. The baseline is the median value for the corresponding day of the week during the five-week period between January 3, 2020, and February 6, 2020. Formula for diffusion index: Mobility around the workplace (% deviation from baseline) minus mobility around residential (% deviation from baseline), and take a seven-day moving average. A more/less negative number indicates more/less people are staying at home instead of going to the office.

What we're watching

- **COVID-19 trends—**Omicron's transmissibility and the degree to which existing vaccines can offer sufficient protection against it will be key to recovery in the services sector and tourism.
- **Fed communication—**As we enter a period of uncertainty regarding the timing of the Fed's expected plan to reduce its asset purchasing program, potential volatility in the USD and U.S. interest rates may weigh on global liquidity—an element that's crucial to Asian growth.

Key market views

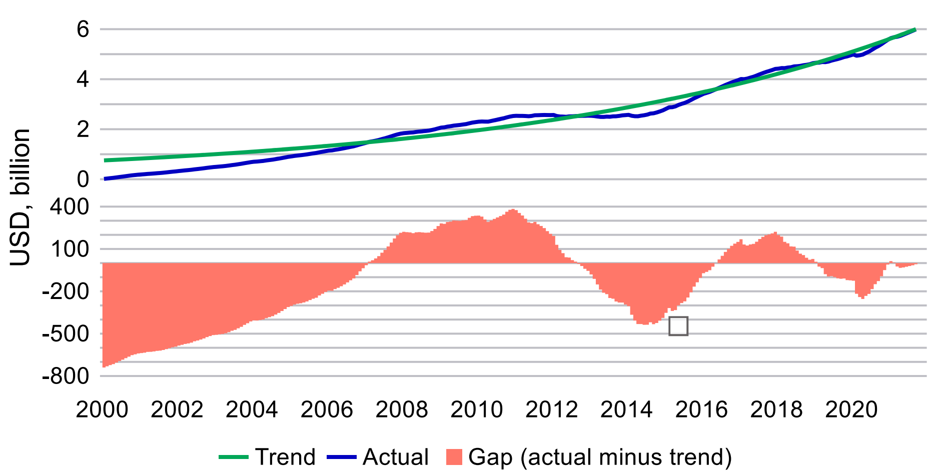
- **Equities and rates—**We think emerging Asia equities and fixed income will be supported by accommodative monetary policy stances and are, broadly speaking, in a better position to withstand Fed taper risks relative to 2013 thanks to stronger external positions, lower reliance on external funding, and better-balanced positioning. We see the scope for economic growth catching up in parts of Southeast Asia as COVID-19 concerns ease.
- **Foreign exchange—**With the USD finding some support now that U.S. real yields seem to have hit a bottom, there may be increasing headwinds to Asian currencies.[1]

"As we enter a period of uncertainty regarding the timing of the Fed's expected plan to reduce its asset purchasing program, potential volatility in the USD and U.S. interest rates may weigh on global liquidity—an element that's crucial to Asian growth."

Risks to our view

- **Upside risk—**If the Omicron variant passes through with limited economic damage, it would enable a quick reopening of borders and will likely support services activity.
- **Downside risk—**Asian exports held up well despite the global supply chain disruption because producers were able to run down elevated inventory. With that buffer depleted, prolonged supply shortages will likely be felt more acutely.

Will net exports hold up when supply chains/inventories are stretched?



Source: Macrobond, Manulife Investment Management, as of December 6, 2021.

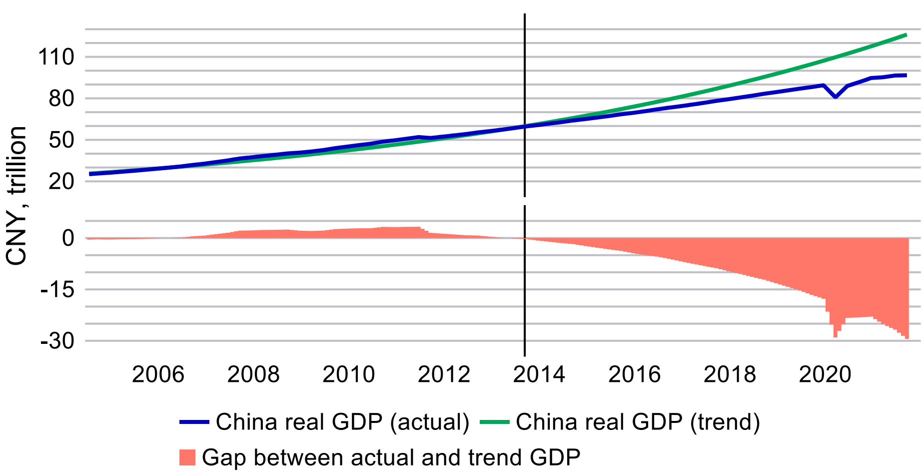
1 Bloomberg, as of December 6, 2021.

China

Big picture

Chinese economic surprises have started to improve relative to expectations, and hopes of policy easing have bouyed sentiment. That said, headwinds to economic growth remain strong—from intermittent lockdowns disrupting domestic activity, particularly services, to continued power shortages and production caps on energy-intensive sectors and weakness in the property sector. In our view, any policy easing will at best cushion, rather than prevent, the continued loss of economic momentum. The People's Bank of China (PBoC) has continued to tighten monetary policy—its balance sheet has shrunk from over 40% of GDP to between 30% and 35% of GDP, reducing its size to nearly half of what it was in 2009. We note that consensus growth forecasts for China have been downgraded in earnest in recent weeks, and we expect further cuts to materialize. The path back to trend GDP, we believe, looks increasingly challenging. The recent Central Economic Work Conference suggests efforts to control debt and rein in the property sector will continue. In our view, policy support will remain measured and insufficient to prevent the economy from slowing further.

China real GDP: increasingly below trend growth



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 6, 2021. The black line in the chart denotes the last time China's real GDP was not below trend growth.

Headwinds to economic growth remain strong—from intermittent lockdowns disrupting domestic activity, particularly services, to continued power shortages and production caps on energy-intensive sectors and weakness in the property sector.

What we're watching

- **Evolution of COVID-19 variant(s)—**If the Omicron variant proves harder to contain than Delta, we can expect the government to introduce tighter containment measures that will negatively affect the services sector and global supply chains.
- **Fed communication—**As we enter a period of uncertainty regarding when the Fed will begin to scale down its asset purchases, we could see potential volatility in the USD and U.S. interest rates, which will likely further tighten USD liquidity and affect China's growth prospects.

Key market views

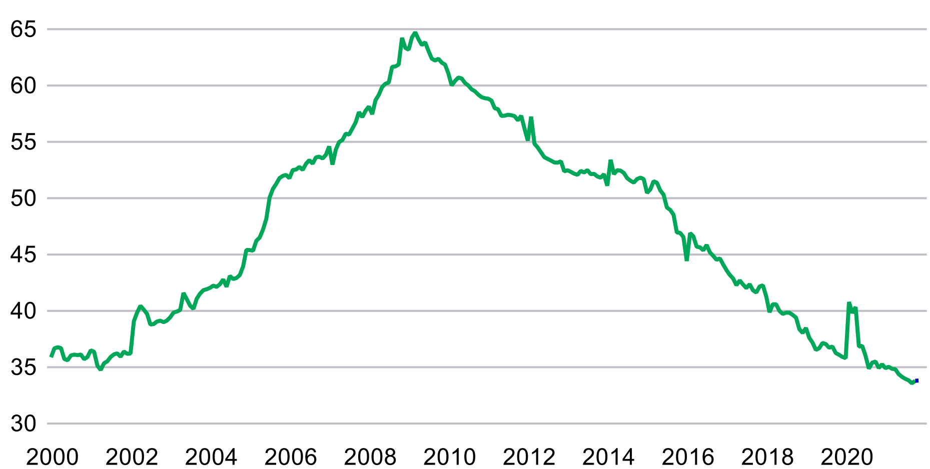
- **Equities—**Investor sentiment remains negative amid elevated regulatory risk and the limited hedge against likely stagflation based on the composition of the MSCI China Index. We also expect Chinese A-shares to outperform H-shares due to relatively less intervention risk.
- **Rates—**Chinese government bonds typically outperform during periods of declining global liquidity, and we don't expect things to be different this time.

"Investor sentiment remains negative amid elevated regulatory risk and the limited hedge against likely stagflation based on the composition of the MSCI China Index."

Risks to our view

- **Upside risk—**Barriers to entry could protect Chinese companies from foreign competition and a possible sudden surge in interest from global equity investors as a result of perennial underallocation to China's A-shares. This would provide much-needed USD liquidity to fuel Chinese economic growth.
- **Downside risk—**Supply chain bottlenecks could become an increasingly binding constraint on export volumes, posing further risks to growth.

PBoC balance sheet as a share of GDP (%)



Source: People's Bank of China, National Bureau of Statistics of China, Macrobond, Manulife Investment Management, as of December 6, 2021.

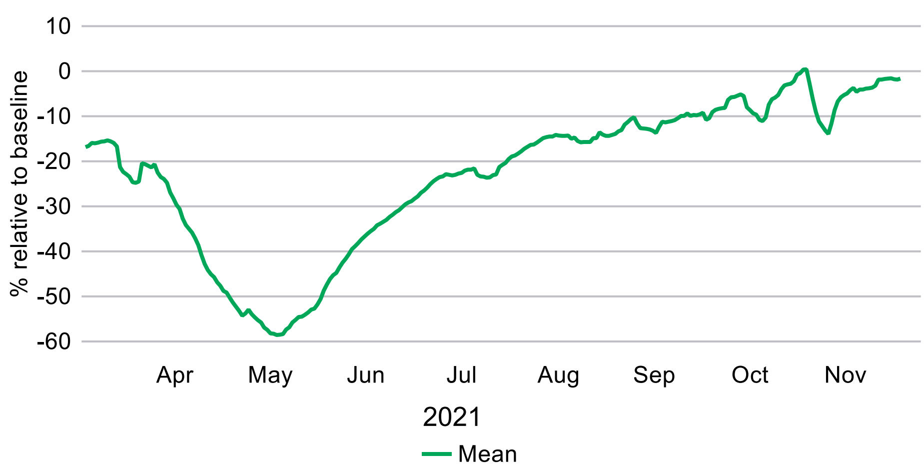
India

Big picture

India's GDP rebound in the third quarter of 2021 was led by the services sector as the easing of social restrictions allowed contact-intensive sectors to recover; however, the emergence of the Omicron variant has refocused attention back on the still-low vaccination coverage in India, meaning the threat of new virus outbreaks and associated disruptions will continue to loom. We expect the Reserve Bank of India (RBI) to maintain its accommodative monetary policy for some time yet.

The big development in Q4 2021 was the repeal of reforms aimed at liberalizing the agriculture sector and, by extension, the precedent this might have set for other major reforms. The decision represents a huge setback for the Modi government and was announced ahead of the Uttar Pradesh election, which is scheduled to begin in February. The vote is widely seen as a referendum on the ruling Bharatiya Janata Party (BJP). Depending on what happens in the coming weeks, it's possible that the government may feel compelled to put other controversial economic reforms on hold.

India: average mobility around workplaces, retail, and recreation



Source: Google's COVID-19 Community Mobility Report, COVID-19 India, Macrobond, Manulife Investment Management, as of December 6, 2021. The baseline is the median value for the corresponding day of the week during the five-week period between January 3, 2020, and February 6, 2020.

"We expect the RBI to maintain its accommodative monetary policy for some time yet."

What we're watching

- **COVID-19 developments—**For now, markets are concerned that the Omicron variant could be as challenging as Delta. Should scientific data show that the variant wouldn't lead to severe sickness despite being more infectious, it could be seen as a positive for India since government experts suggested back in July that nearly 70% of the Indian population might already have the antibodies needed to fend off the virus.
- **Outcome of Uttar Pradesh election—**Understandably, a poor performance from the BJP at the upcoming election could weaken the government's ability to push through potentially painful economic reforms and could set the government's reform agenda back even longer.

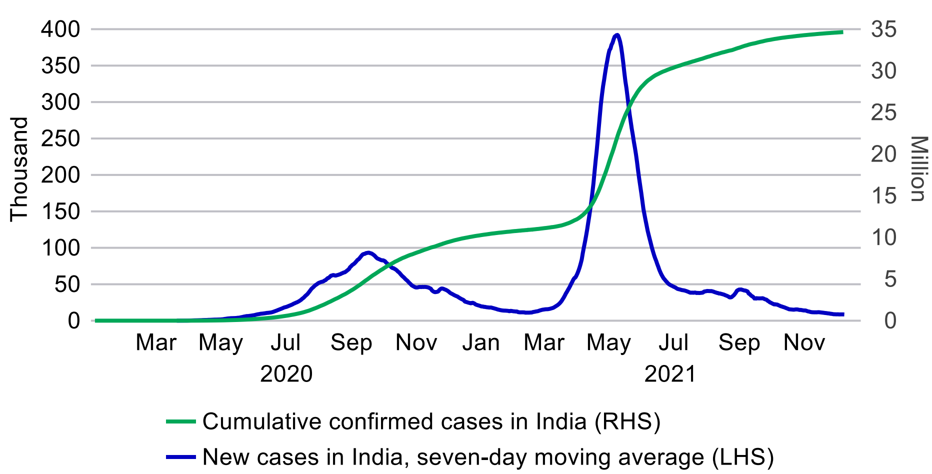
Key market views

Rates, equities, and currencies—We expect Indian fixed income and equities to outperform in the coming months. With monetary policy normalization likely to take place very gradually in the coming years, we expect government bond yields in India to rise only marginally over the medium term and, crucially, by less than most other emerging markets. In our view, that will promote currency underperformance and equity outperformance.

Risks to our view

Upside and downside risks—Consumer confidence remains downbeat, and high-frequency data suggests the initial reopening bounce was already fading as we headed into November. Arguably, much hinges on how the pandemic plays out from here.

Does India have natural immunity after experiencing COVID-19 waves?



Source: COVID19India, World Health Organization, Manulife Investment Management, as of December 6, 2021. LHS refers to left-hand side. RHS refers to right-hand side.

"With monetary policy normalization likely to take place very gradually in the coming years, we expect government bond yields in India to rise only marginally over the medium term and, crucially, by less than most other emerging markets."

Manulife Investment Management

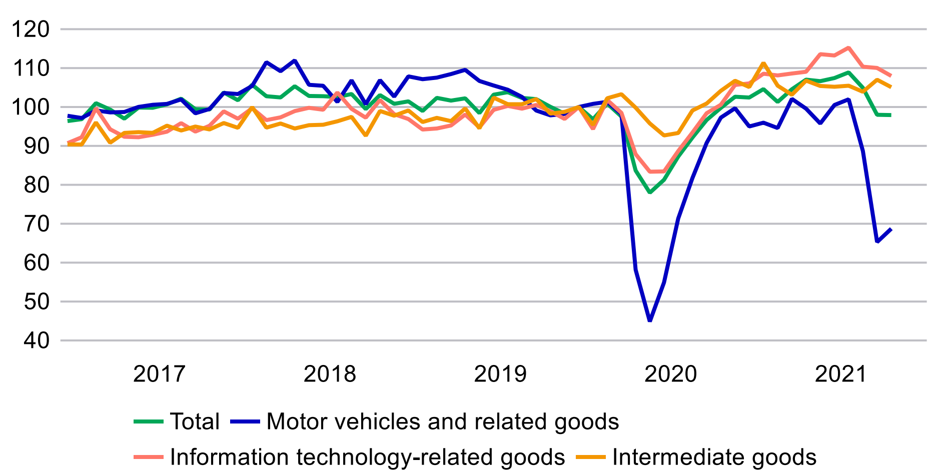
Japan

Big picture

Japan's economic data continued to surprise to the downside in the past three months, and the emergence of the Omicron variant presents added uncertainty to the outlook. With inflation largely contained, the Bank of Japan (BoJ) is set to keep monetary policy loose for longer, even as other central banks start to tighten. Fiscal policy also remains supportive—among the highlights of Prime Minister (PM) Fumio Kishida's recent supplementary budget was the allocation to domestic industry and digital investment, including a ¥400 billion funding for a new Taiwan Semiconductor Manufacturing factory.

Crucially, the budget was underpinned by new capitalism, a key policy proposed by PM Kishida, which seeks to achieve a more even distribution of wealth, with a specific focus on economic national security. Even though this initiative won't alleviate near-term semiconductor shortages, we believe it demonstrates a shift in the government's mindset toward building economic resilience and should help drive strong capital expenditure growth in coming years.

Japan export volumes



Source: Bank of Japan, Macrobond, Manulife Investment Management, as of December 6, 2021. Indexed to 100, where December 2019=100.

"With inflation largely contained, the BoJ is set to keep monetary policy loose for longer, even as other central banks start to tighten."

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What we're watching

- **Politics—**Supply chain disruptions in a wide range of manufacturing sectors have reduced global production activity, placing limits on the extent to which Japanese export volumes can grow.
- **Household consumption—**We're keeping an eye on the extent to which the recently introduced household subsidies will boost household consumption. It's unclear how much of the subsidies will be saved and how much will be spent while the economic climate remains uncertain.

Key market views

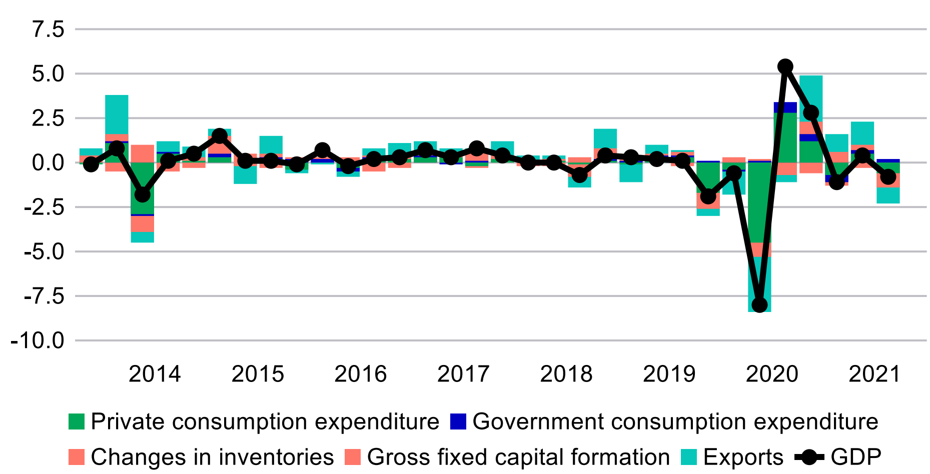
- **Equities—**We expect Japanese equities to outperform. The asset class is generally undervalued versus its global peers, and we foresee support for Japanese stocks coming from the economic reopening. Foreign investors have limited their exposure to this asset class for some time, but it's a position that's worth reconsidering as historical data shows that Japanese equities typically outperform when global liquidity falls.
- **Currencies—**After three months of outperformance versus G10 currencies, we're turning more neutral toward the JPY in Q1 amid the competing influences of narrowing interest-rate differentials and rising uncertainty around COVID-19.

"Supply chain disruptions in a wide range of manufacturing sectors have reduced global production activity, placing limits on the extent to which Japanese export volumes can grow."

Risks to our view

- **Upside risk—**PM Kishida has kicked off discussions to map out a path to move wealth from companies to households under the new capitalism banner. If implemented smoothly, this could be bullish for economic growth but negative for financial asset prices.
- **Downside risk—**Should the structural weakness in Japan employment trends continue, it could hurt growth. Notably, Japan's labor force participation rate has been trending lower since August, and per capita wage growth has also slowed materially. It's an area that warrants attention.

Contributions to Japan quarterly real GDP growth (%)



Source: Cabinet Office (Japan), Macrobond, Manulife Investment Management, as of December 6, 2021.

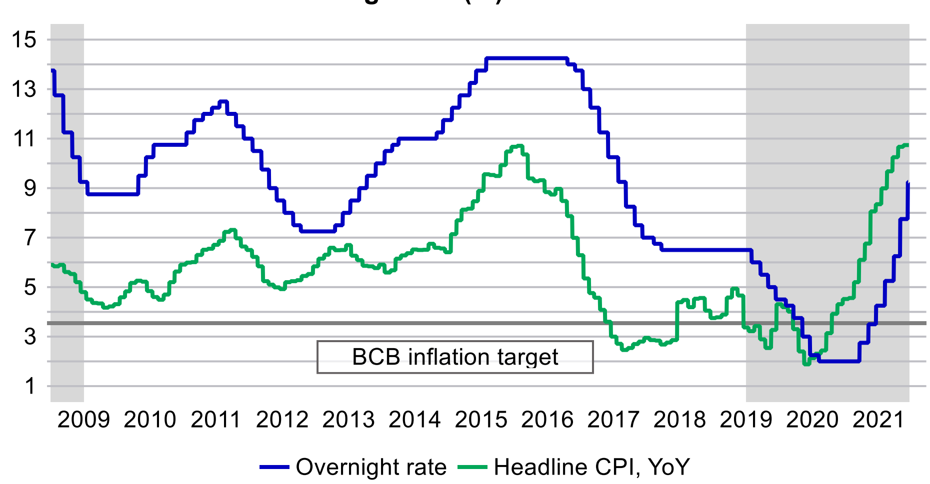
Brazil

Big picture

The worst of Brazil's pandemic-related economic downturn is likely behind us, but uncertainty remains high. Stagflationary tendencies have risen with downside surprises to growth and upside surprises to inflation. Investors were particularly concerned about the country's fiscal picture as President Jair Bolsonaro campaigned to broaden the government's social program—a proposal that could meaning breaching its spending cap. That said, the economy has seen an improvement in the past year in short-term liquidity and credit metrics. Inflation continues to clock in at low double digits due to a rise in food and electricity costs,[1] representing a headwind to growth. However, the spike in energy costs—a consequence of extreme drought, which affected the country's ability to generate electricity through its hydro dams—could ease soon as we head into the rainy season.

The Banco Central do Brasil (BCB) has raised rates aggressively in the last 12 months, but the central bank's actions have yet to translate into strength for the BRL. In our view, BRL volatility will continue to be driven by investor sentiment that's been affected by concerns about fiscal deficits and rising geopolitical uncertainty ahead of October's presidential election.

Hawkish BCB with above-target CPI (%)



Source: Macrobond, Manulife Investment Management, as of December 15, 2021. YoY refers to year over year. CPI refers to Consumer Price Index. BCB refers to Banco Central do Brasil. The gray areas represent recession.

1 Bloomberg, as of December 10, 2021.

"Inflation continues to clock in at low double digits due to a rise in food and electricity costs, representing a headwind to growth."

What we're watching

- **Price levels—**Inflation remains well above the BCB's 2022 target of 3.50% and will likely continue to be a driver of further rate hikes at upcoming central bank meetings this year. Markets expect the Selic rate to hit 11.25% in H122, and interest-rate hikes that are in line with, or greater than, the consensus forecast would likely be favorable for the BRL. Given that inflation at these elevated levels is hurting the consumer and is detrimental to growth, an easing in inflationary pressure could be supportive of the growth picture.
- **Foreign investment flows—**The BRL is trading at historically low levels relative to the USD, and international demand for Brazilian assets remains to be a major driver of the BRL. While sentiment among foreign investors appears stronger than local investors, it remains scarred by a difficult 2021.

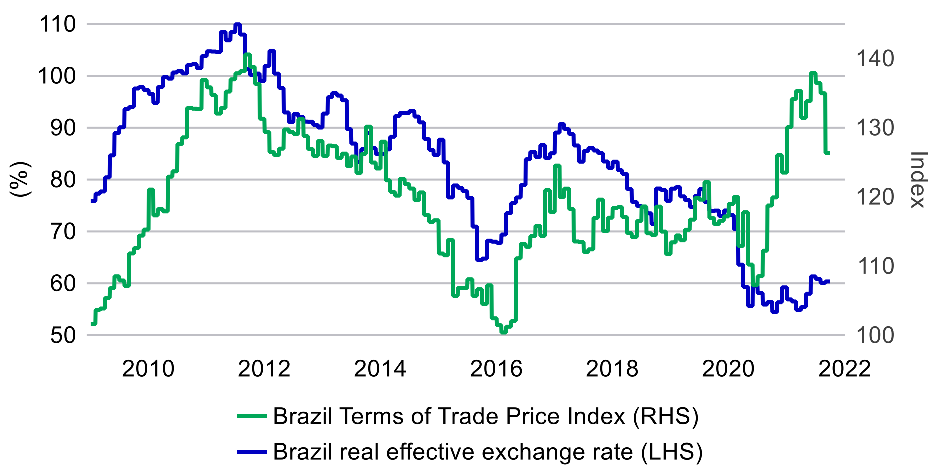
Key market views

- **Currencies—**Given the BRL's risk profile and the elevated level of uncertainty, we expect the currency to trade within, but not break, the trading range it established between May 2020 (high) and June 2020 (low).[1] Absent a material shift in the market's broader tone, we don't expect to see material BRL strength ahead of the presidential election in October.
- **Equities—**Valuations of Brazilian equities are at historically attractive levels, and our analysis shows that the asset class's fundamentals are, broadly speaking, stronger than they were before the pandemic. We believe the MSCI Brazil Index will continue to benefit from the reopening, given the cyclical exposure of the index's sectoral breakdown. Strength in commodities should act as a tailwind to the index, but a fall in Chinese demand for commodities could weaken this theme.

Risks to our view

- **Political uncertainty—**The upcoming presidential election continues to weigh on the economy. As of this writing, President Jair Bolsonaro has slipped into second place in opinion polls, behind former President Luiz Inacio Lula da Silva. Given that both candidates are campaigning on very different political platforms, the outcome of the election could have important implications for Brazil's economy.
- **Fiscal lassitude—**Government spending in Brazil could exceed the official 2022 budget. While social spending typically rises in election years, it threatens Brazil's fiscal position and heightens the risk of further BRL weakness and higher inflation.

Geopolitical risk premium discounting the BRL



Source: Macrobond, Manulife Investment Management, as of December 6, 2021. LHS refers to left-hand side. RHS refers to right-hand side.

1 Bloomberg, as of December 6, 2021.

"Valuations of Brazilian equities are at historically attractive levels, and our analysis shows that the asset class's fundamentals are, broadly speaking, stronger than they were before the pandemic."

Manulife Investment Management

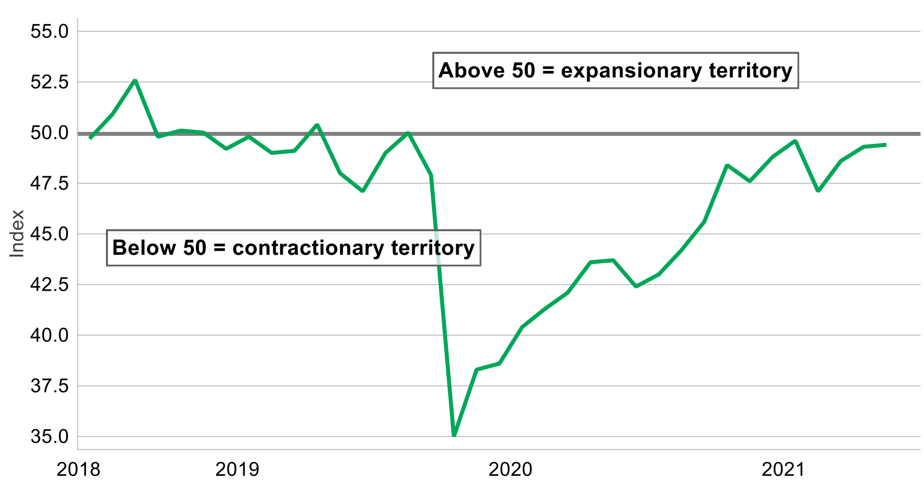
Mexico

Big picture

Mexico's growth picture remains somewhat challenged in the absence of a synchronized economic recovery worldwide, particularly at a time when global financial conditions are also expected to tighten as a result of ongoing central bank policy normalization. While Mexico has fared somewhat better than its emerging-market (EM) peers on growth (owing to its proximity—and economic ties—to the United States) and inflation (thanks to a relatively tight fiscal stance), the country is beset by domestic political issues that remain a critical concern for global investors.

High-frequency activity indicators such as PMIs have yet to break out of levels indicating economic contraction, and medium-term growth expectations appear to have crested with a noted moderation in growth forecasts for both 2022 and 2023. Meanwhile, Banxico continues to deliver policy tightening in a somewhat reluctant manner, as none of the hikes announced in the current tightening cycle has received unanimous support from members of the rate-setting committee. Last, the 11th hour shake-up in the process to name the next Banxico governor is as unexpected as it is worrisome.

Mexico: manufacturing PMI



Source: Macrobond, Manulife Investment Management, as of December 6, 2021. A Purchasing Managers' Index (PMI) reading above 50 signals expansion.

While Mexico has fared somewhat better than its EM peers on growth and inflation, the country is beset by domestic political issues that remain a critical concern for global investors.

What we're watching

- **Central bank independence—** President Andres Manuel Lopez Obrador's last-minute nomination of the deputy finance minister to the Banxico board was completely unexpected. Market participants and global investors are somewhat concerned about central bank board independence at one of the few institutions in the country that's seen as having been left untouched by politics.
- **Global financial conditions—**High foreign ownership of government debt leaves Mexico vulnerable to swings in broader market sentiment. The MXN is trading defensively and hitting fresh one-year lows on the back of coronavirus-related developments,[1] which is likely to remain a concern well into 2022.

Key market views

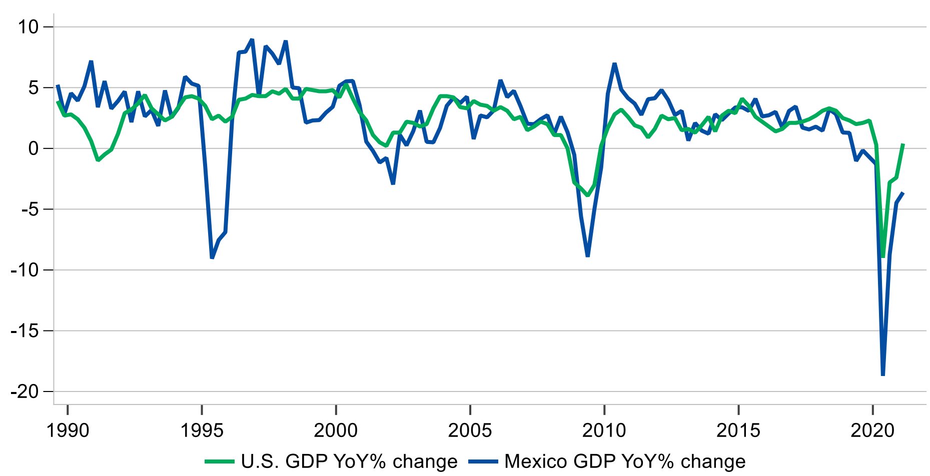
Currencies—From a technical perspective, the trend in MXN (against the USD) seems to be shifting as the currency is buffeted by financial market volatility arising from uncertainty related to the pandemic. We've seen a clear departure from the psychologically important 20.00 level and even a brief push above 22.00.[1] In our view, the risk from here is continued weakness in the MXN or, at best, a consolidation around these weaker levels.

"Market participants and global investors are somewhat concerned about central bank board independence at one of the few institutions in the country that's seen as having been left untouched by politics."

Risks to our view

- **Political landscape—**For an economy whose fortune is closely tied to foreign demand for its assets, it's fair to say that investors are becoming increasingly uncomfortable with the government's unorthodox approach to policymaking.
- **Risk of a lost cycle—**The absence of a meaningful recovery in Mexico's manufacturing sector is worrisome and speaks to the risk of a lost economic cycle despite the significant improvement observed in U.S. data. Mexico-U.S. ties remain strong economically, and the risk from here is of a continued moderation in U.S. growth that would also dampen the outlook for Mexico.

The U.S.-Mexico economic relationship remains strong (%)



Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 6, 2021. YoY refers to year over year.

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.

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Manulife Investment Management

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