Manulife Investment Management

H2 Market Intelligence

Turning the corner —2023 market outlook

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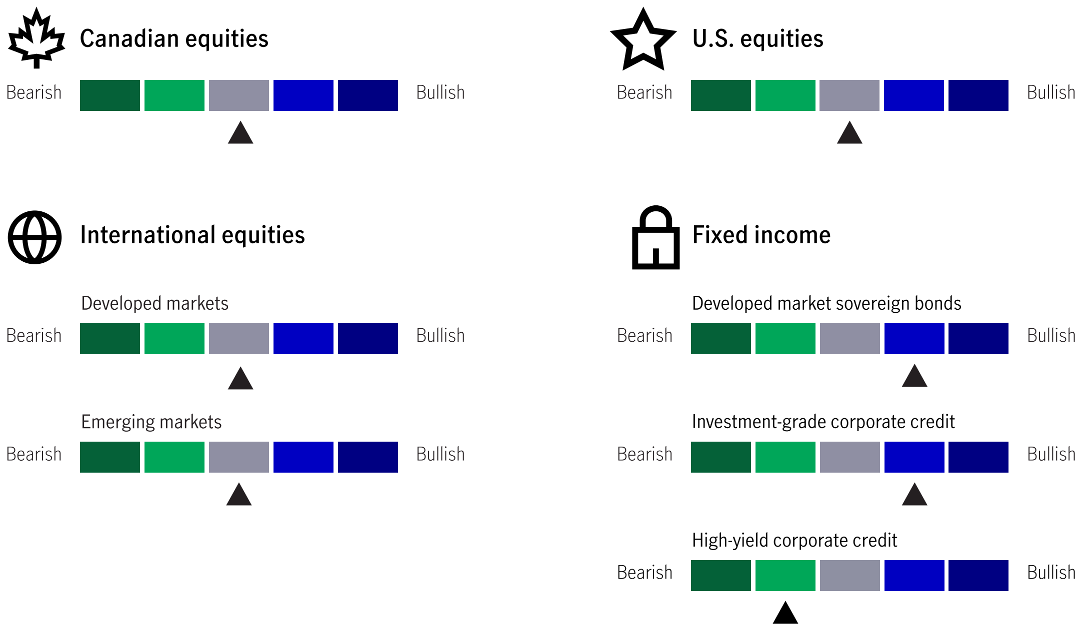
Capital Markets Strategy team's outlook—a snapshot



Source: Capital Markets Strategy, as of May 31, 2023.

Recession postponed, but it's not time to pop the champagne

Soft landing, hard landing, no landing? These terms seem to be front and centre in the financial media, and many aren't even sure what they mean. In essence, the question is whether we'll experience a recession or not in the U.S. and Canada. We believe that the recession has been postponed, not canceled. Despite the aggressive policy tightening we've seen so far, economic activity in developed economies proved to be more resilient than expected amid a strong rebound in the services sector. Data year-to-date suggests that developed economies had a better start to the year than expected and so far, none have slipped into official recession (as defined by the National Bureau of Economic Research).

However, we argue that an eventual declaration of recession doesn't matter as much when it comes to asset allocation, since it's typically announced retroactively. The capital markets are forward looking, so by the time it's proclaimed, it's often already too late to make portfolio changes. The key for us is to try and identify where the balance of risks lies. Given the economic data that we look at, we suggest that the economy is likely to weaken before it gets better.

While there are many new factors at play this time around (pent-up savings from stimulus cheques, potential job hoarding, geopolitics, climate change, among others), it's important not to fall into the trap of saying "this time is different," because it rarely is. Our best tool remains the same as we have used in the past, our table of recession indicators. While not perfect, the trend in economic data points helps to paint either a picture of improving or weakening economic health.

As economic variables tend to ebb and flow, it's not simple enough to use a binary outcome for these signals. Rather, we prefer to use a traffic light signal system; green is good, yellow is slowing, and red is full stop, indicating recessionary levels. We further break the signals down to whether they tend to lead the economy, occur at the same time, or lag.

Signs of a U.S. recession have increased

U.S. Economic Indicators

Leading		Coincident		Lagging	
Yield curve	✗	Consumer confidence	✗	Unemployment rate	✓
Senior loan officer survey C and I	✗	Housing starts	!	Job openings (JOLTS)	✓
ISM new orders minus inventories	✗	ISM manufacturing PMI	!	Inflation	✗
30-year mortgage rate	✗	Credit growth	✓		
New home sales	✗	Industrial production	!		
Investment-grade corporate spreads	!				
Financial conditions	!				
Initial jobless claims	!				

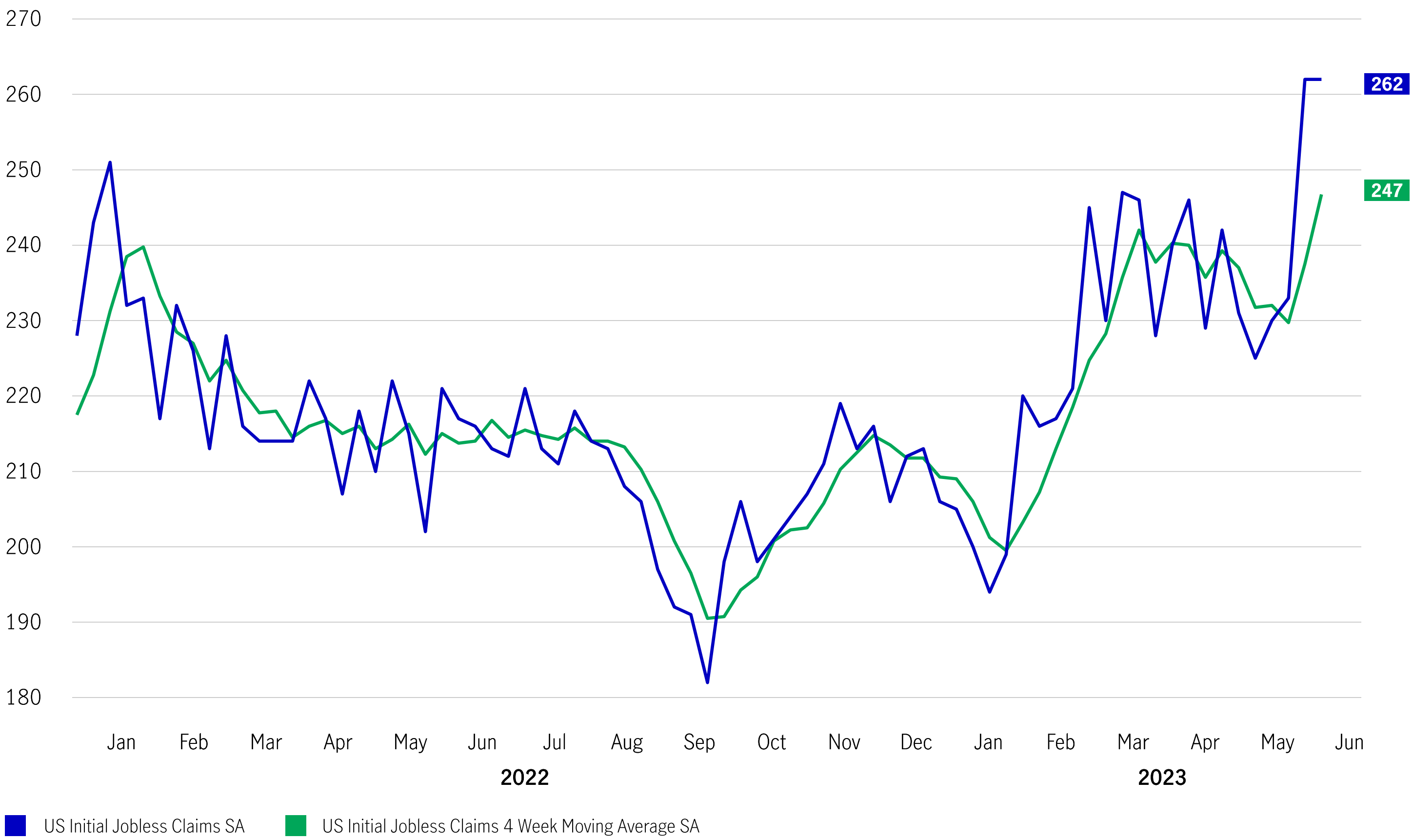
For illustrative purposes only.

Source: Manulife Investment Management, as of June 30, 2023.

Many investors point to the strong unemployment market in the U.S. as a positive signal that a recession has been avoided. However, we argue that the unemployment rate is a lagging rather than leading indicator. This seems to be more true now than in the past, as employers in some sectors are still finding it difficult to fill outstanding positions. They may be more hesitant to cut staff during a tough environment, choosing instead to cut hours worked.

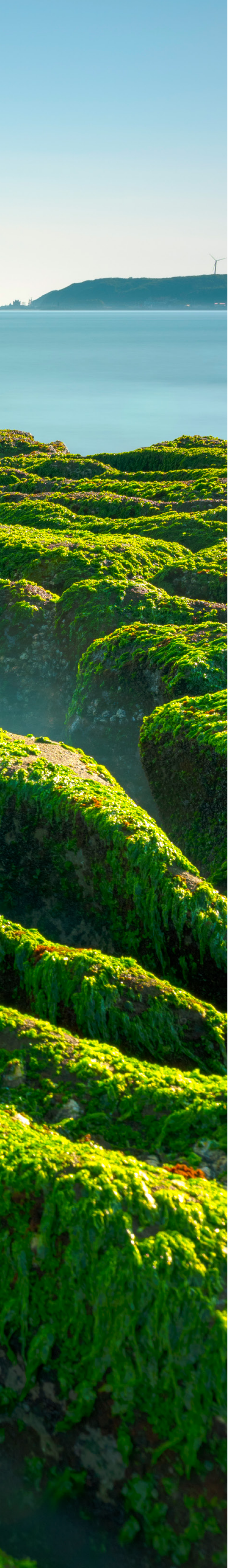
While the unemployment rate is a lagging indicator, initial jobless claims, another aspect of the labour market, tends to lead. Over the past few weeks, we've seen a clear increase in both weekly claims for unemployment insurance and the four-week moving average. These seemingly first cracks in the labour market led us to move that indicator from green to yellow.

Initial jobless claims are increasing



Source: Bloomberg, Macrobond, Manulife Investment Management, as of June 20, 2023.

While there's no mathematical equation for how many indicators need to be yellow or red before we become confident that a recession is knocking on the door, the leading indicator column clearly shows that the balance of risk skews to the downside when it comes to the U.S. economy, with six of the nine in red and the other three in yellow.



Inflation remains too sticky for comfort

A steep run-up in goods prices was the main cause behind the surge in inflation over the past 2.5 years. From energy to food to shipping, many of the factors that drove inflation higher in 2021 and 2022 have eased considerably this year. However, core inflation remains stubbornly high—an outcome of strong income growth and the resilience of economic activity, among other factors—pointing to intensifying upside risks to inflation in services driven by tight labour supply.

The latest data showed a renewed spike in core inflation in the United States and the United Kingdom and a fresh record high in the eurozone. While the rise in core inflation has more to do with higher prices in services as opposed to goods, the price momentum in core goods inflation appears to be inflecting higher again as favorable base effects are largely behind us.

Although the pace in price rises of goods had slowed in the months leading up to January 2023, this had been largely a result of base effects. For instance, one year ago, crude oil and wheat prices jumped nearly 60% on a year-over-year basis; they're now about 20% and 45% lower, respectively. There's a limit to how much further the prices of critical commodity prices can fall going forward.

Why interest rates are likely to stay higher for longer

Persistent price pressures have forced central banks around the world to extend their respective tightening cycles; however, they're proving to be more hawkish than the market had hoped. Take Canada as an example: the Bank of Canada policy pause has recently turned to further tightening, contrary to the market's all-too-simple linear pricing model of "tightening followed by pausing followed by easing followed by risk-on."

We continue to believe:

- The market is premature in its pricing of dovish pivots from central banks, in terms of both timing and magnitude.
- There's a risk that even if the Fed pauses in the coming months, the next move could be more tightening, not easing.
- Markets need to reassess the central bank put for asset prices.

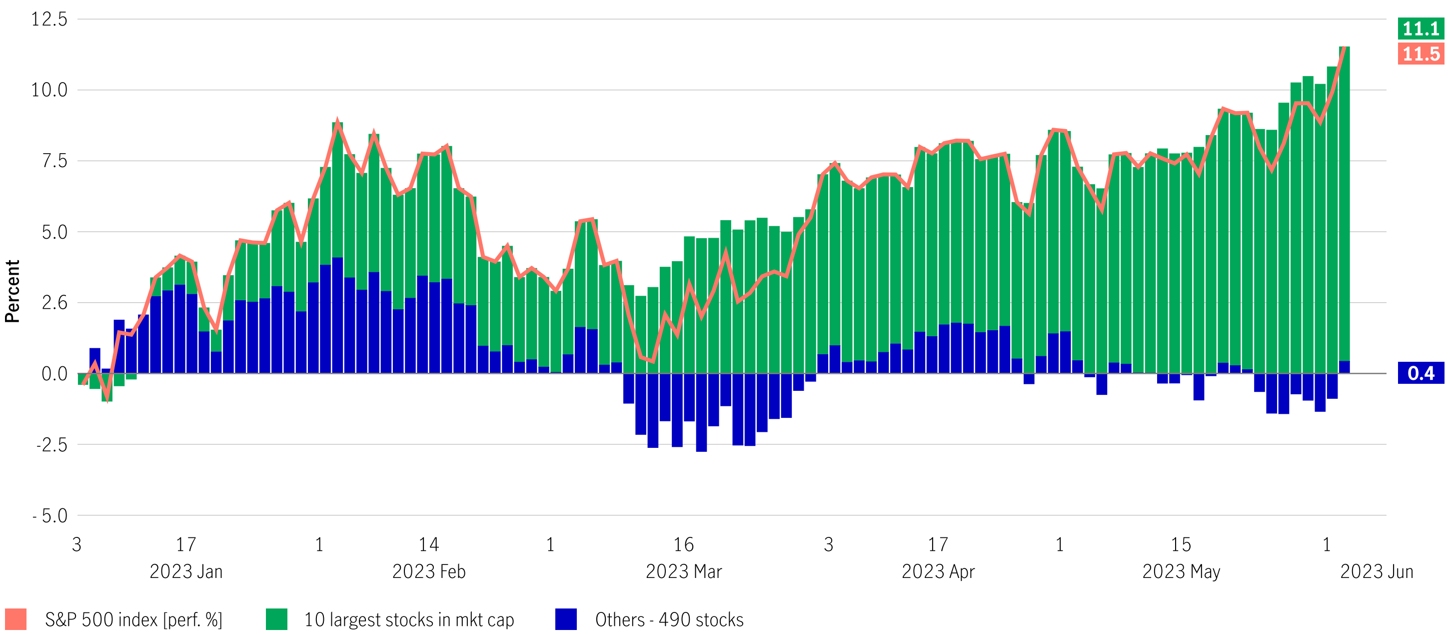
What does that mean for asset allocation? In our view, it means favouring a balanced approach between equities and fixed income, while preferring higher quality companies that can withstand short-term volatility within the equity allocation, and higher-quality credit and longer-duration government bonds for fixed income. However, flexibility within the asset classes is key to managing the constantly shifting economic landscape.

Patience is a virtue when it comes to this equity market

When looking at the opportunities in equities, while we're constructive long term, we see there's much uncertainty near term. From a portfolio construction perspective, we believe a neutral posture in equities makes sense. U.S. equities have rallied strongly to start the year, but it has been predominantly on the back of the euphoria surrounding artificial intelligence (AI) and the potential boon for companies that are even somewhat linked to it.

New bull markets are rarely built on rallies with this little breadth. The top 10 companies by market capitalization are responsible for 82% of the S&P 500 Index's 14.8% return this year. These companies also happen to be benefitting from investors' interest in AI. While this doesn't mean that they're the only companies that have generated positive returns this year, it does suggest that caution might be warranted before chasing returns.

Largest stocks are driving the current S&P 500 rally



Source: S&P Global, Macrobond, Manulife Investment Management, as of June 5, 2023.

The question often comes up as to where a portfolio should be overweight or underweight from a geographic perspective. From a fundamentals perspective, meaning earnings and valuation, there doesn't seem to be an obvious choice. Broadly speaking, an uncertain macroeconomic landscape is a potential headwind for equities. That said, corporate earnings have thus far remained strong, outpacing expectations. Given the challenging environment going forward—slower economic growth, persistent inflation, and higher-for-longer interest rates—earnings growth is likely to slow over the next few quarters. While a material decline in earnings growth is not broadly expected, certain companies or industries may experience this environment differently.

Valuations also don't indicate a clear-cut winner. When looking at valuation, on a trailing price/earnings ratio basis across various global indices relative to their individual longer-term history, many appeared undervalued but not materially so. Even though the S&P 500 seems fairly valued, much of that can be attributed to the recent rally of the top weights in the index.

In environments such as these, we believe it's often best to look at individual security selection rather than specific geographies or sectors. Further, a well-diversified portfolio could help smooth out the ride should we experience choppy waters over the near term.

Fixed income

The opportunity in bonds has been one of the most prominent messages in financial circles to begin this year. While there's no denying this, we believe it's more important to invest in the right bonds at the right time. As we've written in the past, we believe the opportunity in fixed income is likely to unfold in three phases: clipping the coupon, duration is your friend, and take on risk.

The first phase has played and continues to play out well. Last year's pain in fixed income has provided an opportunity going forward—yields across most, if not all, fixed-income instruments, regardless of maturity, type, or credit quality, have moved materially higher since the beginning of last year. This has allowed investors to benefit from the yield provided by the bond ("clipping the coupon"). Further, these yields haven't been this attractive since the Global Financial Crisis almost 15 years ago.

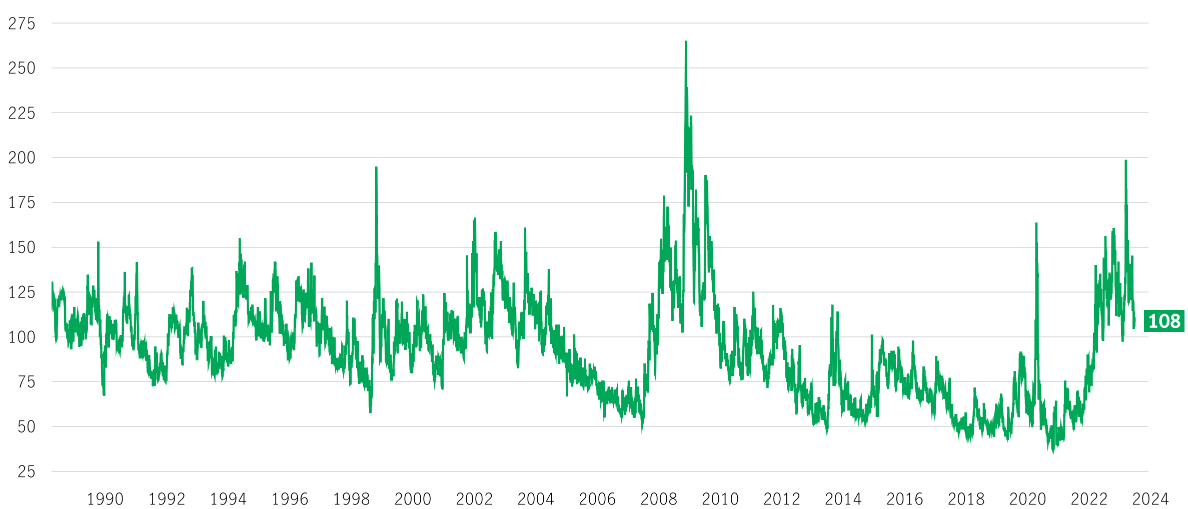
As noted above, we expect economic conditions to weaken, and we're likely going to see a recession in both Canada and the U.S. We're also getting close to the end of the interest-rate tightening cycles of the Bank of Canada and the Fed. Although, there's no specific transition from one phase to the other, the weaker economic data is signaling that we're nearing the second phase.

In this second phase, we want to begin embracing longer-duration and higher-quality fixed-income instruments, such as 10-year government bonds. As the market starts to expect an elevated risk of recession, yields tend to fall. Since 1976, when the U.S. was in a recession, the 10-year U.S. Treasury yield fell by 35% on average. This means that the duration risk that was a headwind to bond returns as yields rose (remember that there's an inverse correlation between yields and price) eventually becomes a tailwind, as the combination of longer duration and falling yields tends to enhance bond returns.

In phase two, by increasing duration and quality while transitioning to longer-dated government bond yields, investors will potentially be mitigating risk while also potentially increasing their return opportunity.

However, the elevated levels of volatility in the Treasury curve shows how important it is to be flexible and active when managing fixed income. It's not as simple as choosing to be short or long duration.

ICE BofA MOVE Index
Implied volatility of U.S. Treasuries

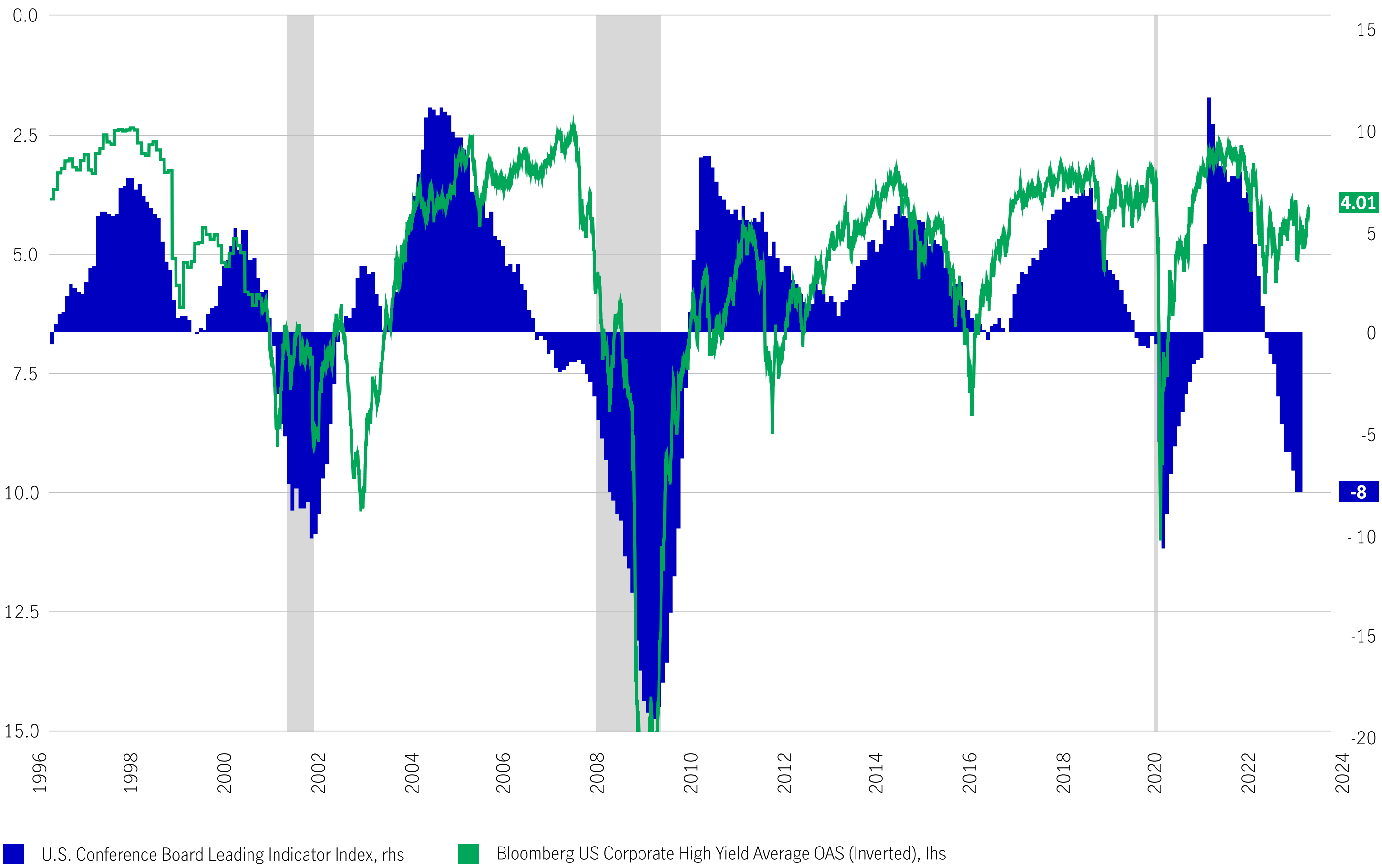


Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy, as of May 31, 2023.

Going back to our table of recession indicators, one of the key leading indicators we follow is the U.S. Conference Board's Leading Economic Index (LEI). The LEI provides an early indication of significant turning points in the business cycle and where the economy is heading in the near term. For the 13th consecutive month, the index has declined. It's now at levels not seen since COVID and the Global Financial Crisis before that; yet the riskier area of fixed income, high-yield corporate credit, hasn't even batted an eye.

While the yields offered by this segment of the credit market are quite attractive at 8.2%, based on the ICE BofA High Yield Constrained Index, the spread remains in the 50th percentile of its historical range. The spread is essentially the additional yield an investor receives to compensate them for the additional risk of investing in a bond compared to similar risk-free bond.

Historically, at these weak levels of LEI, high-yield spreads have been closer to 1000 bps, not 408 bps where they find themselves today.



Source: Bloomberg, Macrobond, Manulife Investment Management, as of June 20, 2023.

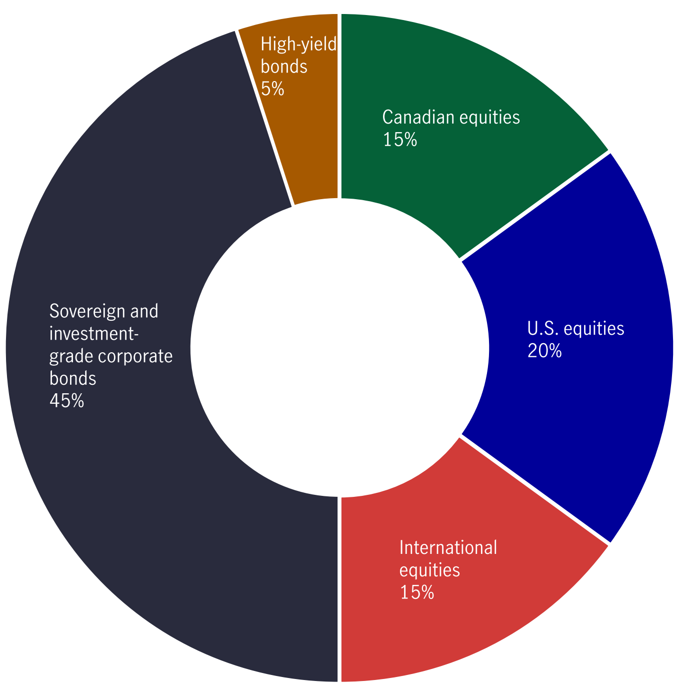
If the weak economic environment continues, high-yield spreads are likely to increase, which would result in downward pressure on prices. While current yields look attractive, the risk in low quality credit at this point in the cycle doesn't seem worth it. During the third phase, once spreads widen out, there'll be a time to reallocate to high yield; this just isn't it.

Illustrative portfolio

Following a 5% decrease in U.S. equity exposure at the end of March, the Capital Markets Strategy Illustrative Portfolio stood at 55% equity and 45% fixed income. Given the continued uncertainty within equities in the near term, and despite reasonable current equity valuations globally, the increasing risk of a shallow recession sometime within the next 6–12 months, has led us to trim our emerging markets exposure allocation by 5% in favour of fixed income. We've also decided to combine emerging markets and international developed equities into a broader international equities allocation. This further supports our messaging that it's less about geographic exposure but more about bottom-up security selection.

As of June 30, 2023, the Illustrative Portfolio reflects a defensive posture with an equal weight between equities and fixed income. The portfolio is well balanced across equity geographies. Throughout the past couple of years, we've been advocating rebalancing portfolios to target asset allocations and dollar-cost averaging into this market. We continue to emphasize that approach today.

CMS Illustrative Portfolio by asset class as of June 30, 2023



Source: Manulife Investment Management, Capital Markets Strategy, as of June 30, 2023.

The Capital Markets Strategy Illustrative Portfolios (the "Illustrative Portfolios") are hypothetical portfolios comprised of various asset classes and Manulife Investment Management's funds. They are designed to illustrate an approach in general terms and are not for specific investors. The Illustrative Portfolios and the related information do not constitute and are not to be construed as, investment advice. Any investment or allocation decisions by an investor should be made with the advice of a qualified investment professional with respect to individual circumstances, preferences, risk tolerance, and after reading the relevant fund facts and prospectuses. Manulife Investment Management Limited shall not have any liability, contingent or otherwise, to any person or entity for the quality, accuracy, timeliness and/or completeness of information in, or related to, the Illustrative Portfolios, or for delays, omissions or interruptions in the delivery of such information. Manulife Investment Management Limited makes no warranty, express or implied, as to the results to be obtained by any person or entity in connection with any use of the Illustrative Portfolios and any data related thereto, or any components thereof, and is not liable for any action or decision made by you or an investor in reliance on the information contained therein.

Looking ahead through 2023 and into 2024

Our philosophy within the Capital Markets Strategy team is fairly simple: we ask ourselves, “How do we make money?”—that also means protecting on the downside. With regards to the markets, it includes, but isn’t limited to, identifying the direction for the economy, inflation, interest rates, and earnings growth; being aware of valuation (but not handcuffing ourselves to it); and understanding that any short-term fickle nature of the market isn’t reflective of the longer-term opportunity set. It’s always important to understand where the balance of risks lie.

The first half of the year had many positive surprises from both an economic and market perspective. However, given the data that we study, we believe it’s premature to pop the champagne cork and declare victory over a recession. Within the context of a slowing global economy, geopolitical risks that remain heightened, falling but sticky inflation, and central banks that are committed to higher-for-longer interest rates, a lack of market volatility can give investors a false sense of security. The key is to remain diligent and follow the process. A kneejerk reaction to either jump on a bandwagon or out of the markets, based on shorter-term market movements could quickly push an investor off course.

Despite these potential risks, the opportunity is ripe for the patient and flexible investor to take advantage. There’ll be more twists and turns and bumps along the way, but we need to remain focused on the road ahead to make sure we arrive at our destination.

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