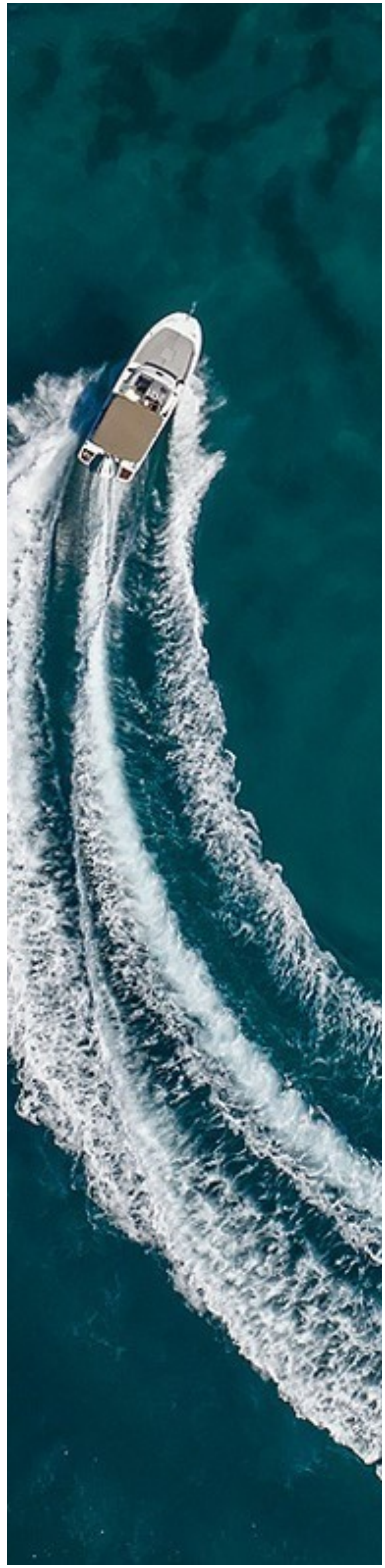
Manulife Investment Management

Q3 2021 | Global Macro Outlook

Last innings of the reopening trade



Frances Donald
Global Chief Economist and Global Head of Macroeconomic Strategy

Sue Trinh
Senior Global Macro Strategist

Alex Grassino
Senior Global Macro Strategist

Eric Theoret
Global Macro Strategist

Erica Camilleri
Investment Analyst

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Global overview

Big picture

It's time to think beyond the reopening and examine factors that could drive the post-COVID-19 global economy. While many countries have only just embarked on the path toward reopening, the world's largest economies—the United States and China—are already well on their way, with Europe and Canada following closely behind as vaccination rollouts accelerate in those countries. Indeed, the road map to reopening has been laid out, and uncertainties surrounding the virus, vaccination, and how economies might fare as they reopen have diminished substantially. Now that the global macro environment is in the last innings of the reopen/ reflation narrative, what comes next?

All things considered, there are important factors that remain supportive of risk assets: Global growth is likely to be running at historically high levels throughout 2021 (and into 2022), and monetary and fiscal policy will continue to be extraordinarily accommodative. In absolute terms, most global macro indicators appear very strong; however, we believe these supportive factors will begin to diminish on a relative basis going forward, implying that we're currently at peak macro—and the road ahead could be bumpy.

In our view, the somewhat more challenging macro environment should be able to mitigate the gradual rise in market rates, and we expect it to be less damaging to equities. Crucially, we believe sector selection, country selection, and regional focus will play a very important role in asset allocation decisions in the coming months—the ability to distinguish which elements in the macro narrative have reached peak (versus those that haven't) could be critical to outcomes in the third and fourth quarters of 2021.

Going forward, we believe macro factors that were previously supportive will begin to diminish on a relative basis, implying that we've arrived at peak macro and that the road ahead will be bumpy.

Peak macro factors

Peak monetary policy accommodation

Global central banks have directly or indirectly indicated that they're taking their foot off the easing pedal. Yes, monetary policy remains extremely accommodative, which is broadly supportive for risk, but U.S. Federal Reserve (Fed) Chair Jerome Powell has hinted that the time to taper the central bank's asset purchasing program is approaching,[1] the Bank of Canada (BoC) began tapering in April,[2] the Bank of England (BoE) has firmed up its rate forecast[3] and its quantitative easing (QE) is scheduled to be done by year end, and the European Central Bank (ECB) has upgraded the balance of risks to growth from tilting to the downside to neutral.[4] Even the Bank of Japan (BoJ) continues to entertain the prospect of widening the 10-year yield's target band, while the People's Bank of China (PBoC) has begun tightening monetary conditions. It's fair to say that their plans have already been well telegraphed; however, monetary accommodation has reached an inflection point—and we've entered a period in which communication errors (and potential policy errors) are no longer unthinkable.

Peak U.S. fiscal policy support

Fiscal spending in the United States and globally is likely to stay elevated (which explains why the five-year inflation outlook in a post-COVID-19 world is higher than before COVID-19); however, we expect the fiscal impulse is going to wane significantly in the next two years. Should this happen, it'll translate—mathematically—into a sizable *drag* on growth in 2022. In our view, this should be understood as a fiscal cliff. In fact, when the expected reduction in fiscal spending is expressed as a percentage share of the expected resultant fall in fiscal deficit, it's likely to be the largest fiscal cliff since the 1940s. Unsurprisingly, this has fueled speculation that the current growth cycle will be a very short one. While we expect a sizable drop in U.S. growth in late 2022, we certainly don't expect a recession to materialize.

"While we expect a sizable drop in U.S. growth in late 2022, we certainly don't expect a recession to materialize."

1 "Fed's Taper Timing Moves Into Focus After Dot-Plot Surprise," Bloomberg, June 18, 2021. **2** Bank of Canada, April 21, 2021. **3** Bank of England, May 6, 2021. **4** European Central Bank, June 2021.

Peak reflation

We've discussed inflation at length in the last quarter, and our view remains that inflation is likely to stay elevated throughout Q3 before easing back to around 2.0% in 2022, followed by structurally higher inflation—possibly closer to the 2.5% mark—in 2023 and beyond. In that sense, the phrase peak reflation—as it's used here—is less a comment on direct measured inflation (although that most likely did peak in May 2021) and more a reflection of our expectation that market-based measures of inflation, such as breakevens and consumer confidence expectations, have peaked. Problematically, we expect the reflation narrative to move from being framed as a positive development to being seen as a warning about higher input costs across a select set of industries that have been beset by supply chain disruptions. In other words, certain areas may continue to face margin squeezes while others experience relief, thereby increasing the value of solid active management in the equities space. Importantly, there's little central banks can do to mitigate the situation.

Peak China impulse

The Chinese economy was first to enter into a COVID-19 recession and the first to emerge out of it. China is also the first country to materially tighten fiscal and monetary support through a range of measures—including the introduction of new regulations to dampen speculation in the property sector. As a result, China's credit impulse has decelerated, a development—as we've learned from past experience—that could hurt global trade and global industrial production.

Peak aggregate U.S. data

To be clear, our view on the U.S. economy hasn't changed: We still expect growth to remain robust throughout 2021, and into 2022 thanks to fiscal stimulus (which remains high in absolute terms), pent-up consumer demand, and high levels of savings. However, it's important to note that much of these positive factors have already been priced in and there are a few key sectors that could begin to decelerate this summer (i.e., slipping to levels that should still be considered as healthy when viewed from a historical context). These include housing activity, retail sales, and industrial activity. Indeed, we see more downside risks than upside risks on this front and, therefore, scope for disappointment.

China's credit impulse has decelerated, a development—as we've learned from past experience—that could hurt global trade and global industrial production.

Factors not yet at peak

While several key growth drivers have peaked, there are others that have yet to do so.

Europe and Canada

The eurozone and Canada have significantly lagged the U.S. reopening due partly to a slower vaccine rollout—the pace has since picked up but market expectations have yet to catch up—which we believe could create opportunities. Crucially, there's still room for these two economies' macro narrative to surprise to the upside, especially in Europe, where the ECB remains the most accommodative of all global central banks.

Global labor markets

Employment rates—and associated data—have always been lagging indicators, but in this case, we believe there's substantial progress to be made. In our view, September could see the return of labor supply, as various government support programs come to an end (in the U.S. and in Canada), concerns about COVID-19 diminish as inoculation rates rise, and in-person schooling resumes. Barring surprises, these developments could keep wage pressures at bay.

Global capital expenditure

Capital investment is critical to global growth, and we believe this is one area that has the potential to provide the positive surprise needed to offset peak fiscal policy (and monetary policy). Our leading indicators suggest capex is the pillar of the next phase of global growth and will likely mollify concerns relating to the duration of the current growth cycle.

Select emerging markets

While we remain cautious on the broad emerging-market (EM) universe, we believe several markets could surprise to the upside, including Brazil, South Korea, Indonesia, and India.

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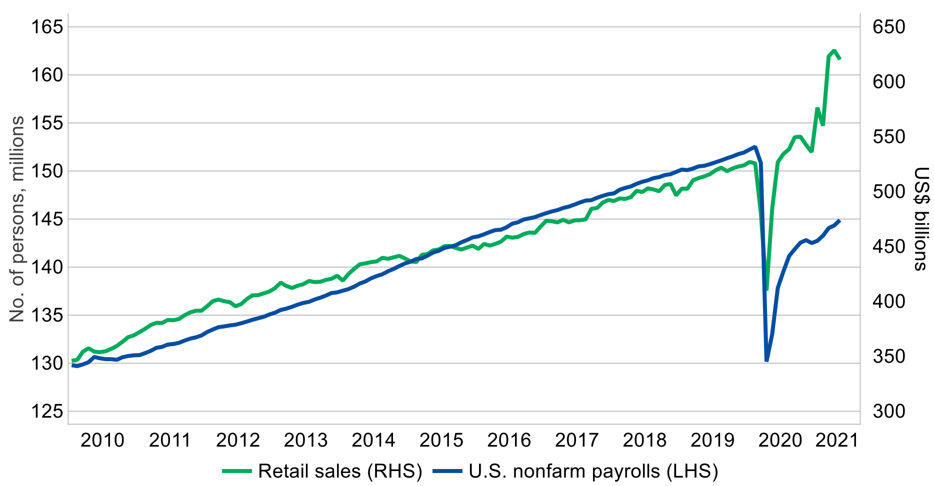
United States

Big picture

The United States has continued its period of strong growth as swift normalization from the pandemic and continued massive fiscal support have accelerated economic activity. Many of the indicators traditionally used to gauge U.S. economic health remain distorted and could take months before they're able to produce reliable readings that reflect the real economy. In our view, this should remain a theme for the balance of the year. But as these factors dissipate, normalization will be a welcome development: Higher employment, supply chain improvements, and the accompanying easing of inflationary pressures will all be met with relief. Conversely, moderations toward even healthy growth rates to areas such as housing and the consumption of goods could feel like a letdown after the feverish pace experienced over the last several quarters. From a policy perspective, we maintain that—on balance—economic data will provide the Fed with enough of a justification to make its intention to begin reducing the pace of QE clear before the end of the year, and quite possibly in the third quarter.

Key gauges of economic activity are still at extremes



Source: U.S. Census Bureau, Bureau of Labor Statistics, Macrobond, Manulife Investment Management, as of June 11, 2021. LHS refers to left-hand side; RHS refers to right-hand side.

"From a policy perspective, we maintain that—on balance—economic data will provide the Fed with enough of a justification to make its intention to begin reducing the pace of QE clear before the end of the year, and quite possibly in the third quarter."

What we're watching

- **Evidence that we're progressing toward normalized levels of activity—**Most gauges of activity won't be all the way there yet, but several indicators should be showing some early signs of coming off extreme levels. Specifically, we'll be looking for lower inflationary pressure, strong jobs gains ahead of the expiry of enhanced unemployment benefits in September, and for measures of production and consumption to be heading toward more moderate, but still healthy, levels.
- **Clarity on where policy will be headed—**This applies to both monetary policy, where we'd expect to see greater clarity as to *when* tapering might commence, and fiscal policy, where a clearer picture of the magnitude and scope of a workable infrastructure bill will start to emerge.

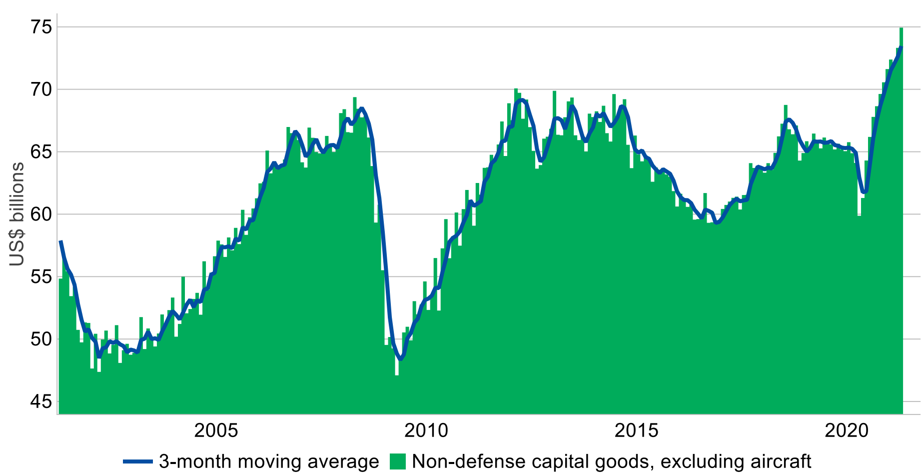
Key market views

- **Equities—**Since the S&P 500 Index appears to be fully valued, we believe that modest index-level returns could persist over the summer months. We maintain that stock selection and sector rotation will be critical components of generating return in the coming quarter.
- **Rates—**After peaking around the end of the first quarter, rates have more or less moved sideways. At current levels, we believe the downside risk to yields is limited. In our view, the next catalyst that'll trigger market rates to move higher will either be tighter monetary policy, which would come in the form of a timeframe around the unwinding of QE, or data surprises that force market participants to reassess what's a broadly consensus and well-entrenched base-case expectation.

Risks to our view

- **Capex/business investment could represent a material risk to the upside**—Business spending and continued inventory restocking could provide a continued support to growth in the short term and, over the medium to long term, could push overall productivity higher.
- **Once you've hit the peak, there's only one direction to go**—Monetary policy is already well past its peak stimulative impact, while initially overly ambitious fiscal plans are in the process of being diluted.

U.S. core business spending has shot up in the past year



Source: U.S. Census Bureau, Macrobond, Manulife Investment Management, as of June 10, 2021.

"Monetary policy is already well past its peak stimulative impact, while initially overly ambitious fiscal plans are in the process of being diluted."

Canada

Big picture

From macro laggard to leader—that's how we'd characterize Canada's evolving economic outlook. For one, the pace of vaccinations in the country is one of the most aggressive globally. Crucially, although policymakers have chosen to reopen the economy slowly (particularly in Ontario), when it *does* happen, we believe it'll experience a sizable pop in growth that'll be at least be on par with—if not exceed—what we saw in the United States, albeit with a three- to six-month lag.

Meanwhile, fiscal support remains entrenched, with the federal government having unveiled CAD$100 billion in new spending over the next three years in its recent budget, including CAD$32 billion in ongoing COVID-19-related support for workers and businesses.[1]

This brighter outlook has certainly encouraged the BoC, which is arguably one of the most hawkish central banks globally. Asset purchases (QE) are being tapered, and the central bank says it believes "inflation will sustainably return to target (2%) sometime in the second half of 2022."[2] Market participants believe this communication implied that the central bank could raise rates more than once next year and have consequently priced this outcome into the bond market. While relatively strong and sustained fiscal support and high vaccination rates will enable the BoC to normalize policy before its developed-market peers, the path to normalization isn't quite so straightforward. The Canadian economy remains overlevered and is home to a particularly vulnerable housing market as well as a currency that's roughly 8% stronger than it was (against the USD) before the pandemic struck.[3] Specifically, we believe that the stronger Canadian dollar is in part driven by the perceived policy divergence between the BoC (hawkish) and the Fed (dovish)—a perception that isn't likely to dissipate soon.

"The Canadian economy remains overlevered and is home to a particularly vulnerable housing market as well as a currency that's roughly 8% stronger than it was (against the USD) before the pandemic struck."

1 Trudeau Introduces Pre-election Budget in Canada: Key Takeaways," Bloomberg, April 19, 2021. **2** "Monetary Policy Report," Bank of Canada, April 21, 2021. **3** Bloomberg, as of June 15, 2021.

What we're watching

- **Housing**—Housing activity continues to be an important focal point and poses a risk to the broader outlook. Our list of concerns has grown (beyond financial stability) to include the likelihood that structurally high house prices could dampen corporate competitiveness, encourage cost-push inflation, and drive intra-province immigration flows inside and, potentially, out of Canada—both of which could be detrimental to growth.
- **BoC**—The central bank is tapering its asset purchases (possibly because its share of total Canadian government bond market remains around 40%[3] and therefore is uncomfortably high). In our view, further adjustments to its purchases need to be managed in a way that doesn't encourage unwarranted tightening or disruptions.

Key market views

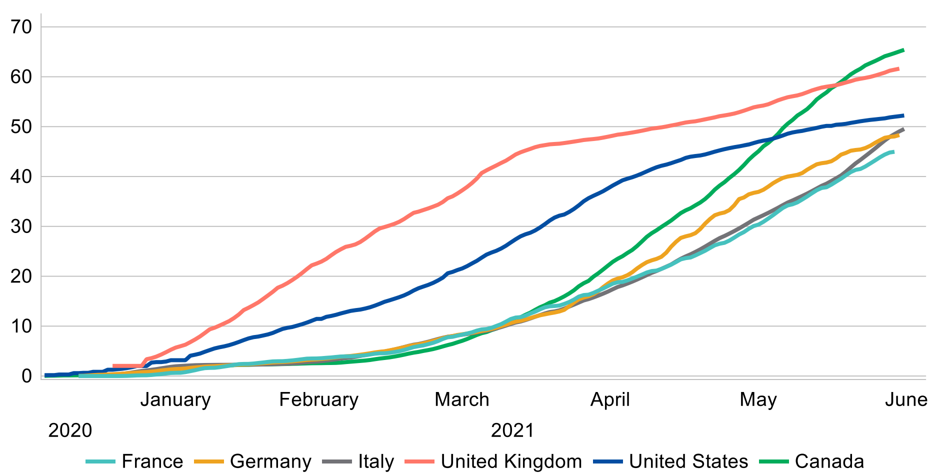
- **Currency**—The Canadian dollar (CAD) is supported by rising energy prices and the perceived policy divergence between the BoC and the Fed. While we expect both drivers behind CAD strength to moderate, we believe the U.S. dollar (USD) will remain relatively weak. As such, we expect USD/CAD to remain rangebound, staying in the 1.20 to 1.25 range in Q3.
- **Rates**—In our view, the market will eventually reduce its rate hike expectations in 2022 (and possibly 2023); however, we don't expect it to occur in the next quarter, which is when Canada is likely to see sizable improvements in economic data. Therefore, Canadian rates are likely to follow the global pattern and continue to mirror movements in the U.S. bond market.

"In our view, the market will eventually reduce its rate hike expectations in 2022 (and possibly 2023); however, we don't expect it to occur in the next quarter, which is when Canada is likely to see sizable improvements in economic data."

Risks to our view

- **USD/CAD**—While we expect the CAD to remain rangebound, further strengthening could dampen the economic recovery and affect Canada's ability to participate in the revival in global trade activity.
- **Government spending**—Fiscal policy remains highly supportive, but some measures aimed at providing income support will begin to fade in the coming months (the critical Canada Recovery Benefit is set to expire after September 25[4]). The drop in the level of income support available to households and businesses will test the resilience of the economic rebound.
- **Energy prices**—Higher energy prices can provide additional support to the economy.

Share of population that's received at least one dose of vaccine (%)



Source: Our World in Data, Macrobond, Manulife Investment Management, as of June 18, 2021.

4 "Canada Recovery Benefits Act," October, 2020.

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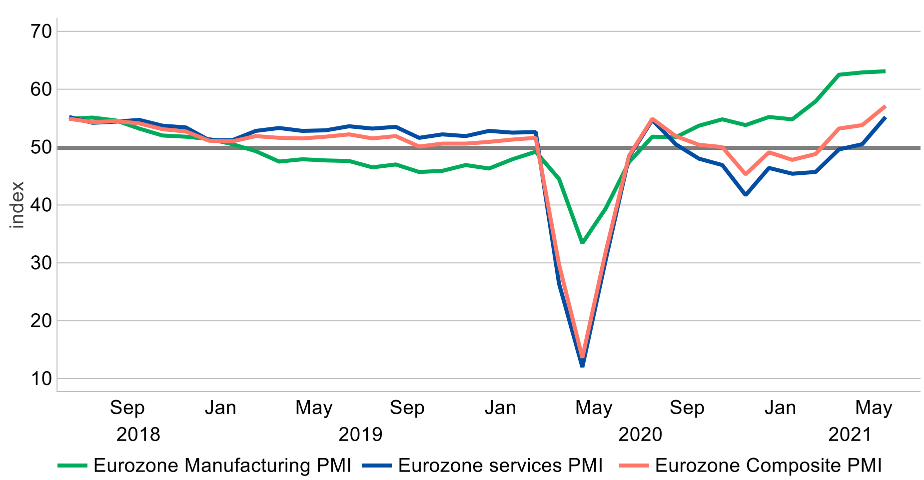
Euro area

Big picture

In our view, Europe's catch-up period still has legs as high-frequency growth indicators reveal a continued acceleration across both manufacturing and services.[1] Leading sentiment indexes are elevated, along with an economic surprise index that suggests a continued underappreciation of the balance of risks on the part of market participants. Policymakers at the ECB have correspondingly adjusted their assessment of the risks to growth from downward to neutral and are doing their best to push the asset purchase tapering discussion to the September meeting. European sovereign bond spreads have widened modestly but remain well contained relative to their historical ranges. In terms of political risk, the upcoming German election is expected to deliver a status quo result with Greens as a key player in the next coalition government.[1]

"Leading sentiment indexes are elevated, along with an economic surprise index that suggests a continued underappreciation of the balance of risks on the part of market participants."

Euro area PMIs



Source: IHS Markit, Macrobond, Manulife Investment Management, as of June 10, 2021. PMI refers to Purchasing Managers' Index.

1 "Germany's Upcoming Ballot Is a Climate Election," Bloomberg, June 11, 2021.

What we're watching

- **Catch-up trade—**Europe's delayed success on the vaccine front has paved the way for a continued upswing in growth going into the second half of the year.
- **The K-shaped inversion—**The expected inversion will likely be supportive of growth; however, it's also likely to remain relatively underwhelming when compared with the United Kingdom.
- **Inflation and the ECB—**Officials at the central bank are doing their best to maintain expectations for continued accommodation as internal staff macroeconomic projections reveal a longer-term inflation forecast in the mid- to 1% range.[2]

Key market views

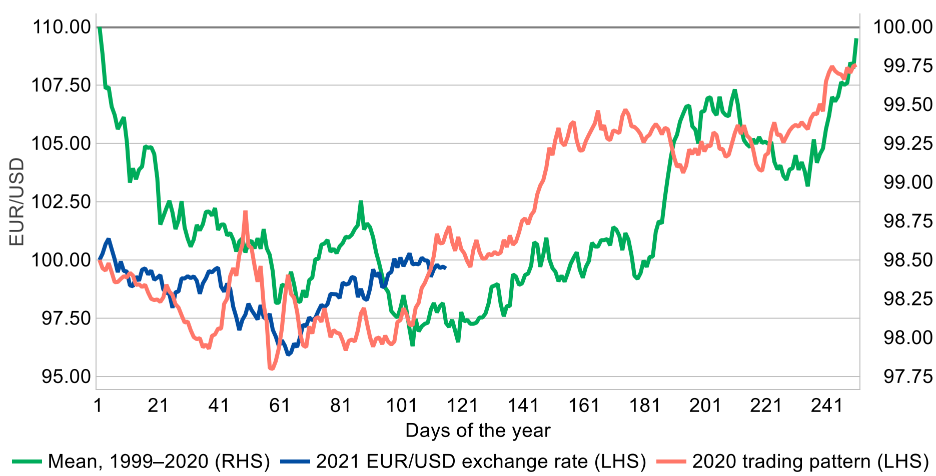
- **Rates—**Spreads between the German bund and the French Italian government bonds have widened over the past several months and are likely to retain a widening bias as the ECB taper discussion picks up pace in H2 2021.
- **Currency—**The euro is expected to remain well supported in the second half of 2021 against the USD, reflecting both underappreciated upside risk to growth as well as historically observed seasonal trends.

"Europe's delayed success on the vaccine front has paved the way for a continued upswing in growth going into the second half of the year."

Risks to our view

- **Vaccines, variants, and the reopening—**The reopening trade is widely expected to continue well into the second half of the year; however, the emergence of variance-driven outbreaks—in view of the bloc's relatively low vaccination rate—suggests near-term downside risks to growth.
- **Political risk—**In our view, near-term political risk is limited to the upcoming German election in September, which is expected to deliver a status quo result with the Green Party emerging as a key player in the next coalition government. Uncertainty relating to the outcome of next year's French election is also being felt in the currency market.

Seasonal trading pattern: EUR vs. USD



Source: Macrobond, Manulife Investment Management, as of June 10, 2021. LHS refers to left-hand side; RHS refers to right-hand side.

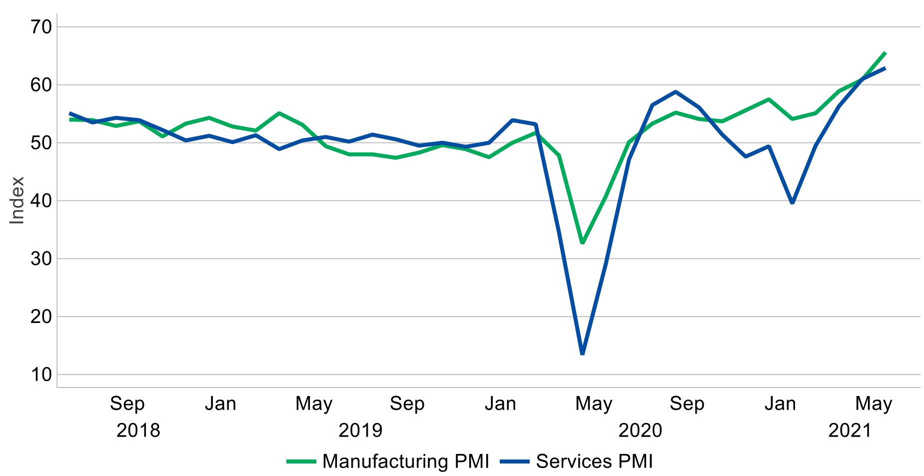
2 "Macroeconomic projections June 2021," European Central Bank, June 2021.

United Kingdom

Big picture

The United Kingdom's early success in vaccine rollout has translated into a comparatively earlier reopening and a firmer economic outlook overall. That said, an inversion of last year's K-shaped recovery (i.e., a reversal of the 2020 environment in which the manufacturing sector soared while the services sector sank) has yet to be observed, given that the country remains in the early stages of reopening; however, we continue to believe that the U.K. economy will capture greater upside as the services sector benefits from the loosening of restrictions to economic activity. Policymakers at the BoE are sounding increasingly confident about Britain's economic outlook and have begun lifting interest-rate expectations with firmer forward guidance. Fiscal developments have been relatively limited as officials have shifted their focus from domestic matters to multilateral discussions on global tax coordination.

U.K. PMIs



Source: IHS Markit, Macrobond, Manulife Investment Management, as of June 10, 2021. PMI refers to Purchasing Managers' Index.

"Policymakers at the BoE are sounding increasingly confident about Britain's economic outlook and have begun lifting interest rate expectations with firmer forward guidance."

What we're watching

- **Confirmation of services activity outperformance over manufacturing activity—**Success on the vaccine rollout front has been incorporated into the economic outlook, but it has yet to show up in the actual data. Confirmation will be critical, given that markets have already priced a stronger outlook for growth.
- **Post-Brexit/TCA developments—** Some market participants remain concerned about the outlook for trade in the aftermath of Brexit and the recent signing of the EU-U.K. Trade and Cooperation Agreement (TCA). We feel that these concerns are more than compensated for by the confidence and stability that this agreement provides.

Key market views

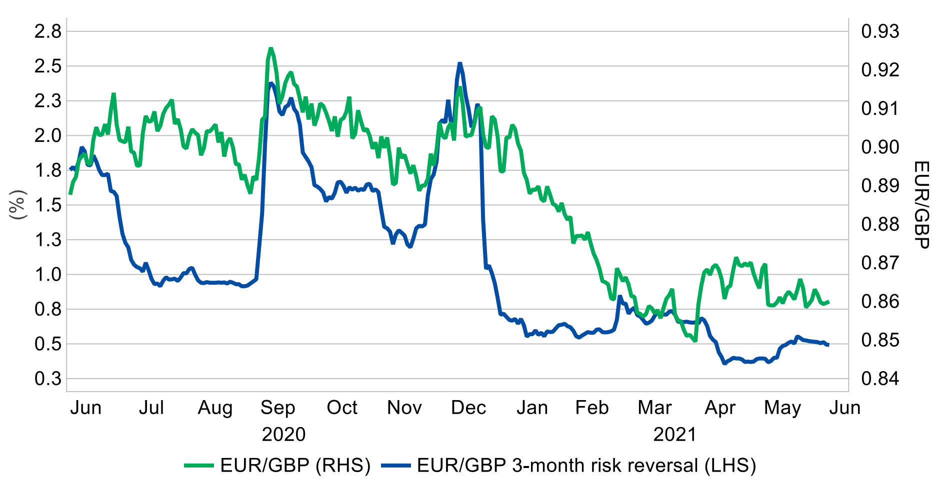
Currency—The pound sterling's (GBP's) appreciation against the euro (EUR) appears to have stalled over the last couple of months; however, we believe there could be scope for the GBP to strengthen further, heading toward the lower 80s level. There's been a buildup in speculative bearish positions in the GBP (against the EUR) recently, which we believe could be vulnerable in the event of a technical break. The options market is signaling weaker demand for protection against a weaker GBP.

"While GBP strength appears justified, we remain concerned about the possibility of an overshoot and an unwanted tightening of financial conditions through a higher exchange rate, most notably versus the EUR."

Risks to our view

- **Central bank policy normalization—**The BoE shifted from a dovish stance to a neutral position. Concerns related to upside risks are gaining traction, but we believe they may be somewhat misplaced and premature.
- **Relative reopening divergence—**The vaccine rollout has been successful, and the economy seems poised to do well. While GBP strength appears justified, we remain concerned about the possibility of an overshoot and an unwanted tightening of financial conditions through a higher exchange rate, most notably versus the EUR.
- **Trade—**U.K.-North Ireland trade remains worrying in a post-Brexit setting. The EU may feel emboldened to take a tougher stance as the bloc emerges from the crisis.

EUR/GBP and risk reversals



Source: Bloomberg, Macrobond, Manulife Investment Management, as of June 10, 2021. LHS refers to left-hand side; RHS refers to right-hand side. Risk reversal reflects the cost of protection against currency fluctuation. When it falls, it can be viewed as easing concerns that a currency (in this instance, the EUR) might strengthen and vice versa.

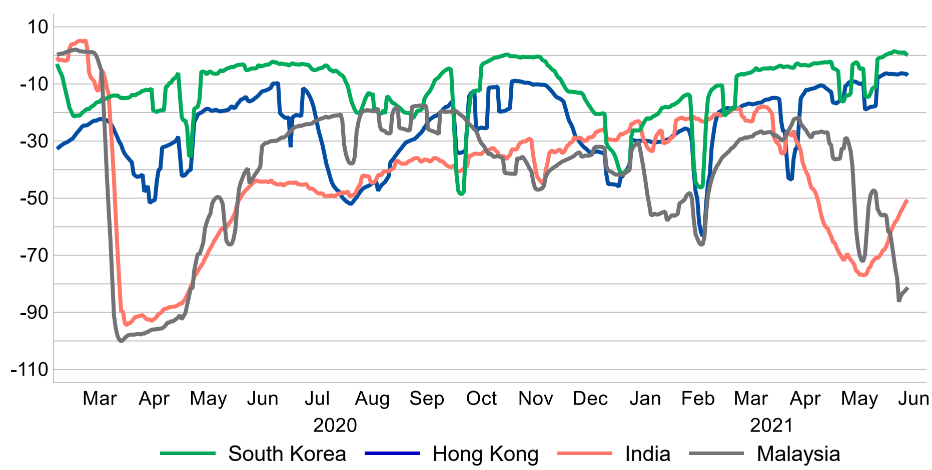
Asia

Big picture

Asia's economic outlook continues to hinge on the course of the pandemic, despite the region's early successes in containment. The region is lagging in vaccine rollouts relative to the United States and Europe. In addition, the latest virus surge led to significant tightening in people movement, with South Korea and Hong Kong registering the highest rates of mobility currently, and Malaysia and India at the opposite end of the spectrum.[1] The good news is that the region's manufacturing sector hasn't been subject to full lockdown restrictions and is holding up better relative to last March, thanks to strong foreign demand for Asian exports. Governments have also responded with more stimulus measures to support economies through lockdowns, albeit in varying degrees, thereby amplifying the unevenness of the recovery. The recent economic setback reinforces our view that interest rates will remain low across the region for some time to come.

> "The good news is that the region's manufacturing sector hasn't been subject to full lockdown restrictions and is holding up better relative to last March, thanks to strong foreign demand for Asian exports."

Mobility diffusion indexes (relative to baseline)



Source: Google's COVID-19 Community Mobility Report, University of Oxford, Macrobond, Manulife Investment Management as of June 10, 2021. The baseline is the median value for the corresponding day of the week during the five-week period between January 3 and February 6, 2020.

1 Our World in Data, as of May 8, 2021.

What we're watching

- **Manufacturing sector slowdown—** As global consumer demand normalizes, a risk is that pandemic-related goods demand—a key pillar of growth through the pandemic—declines. We may already be seeing signs of this with the recent slowing in manufacturing Purchasing Managers' Indexes (PMIs) after an almost uninterrupted multimonth expansion.
- **Fed communication—**As we enter a period of uncertainty regarding the timing of Fed tapering, potential volatility in the USD and U.S. rates is likely.

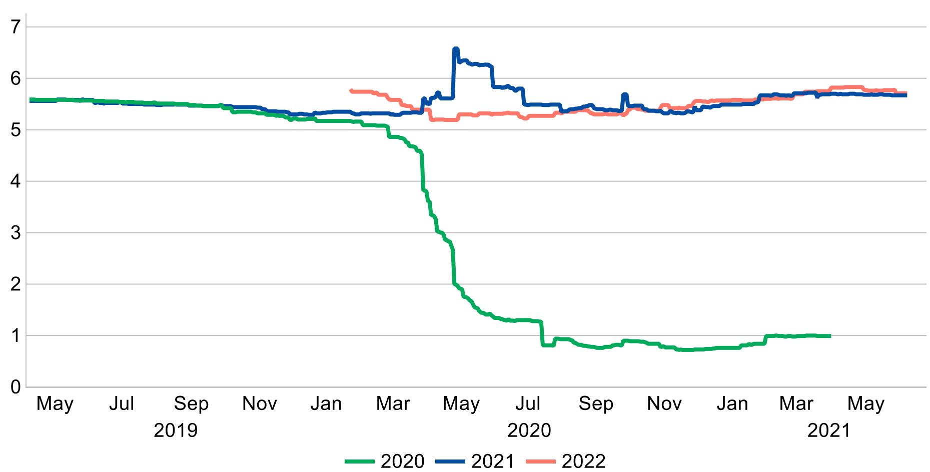
Key market views

- **Rates and equities**—We believe 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 versus 2013. In our view, stronger external positions, lower reliance on external funding, and better-balanced positioning are the main counterbalancing forces.
- **Foreign exchange—**With China warning against renminbi (CNY) appreciation and the USD finding some support from bottoming in U.S. real yields, there may be increasing headwinds to Asian currencies. The South Korean won, the Malaysian ringgit, and the Indonesian rupiah typically underperform in stronger USD/CNY environments. But the Australian dollar, the New Zealand dollar, and the EUR usually fare even worse under these conditions, likely reflecting better liquidity in these currencies.

Risks to our view

Upside and downside risks will be dependent on the pace of the recovery in services and domestic demand—While manufacturing has been a bright spot for many economies, a self-sustaining recovery requires domestic demand growth. The success of the vaccine rollout will be a crucial factor in how quickly domestic demand can recover.

Asia ex-Japan consensus GDP growth forecasts (YoY%)



Source: Bloomberg, Macrobond, Manulife Investment Management, as of June 10, 2021. YoY refers to year over year.

"We believe 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 versus 2013."

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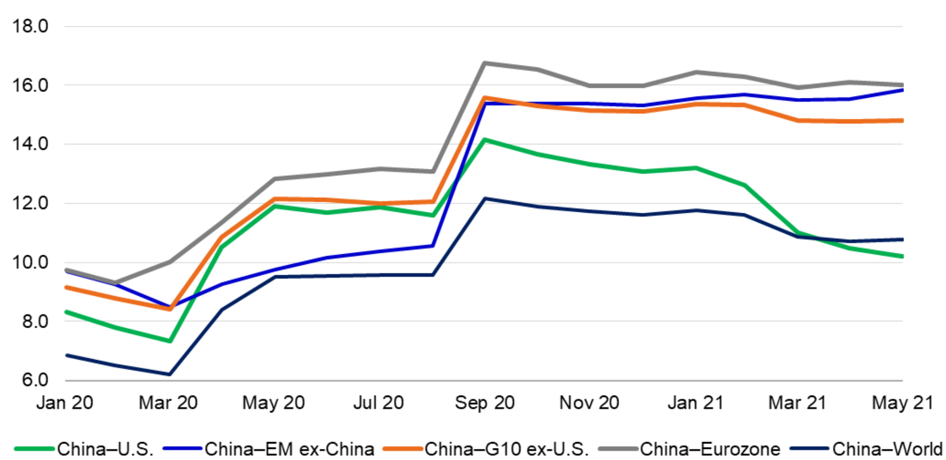
China

Big picture

A string of negative surprises in activity data has led to a narrowing in consensus expectations for China's GDP differentials. As headline growth rates remain distorted by base effects from last year's COVID-19 downturn, it makes sense to focus on a longer horizon that captures the loss of output in 2020 and the extent to which expected recoveries in 2021 and 2022 can offset the economic damage. On this basis, China has seen only modest revisions since September 2020. The usual lag between policy implementation and impact means recent policy tightening—monetary, fiscal, credit, and regulatory—is likely to become a more forceful drag later this year.

"The usual lag between policy implementation and impact means recent policy tightening—monetary, fiscal, credit, and regulatory—is likely to become a more forceful drag later this year."

Cumulative forecast revisions to China's GDP growth differentials 2020–2022 (%)



Source: Bloomberg, Manulife Investment Management, as of June 3, 2021. EM refers to emerging market and is represented by the following economies: Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, the Philippines, Poland, Russia, South Africa, and Turkey.

What we're watching

- **Chinese credit growth—**The government is targeting a much weaker credit impulse this year than in 2020, and the credit slowdown can be expected to translate into a growing drag in the wider economy as we head into the second half of the year. This isn't just relevant to China specifically—it carries downside implications for global trade, global PMIs, and global industrial production.
- **Worsening supply shortages—**Profit margins have compressed on the back of higher input prices, scattered COVID-19 outbreaks (which led to localized lockdowns), and sluggish consumer demand. Geopolitical disruptions could lead to tighter foreign import controls, amplifying this trend.

Key market views

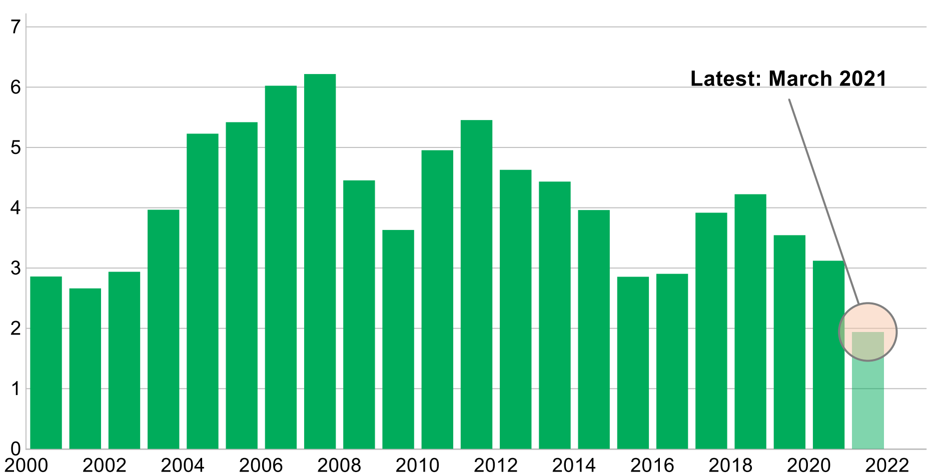
Currency—We expect CNY/H[1] to underperform. The fundamentals that supported CNY's appreciation have become much less supportive: China's cyclical tailwinds and yield spreads have peaked as the rest of the world recovers; incremental normalization in global consumption patterns will likely result in a smaller current account surplus; the completion of China bonds' inclusion in the Bloomberg Barclays Global Aggregate Bond Index and the J.P. Morgan Global Bond Index–Emerging Market and slower-than-expected FTSE World Government Bond Index inclusion suggests much lower passive inflows. Additional pressure on the currency could also come from negative seasonality in Q2 and Q3 from rising outbound dividend payments by China-based companies listed outside the mainland and the Chinese government's resolve to support its underhedged exporters with a weaker CNY.

"The recent PPI inflation pressure isn't likely to trigger aggressive policy tightening as the pass-through from the PPI to the Consumer Price Index is still limited."

Risks to our view

- **Upside risk—**The recent Producer Price Index (PPI) inflation pressure isn't likely to trigger aggressive policy tightening as the pass-through from the PPI to the Consumer Price Index is still limited. Even as credit growth slows, China has a stated policy to boost investment in infrastructure investment regardless, which should still record positive YoY growth.
- **Downside risk—**Broad credit growth and fiscal support are slowing faster than expected, leading to rising defaults and financial stress. Continued malinvestment increases long-term financial stability risk.

State-owned enterprises: return on assets (%)



Source: National Bureau of Statistics, Macrobond, Manulife Investment Management, as of June 10, 2021.

1 CNY and CNH both refer to the renminbi, or the Chinese yuan. The CNY is traded in the on-shore Mainland China market, while the CNH is traded in the offshore market.

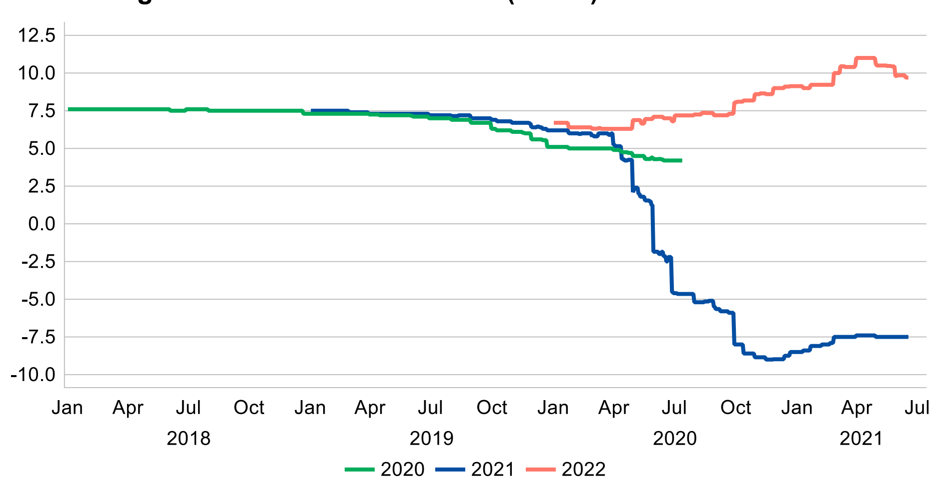
Manulife Investment Management

India

Big picture

Even as the latest COVID-19 wave appears to be easing, state governments have indicated that they'll be taking a more measured approach to easing restrictions, suggesting a more gradual economic recovery ahead—one proposal raised the possibility of lifting restrictions based on vaccination progress. Given the slow vaccine rollout to date, this wouldn't bode well for a quick easing in mobility restrictions. The good news is that the central government and the Reserve Bank of India (RBI) are fully committed to spur an economic recovery. The RBI announced more QE measures in early June and took further steps to support areas of the economy that have been hurt by lockdowns and provided additional liquidity support for contact-intensive sectors. The central bank also extended its liquidity window for the Small Industries Development Bank of India to support the credit needs of small and medium-sized enterprises and relaxed the limit on loans that banks can restructure.

India GDP growth consensus over time (YoY%)



Source: Macrobond, Manulife Investment Management, as of June 11, 2021.

"The good news is that the central government and the RBI are fully committed to spur an economic recovery."

What we're watching

- **How the pandemic evolves—**We're monitoring the progress of vaccine rollouts and mobility restrictions.
- **India's consumer demand—**Consumer demand has slowed sharply since late last year; consumer sentiment remains well below prepandemic levels.

Key market views

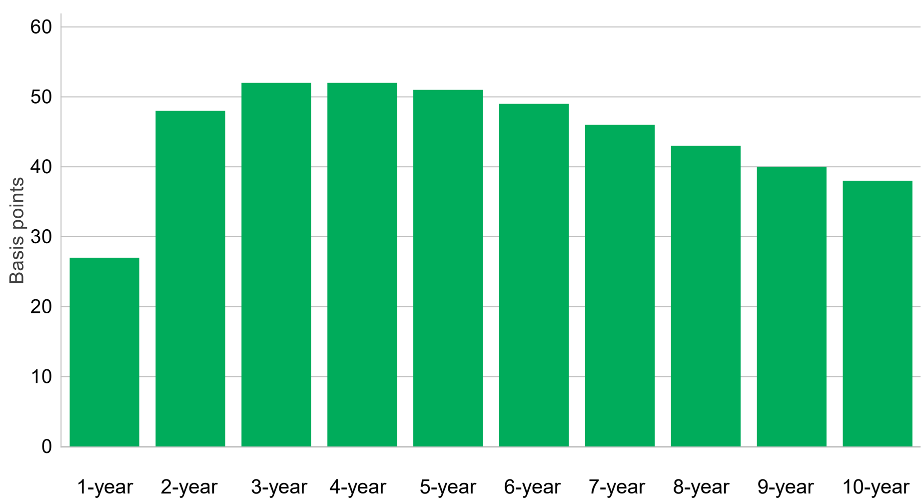
Rates, currency, and equities—We expect Indian government bonds and Indian equities to outperform; however, in our view, the India rupee will underperform. The boost in QE should cap longer-term yields in the months ahead and support equities. Since rising bond yields could threaten India's nascent recovery, the RBI may yet do more to lower the yield curve. We believe interest-rate cuts remain on the table, in line with the RBI's pledge to maintain an "accommodative stance as long as necessary to sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy."[1]

"Consumer demand recovery has slowed sharply since late last year; consumer sentiment remains well below prepandemic levels."

Risks to our view

Upside and downside risks—States could loosen restrictions rapidly, presenting a key upside risk to our near-term forecasts. That said, while a slow vaccine rollout could lead to a rapid reopening, it would also increase the threat of renewed virus outbreaks, potentially with more contagious variants. A faster initial recovery could come at the cost of a relapse further ahead.

Belly of the yield curve bore the brunt of the rise in yields year to date



Source: Clearing Corporation of India, Macrobond, Manulife Investment Management, as of June 11, 2021.

1 "Resolution of the Monetary Policy Committee," Reserve Bank of India, April 7, 2021.

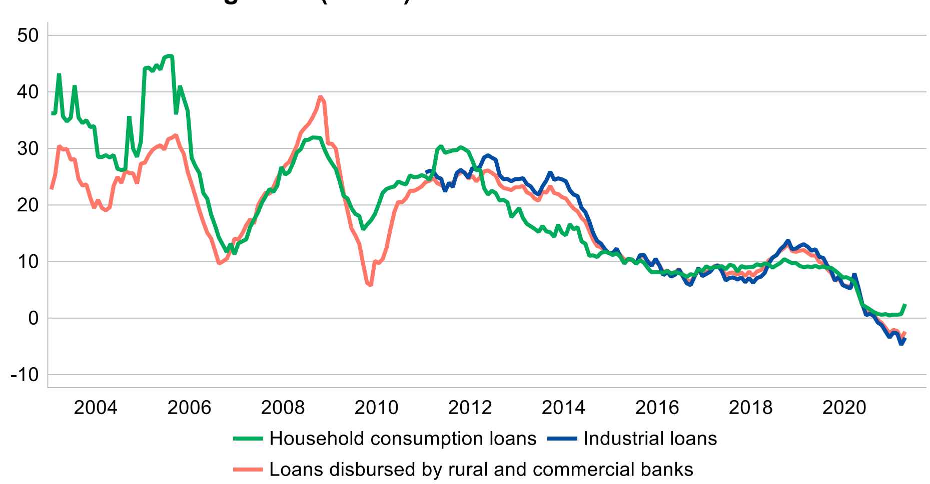
Manulife Investment Management

Indonesia

Big picture

Indonesia's economy contracted by 0.7% YoY in Q1. While this was up from –2.2% YoY in Q4 of last year,[1] the improvement was almost entirely due to base effects. Despite the sluggish recovery and having one of the highest real policy rates in Asia, Bank Indonesia (BI) left its policy rate at 3.5% and signaled that it was in no rush to adjust its monetary policy settings again this year.[2] Part of BI's relatively sanguine view is its belief that private consumption is being held back by COVID-19 restrictions. However, the economy's depressed credit growth predates the COVID-19 pandemic—we think BI will be compelled to ease monetary policy further later this year.

Indonesia: credit growth (YoY%)



Source: Bank Indonesia, OJK, Macrobond, Manulife Investment Management, as of June 11, 2021. YoY refers to year over year.

1 Statistics Indonesia, as of June 6, 2021. **2** Bank Indonesia, May 25, 2021.

"Despite the sluggish recovery and having one of the highest real policy rates in Asia, BI left its policy rate at 3.5% and signaled that it was in no rush to adjust its monetary policy settings again this year."

What we're watching

- **How the pandemic evolves, high-frequency mobility data, and the vaccine rollout—**As of this writing, daily COVID-19 cases remain above 5,000 a day. Social distancing measures and the slow vaccine rollout remain a major drag on activity. So far, Indonesia has inoculated less than 7% of its population.[3]
- **U.S. real yields—**A continued rise in U.S. real yields leaves Indonesia vulnerable in the region: It's the only Asian economy running a current account deficit (on a four-quarter moving average basis),[4] which leaves it beholden to foreign bond inflows.

Key market views

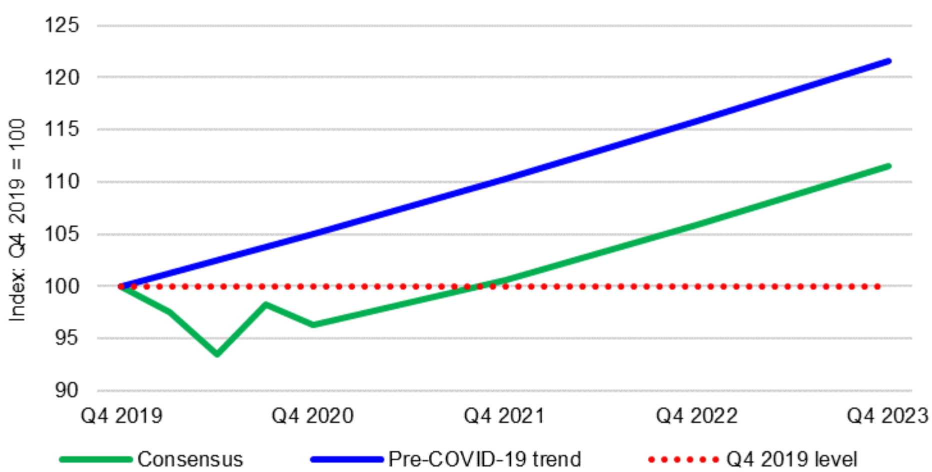
Rates, equities, and currency—We expect Indonesia government bonds and equities to outperform; however, the Indonesian rupiah will likely underperform. In our view, BI will need to lean against high real yields and eventually increase the size of its debt monetization program.

"A continued rise in U.S. real yields leaves Indonesia vulnerable in the region: It's the only Asian economy running a current account deficit (on a four-quarter moving average basis), which leaves it beholden to foreign bond inflows."

Risks to our view

- **Upside risk—**A quicker-than-expected improvement in COVID-19 case counts and an acceleration in vaccinations (from a low base) could help support sentiment and a faster return to some semblance of normalcy.
- **Downside risk—**Restrained policy stimulus: Government expenditure remains limited, and BI runs the risk of falling behind the curve. Without sufficient and timely stimulus, the recovery will likely be much slower. By the end of 2023, consensus is for Indonesia's GDP to still be 10% below its pre-COVID-19 trend.

Indonesia: consensus GDP forecast vs. pre-COVID-19 trend



Source: Bloomberg, Manulife Investment Management, as of June 11, 2021.

3 Our World in Data, as of June 6, 2021. **4** Bloomberg, as of June 6, 2021.

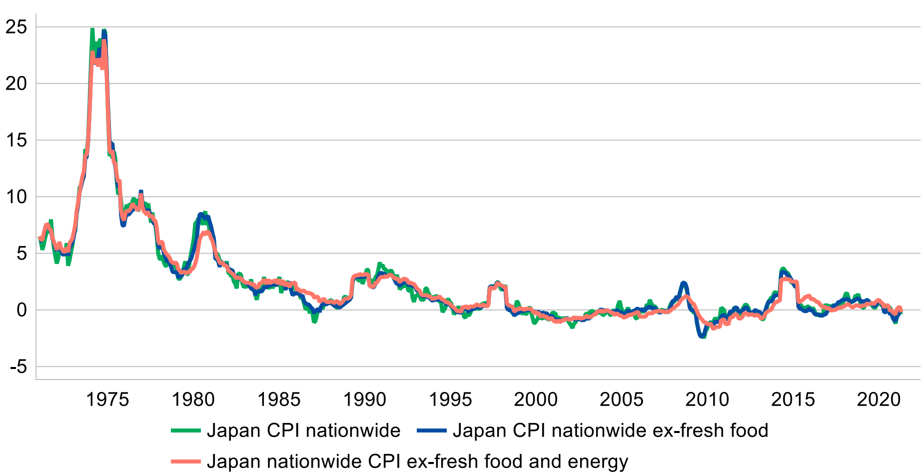
Japan

Big picture

Japan's economic prospects have dimmed and headwinds appear to be strengthening into Q3 as government officials struggle to balance renewed virus outbreaks ahead of the unpopular—and already delayed—Summer Olympic Games. Japan's economy contracted in Q1, and recent PMI data reveals a services sector that remains challenged, with readings pointing to contraction.[1] Japan appears to have struggled to tap into the improvement in global growth outlook—perhaps a reflection of the makeup of the Japanese economy, in which the manufacturing sector has a larger share. Since manufacturing-heavy economies were relatively less affected over the course of the pandemic, the upside offered by the global rebound is understandably limited. Inflation in Japan remains muted, with all key measures in deflationary territory.

"Japan appears to have struggled to tap into the improvement in global growth outlook—perhaps a reflection of the makeup of the Japanese economy, in which the manufacturing sector has a larger share."

Japan Consumer Price Index (YoY%)



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

1 Bloomberg, as of June 10, 2021.

What we're watching

- **Politics**—Japanese Prime Minister Yoshihide Suga's approval rating has fallen to a record low,[2] ahead of a widely expected snap election that could take place in the autumn. Political uncertainty could hurt sentiment amid growing speculation that former Prime Minister Shinzo Abe could mount a political comeback.[3]
- **Data**—The overall tone of economic data remains relatively weak and there appear to be no signs of near-term upside risks to growth. We'll continue to keep a close eye on PMI, trade, and industrial production releases.

Key market views

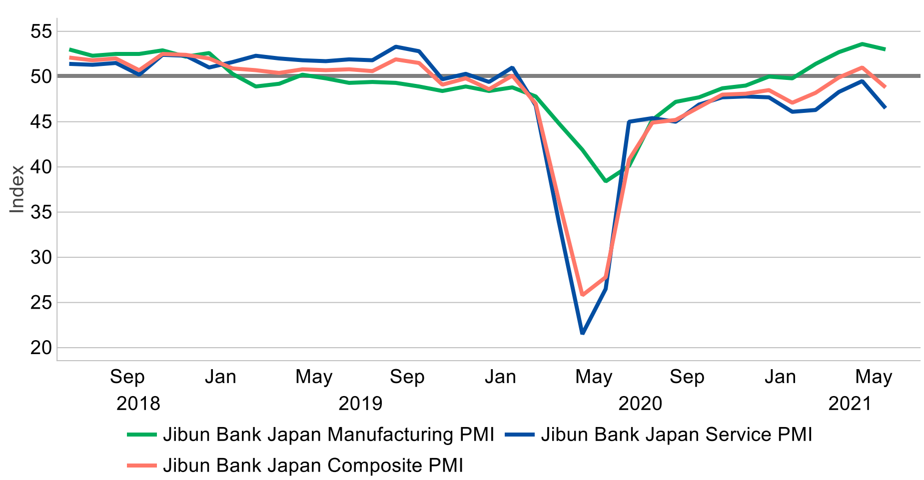
Currency—The Japanese yen remains beholden to global developments—specifically the level of longer-term U.S. interest rates. The U.S. 10-year Treasury yield remains the currency's most important driver as domestic yields hover just above zero.

"Political uncertainty could hurt sentiment amid growing speculation that former Prime Minister Shinzo Abe could mount a political comeback."

Risks to our view

- **Virus and vaccines**—Japan's vaccine rollout has lagged its developed economy peers, and the country is also facing ongoing challenges in its fight against the pandemic. Most major urban centers remained in a state of emergency as of late Q2 2021.
- **Olympics and politics**—The Tokyo Olympics remain deeply unpopular among voters, whose dissatisfaction has pushed Japan Prime Minister Yoshihide Suga's approval ratings to record lows. Political uncertainty is, in our view, elevated.

Japan PMIs



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

2 "Suga's approval rating sinks to record low," the *Japan News*, June 7, 2021. **3** "Abe rallies conservative base amid speculation over comeback," the *Japan Times*, May 9, 2021.

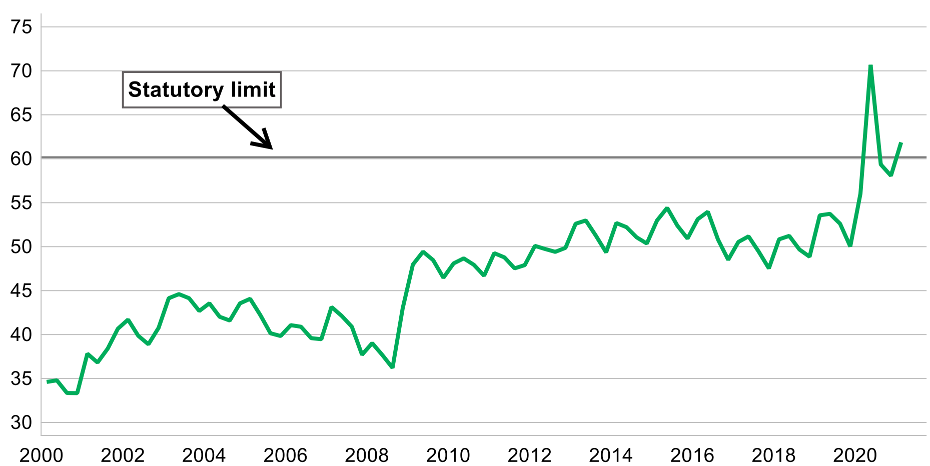
Malaysia

Big picture

The COVID-19 outbreak in Malaysia has worsened. The ratio of infection per capita is the highest in Southeast Asia, and people mobility in the country is now the lowest in the region,[1] owing to a controversial countrywide state of emergency, which was followed by a 14-day total lockdown that began on June 1.[2] Despite the hit to near-term economic activity, fiscal space has become much more limited as government debt is now hitting the statutory debt limit of 60% of GDP,[3] constraining the government's ability to provide additional support measures. This leaves the responsibility of spurring economic recovery to Bank Negara Malaysia (BNM). We expect the central bank to announce an interest-rate cut in the coming quarter.

"Despite the hit to near-term economic activity, fiscal space has become much more limited as government debt is now hitting the statutory debt limit of 60% of GDP, constraining the government's ability to provide additional support measures."

Government debt expressed as a percentage share of GDP



Source: Malaysian Ministry of Finance, Macrobond, Manulife Investment Management, as of June 11, 2021.

1 Our World in Data, as of June 10, 2021. **2** "Malaysia Enters 'Total Lockdown' as COVID-19 Surge Continues," the *Diplomat*, June 1, 2021. **3** Ministry of Finance Malaysia, March 22, 2021.

What we're watching

- **Credit rating review—**Standard & Poor's is due to conduct its annual review of Malaysia's sovereign rating, and there's a risk that Malaysia's sovereign credit rating could be downgraded from A– to BBB+ owing to the weaker-than-expected fiscal position, rising public debt, growing doubt over the momentum of fiscal reform in light of the decision to reintroduce the costly fuel subsidy program,[4] and growing political uncertainty ahead of the upcoming general election.[5]
- **Central bank watch—**An interest-rate cut is likely, with the possibility of unconventional monetary policy easing given Malaysia has a very negative policy rate (~3%).[3]

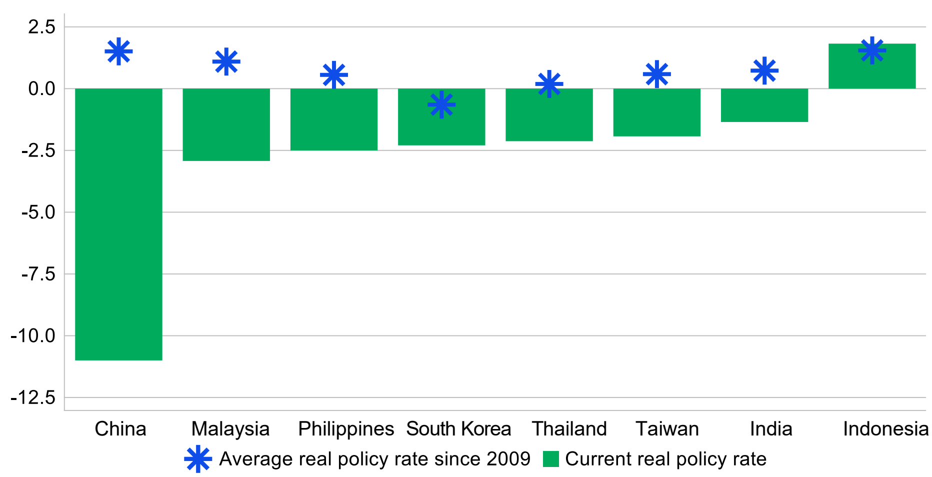
Key market views

- **Currency and equities—**The Malaysian ringgit (MYR) and Malaysian equities are likely to underperform. Growth and yield differentials look set to narrow further, and foreign investors may not take kindly to unconventional monetary policy.
- **Rates**—We expect rates at the front-end of the yield curve to move lower as BNM is forced to deliver additional monetary easing to support the economy.

Risks to our view

- **Upside risk—**Assuming that COVID-19 case counts fall again and restrictions are eased, the economy could resume its recovery in the second half of this year. The government is aiming to inoculate the 30% of the country's population in high-risk groups by late July.
- **Downside risk—**Elevated political uncertainty: Elections are expected to take place once the state of emergency ends. They're currently scheduled to expire on August 1, but it's also unclear whether the emergency powers will indeed be lifted.

Real policy rates in Asia (%)



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

3 Bloomberg, June 8, 2021. **4** Ministry of Finance Malaysia, February 10, 2021. **5** "Malaysian PM Muhyiddin says election will be held as soon as Covid-19 pandemic end," *Straits Times*, March 1, 2021.

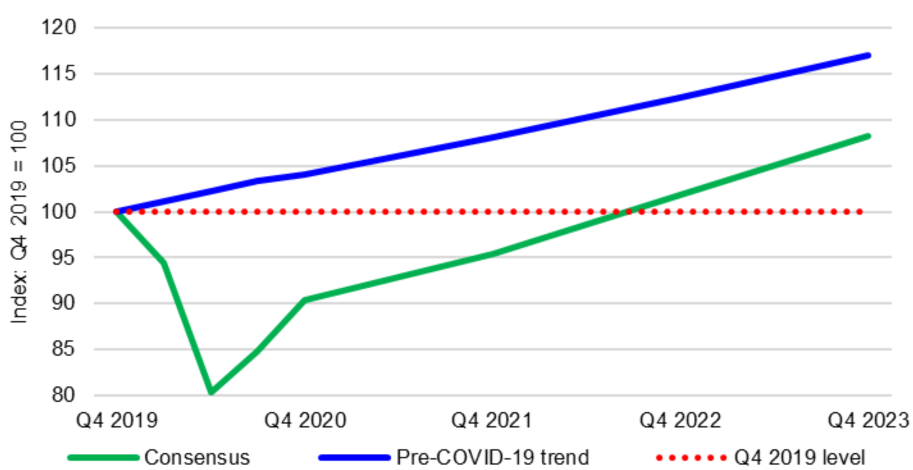
"An interest-rate cut is likely, with the possibility of unconventional monetary policy easing given Malaysia has a very negative policy rate (~3%)."

Philippines

Big picture

The Philippines' economic recovery has fallen behind its regional peers. GDP ended 2020 almost 14% below its prepandemic trend—GDP growth expanded by just 0.3% quarter over quarter in Q1 as a surge in COVID-19 infections prompted tighter mobility restrictions.[1] Daily cases have eased since mid-April, but remain elevated at more than 6,000 cases a day, and mobility data is around 40% below pre-COVID-19 levels.[2] Current consensus expects the economy to make very limited progress in closing the gap between GDP and trend GDP. Headline inflation should ease as food prices fall and energy base effects drop out of the annual comparison, creating space for Banko Sentral ng Pilipinas (BSP) to ease monetary policy later this year. Since real interest rates are already deep in negative territory,[3] BSP may need to get creative with alternative modes of easing; for instance, injecting more liquidity into the financial system instead of an outright cut to the benchmark policy rate.

Philippines consensus GDP forecasts vs. pre-COVID-19 trend



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

1 Philippine Statistics Authority, as of June 10, 2021. **2** Our World in Data, as of June 10, 2021. **3** Bloomberg, as of June 10, 2021.

"Headline inflation should ease as food prices fall and energy base effects drop out of the annual comparison, creating space for BSP to ease monetary policy later this year."

What we're watching

- **COVID-19 case counts—**A high number of infections is holding back the recovery.
- **Rising funding costs—**Should global real yields rise sharply, leading to tighter global liquidity, the Philippines may be subject to greater financial market instability since its external metrics are weaker now relative to both the 2011 global reflation episode and 2013's taper tantrum.

Key market views

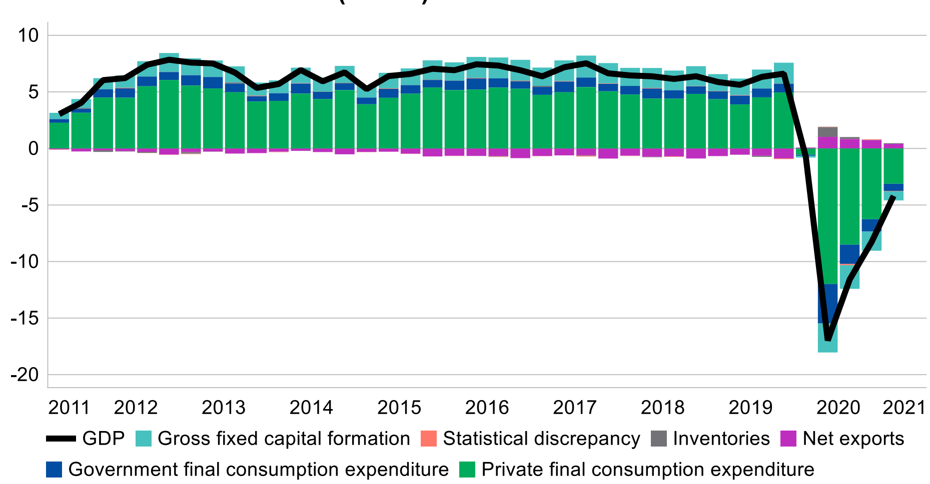
Currency and equities—We believe the Philippine peso and the country's equity market will underperform**.** Insufficient policy support to date means it will likely take much longer for the economy to recover lost output and will therefore likely remain a regional laggard. In our view, recent equity outperformance based on expected easing in mobility restrictions looks stretched. Foreign portfolio flows have remained subdued since late last year.

"Should global real yields rise sharply, leading to tighter global liquidity, the Philippines may be subject to greater financial market instability since its external metrics are weaker now relative to both the 2011 global reflation episode and 2013's taper tantrum."

Risks to our view

- **Upside risk—**Coordinated fiscal and monetary easing**—**to date, fiscal support has been limited, with the BSP having to do the bulk of the heavy lifting to support the recovery. Coordinated easing is required to spur a more forceful economic recovery.
- **Downside risk—**Vaccine rollouts remain slow and mobility restrictions continue to be tight**—**both factors are weighing on household consumption, the economy's predominant growth engine. Mobility data suggests economic activity is only beginning to resume gradually.

Contributions to real GDP (YoY%)



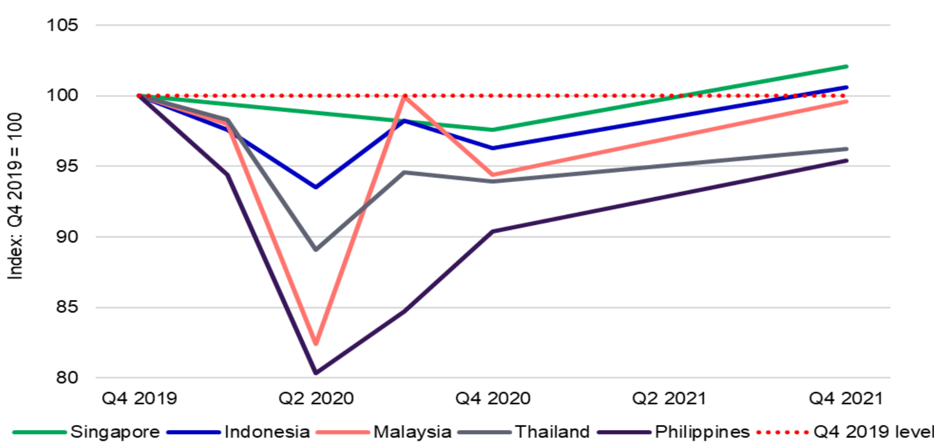
Source: Philippine National Statistical Coordination Board, Macrobond, Manulife Investment Management, as of June 6, 2021. YoY refers to year over year.

Singapore

Big picture

Final Q1 GDP growth was revised upward from 0.2% to a higher-than-expected 1.3% (on a YoY basis), owing to stronger growth in both the manufacturing and services sectors.[1] But the economic recovery suffered a setback recently due to a jump in COVID-19 cases and the imposition of tighter mobility restrictions, which weighed on the services sector. In our view, however, there are some reasons to be hopeful. Singapore's economic output has already returned to prepandemic levels in Q1—ahead of its ASEAN peers[2]—thanks to stronger fiscal and credit support measures; the government's more cautious approach toward reopening the economy also helped. Crucially, the city-state made significant progress with its vaccination program. If the current pace of vaccination is sustained, it could have 70% of its population fully vaccinated by August and could potentially fully reopen the economy much sooner than its neighbors.

ASEAN consensus GDP forecast vs. pre-COVID-19 trend
Singapore output is back above the prepandemic level in Q1



Source: Bloomberg, Manulife Investment Management, as of June 11, 2021. ASEAN refers to the Association of Southeast Asian Nations.

"If the current pace of vaccination is sustained, it could have 70% of its population fully vaccinated by August and could potentially fully reopen the economy much sooner than its neighbors."

1 Department of Statistics Singapore, May 25, 2021. **2** Bloomberg, as of June 10, 2021.
3 "Singapore Seeks Vaccination Of All Adults By August," Bloomberg, May 25, 2021.

What we're watching

- **The pace of recovery in the services sector and domestic demand—**Private consumption remains a key drag on growth and is still 9.8% below prepandemic levels.[2]
- **World vaccination trends and travel bubble developments—**As a transport and business hub, the return of globetrotters would be a positive development.

Key market views

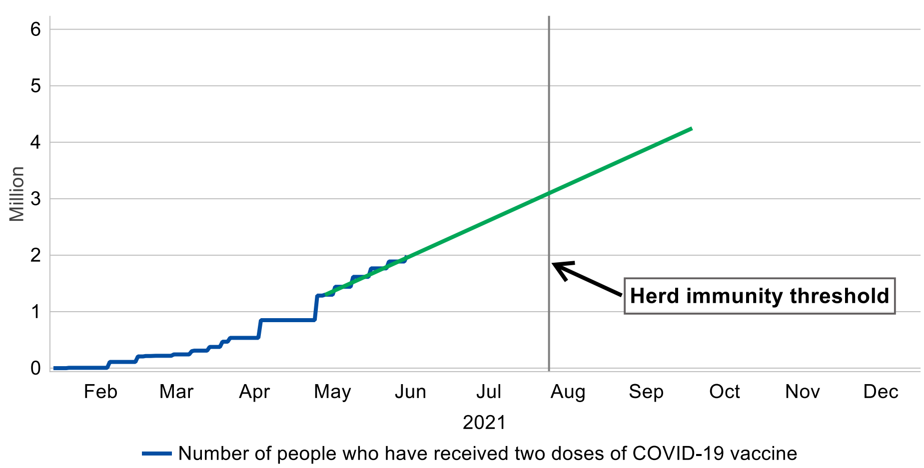
- **SGD rates outperformance—**In our view, Singapore's economy and markets should be clear beneficiaries as the global economy recovers, particularly since Singapore dollar (SGD) rates are trading below USD rates.
- **Currency—**We expect the nominal effective exchange rate to be supported by rising market expectations for some form of foreign exchange policy tightening ahead of the next policy announcement from the Monetary Authority of Singapore, which takes place in October. The likelihood of this taking place will be heightened if flare-ups in new COVID-19 cases in the global/regional economies are contained.

Risks to our view

- **Upside risk—**Provided mobility restrictions are lifted on schedule, the economy should make up most of its lost ground in the second half of 2021.

- **Downside risk—**Since Singapore is ahead in vaccinations, it will be a good case study for the effectiveness of vaccines. Continued COVID-19 flare-ups or rolling mobility restrictions would be a major setback on the path to normalization.

Is herd immunity within reach in Singapore?



Source: Our World in Data, Macrobond, Manulife Investment Management, as of June 11, 2021. The green portion of the chart represents vaccination rate forecasts, based on current inoculation pace.

"Provided mobility restrictions are lifted on schedule, the economy should make up most of its lost ground in the second half of 2021."

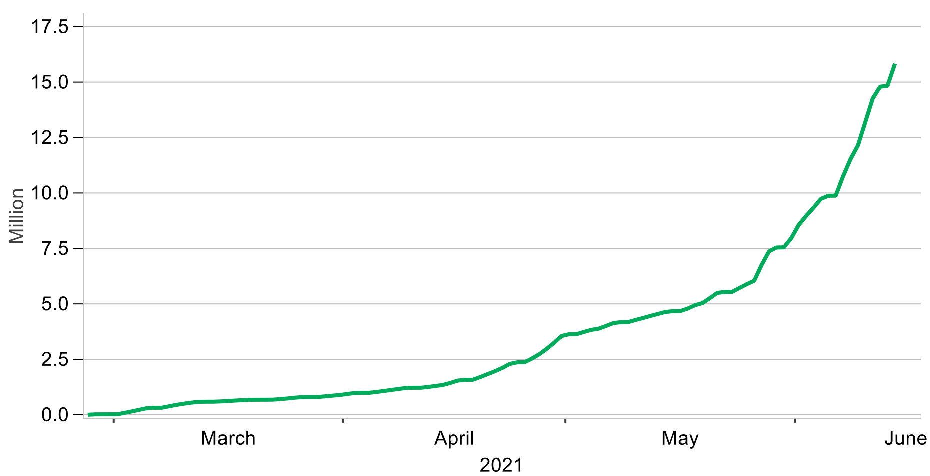
South Korea

Big picture

South Korea has ramped up its vaccination program—16.4% of the population has now taken a first dose.[1] The government expects to meet its vaccination target for the first half of the year by inoculating up to 14 million people. Officials also brought forward the country's target of vaccinating 70% of its population from November to the third quarter, which has important implications for the speed of the economic recovery.[1] Restrictions on movements are being eased further, and mobility data is back above prepandemic levels[2]—a precondition for a strong rebound in consumer spending and self-sustaining economic growth. Should the economic recovery continue to progress at its current rate, the Bank of Korea (BoK) may start shifting its attention away from supporting growth and back toward containing financial risks through macroprudential tightening. In our view, fiscal policy will remain expansionary in the runup to the March 2022 presidential election.

"Should the economic recovery continue to progress at its current rate, the BoK may start shifting its attention away from supporting growth and back toward containing financial risks through macroprudential tightening."

South Korea: number of COVID-19 vaccine doses administered



Source: Our World in Data, Macrobond, Manulife Investment Management, as of June 10, 2021.

1 "S. Korea's vaccination drive picks up speed, little slow down in new infections," Reuters, June 8, 2021. **2** Bloomberg, as of June 8, 2021.

What we're watching

- **Mobility rates—**Although social mobility in South Korea has returned to pre-COVID-19 levels, the key question is whether it can be sustained.
- **The BoK appears to be growing concerned about the side effects of prolonged emergency policy settings—**In May, it added a sentence to its policy statement, noting that it would be "paying closer attention to the buildup of financial imbalances such as fund flows concentrated in asset markets and household debt growth."[3] Governor Lee added in the press conference that the issue needs to be countered before it's too late.

Key market views

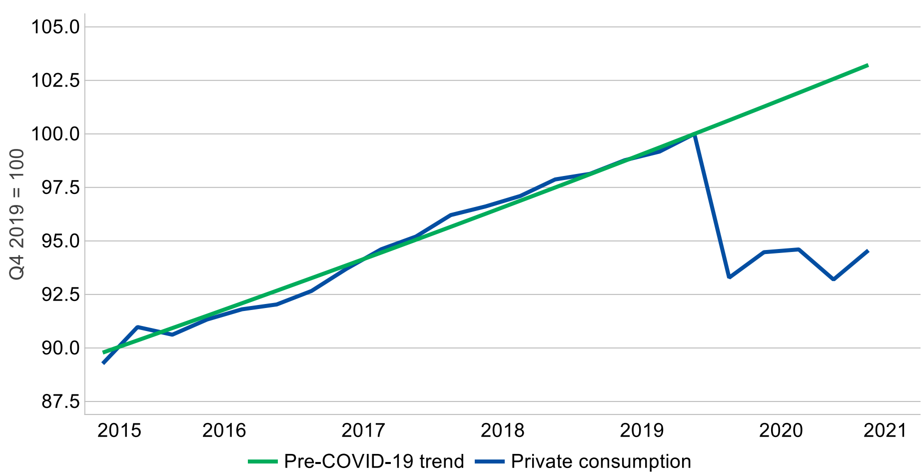
- **Rates—**In our view, the market's pricing of front-loaded rate hikes beginning in Q4 looks too aggressive. Conventional monetary tightening will be gradual given weak consumption growth, high household debt, and the presidential election in March 2022. We think the BoK will instead use macroprudential/tax measures to curb property prices and household debt.
- **Currency and equities—**We believe the Korean won and Korean equities market could outperform on the back of light positioning, expected growth outperformance, and unwinding of aggressive rate hike expectations.

"We believe the Korean won and Korean equities market could outperform on the back of light positioning, expected growth outperformance, and unwinding of aggressive rate hike expectations."

Risks to our view

- **Upside risk—**Buoyant exports helped drive stronger-than-expected GDP growth in Q1 and should continue to do so in the months ahead.
- **Downside risk—**The main weak spot for the economy is private consumption, which is a function of persistently weak private sector hiring and/or constrained wage growth.

South Korea: household consumption remains a weak spot



Source: Bank of Korea, Macrobond, Manulife Investment Management, as of June 11, 2021.

3 "Monetary Policy Decision," Bank of Korea, May 27, 2021.

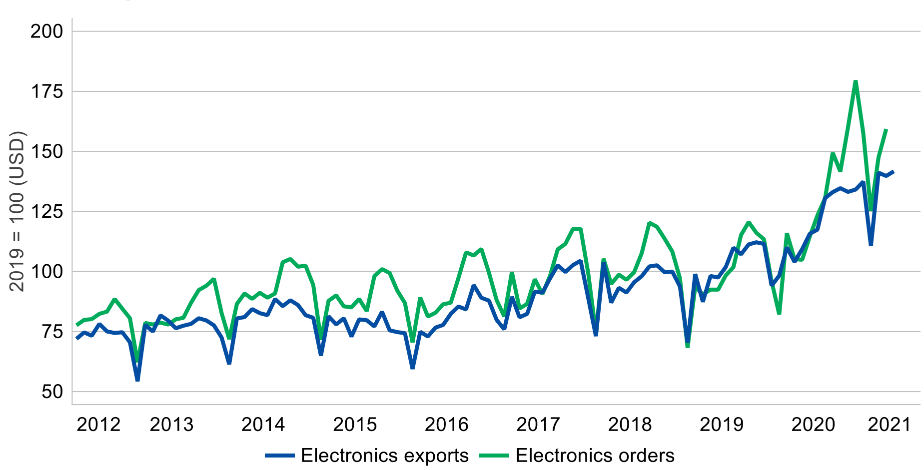
Taiwan

Big picture

Taiwan's economy grew by an impressive 8.2% YoY in Q1, but the island's economic outlook has taken a turn for the worse in recent weeks as a drought, supply shortages, and a jump in COVID-19 cases weighed on growth. Our calculations showed that tighter mobility restrictions have led to a sharp decline in the mobility diffusion index, to 40% below prepandemic levels. Since factories remain open, the hit to exports from the recent COVID-19 wave has been limited, although there remain scattered disruptions arising from the mandatory quarantining of workers.[1] The Central Bank of the Republic of China (CBC) and the central government have been actively promoting economic recovery: The CBC has expanded and extended its loan guarantees program to small and medium-sized enterprises, while the government enlarged its fiscal support.

"Our calculations showed that tighter mobility restrictions have led to a sharp decline in the mobility diffusion index, to 40% below prepandemic levels."

Taiwan exports and orders: electronics



Source: Taiwan Ministry of Economic Affairs, Taiwan Ministry of Finance, Macrobond, Manulife Investment Management, as of June 10, 2021.

1 "Taiwan to quarantine workers to contain COVID spike at tech firm," Reuters, June 6, 2021.

What we're watching

- **Taiwan has experienced the worst run of luck when it comes to critical infrastructure and logistics—**The *Ever Given* made global headlines after the Taiwanese-owned container ship was stuck in the Suez Canal, a fire in West Java dealt a blow to the island's plans to boost its energy supply, while an accident at a thermal power plant led to islandwide blackouts in May. These episodes are increasing in frequency and scale, disrupting production capacity.
- **Inflation—**Rarely a concern in Taiwan, but May's core CPI inflation rose to 1.6% YoY.[2]

Key market views

- **Equities**—We continue to think there could be a relative value opportunity here and expect Taiwan equities to underperform South Korea in the coming year.
- **Currency—**Although there are signs that the USD is rebounding and the CNY is topping out (which typically suggests that the Taiwanese dollar would weaken against the greenback), there are mitigating factors that may contain depreciation pressures in the event U.S. financial conditions tighten considerably (e.g., limited real effective exchange rate misalignments) and/or Taiwan's external position improves.

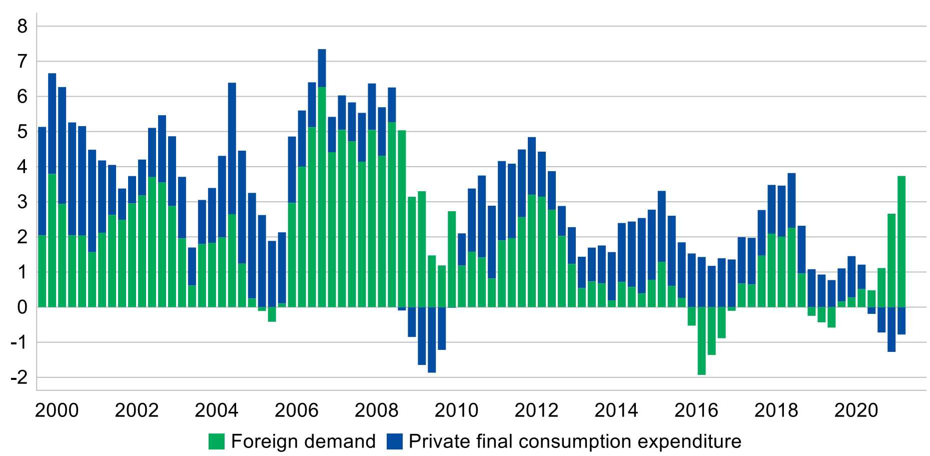
"Self-sustaining growth requires strong private domestic demand, and Taiwan's consumption growth remains a drag on GDP growth."

Risks to our view

- **Upside risk**—A backlog of demand for electronic items should mean export growth will help cushion some of the economic losses**,** a view supported by the elevated PMI reading of 62 in May.[3]
- **Downside risk—**An overreliance on foreign demand to drive growth leaves the economy vulnerable changing appetite for Taiwan's exports. Self-sustaining growth requires strong private domestic demand, and Taiwan's consumption growth remains a drag on GDP growth. This represents downside risk to the island's economic outlook should global consumption patterns normalize.

Contributions to real GDP (%)

Reliance on foreign demand and private consumption weights on growth



Source: Taiwan Directorate-General of Budget, Accounting and Statistics, Macrobond, Manulife Investment Management, as of June 11, 2021.

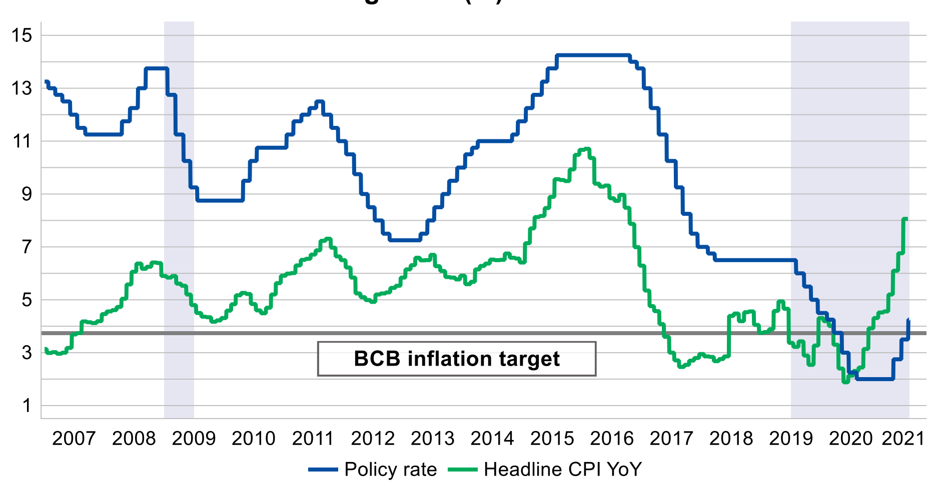
2 Directorate-General of Budget, Accounting and Statistics, Taiwan, May 2021. **3** Markit, June 1, 2021.

Brazil

Big picture

The worst of Brazil's economic downturn arising from the COVID-19 outbreak is likely to be behind us as we head further into the second half of 2021. Q1 growth surprised to the upside, bolstered by inventory rebuilding and the commodity boom that pushed agricultural GDP to its highest level since 2017.[1] Coronavouchers (amounting to ~US$110 a month distributed to 30% of the population[2]) were reinstated in April and are expected to end in July. The Banco Central do Brasil (BCB) responded to these improvements and higher inflation by raising rates by 75 basis points (bps)—first in March, then in May and June,[3] making it one of the most hawkish major central banks globally. The BRL strengthened in Q2 as a result, although it remains near historically low levels. The BCB intervened with currency swaps in the first half of 2021 to support the BRL, which proved to be effective. We expect negative investor sentiment to continue to ease in the coming quarters as the severity of the pandemic and the geopolitical risk premium unwind, further supporting growing foreign inflows to Brazilian assets.

Hawkish BCB with above-target CPI (%)



Source: Macrobond, Manulife Investment Management, as of June 21, 2021. YoY refers to year over year. CPI refers to Consumer Price Index. The gray areas represent recessions.

1 Macrobond, as of June 10, 2021. **2** "COVID in Brazil: Hunger worsens in city slums," BBC News, April 18, 2021. **3** Banco Centro do Brasil, June 16, 2021.

"We expect negative investor sentiment to continue to ease in the coming quarters as the severity of the pandemic and the geopolitical risk premium unwind, further supporting growing foreign inflows to Brazilian assets."

What we're watching

- **Inflation—**Inflation remains above the BCB's 3.75 target and could, in our view, drive further interest-rate hikes.
- **The BCB is widely expected to hike rates by 75 bps twice—**first at its August meeting and again at its September meeting. As of this writing, consensus expectations are for the Selic rate to end the year at 5.75%. Understandably, rate hikes that are in line or greater than consensus forecast will be favorable for the BRL.
- **Foreign investor flows remain a major driver of BRL strength—**Foreign participation in local currency corporate bond sales rose in Q2.[4] If this were to continue, the BRL could strengthen further, and overall market sentiment could improve.
- **Geopolitical uncertainty—**President Jair Bolsonaro's handling of the pandemic could influence the outcome of the 2022 election.

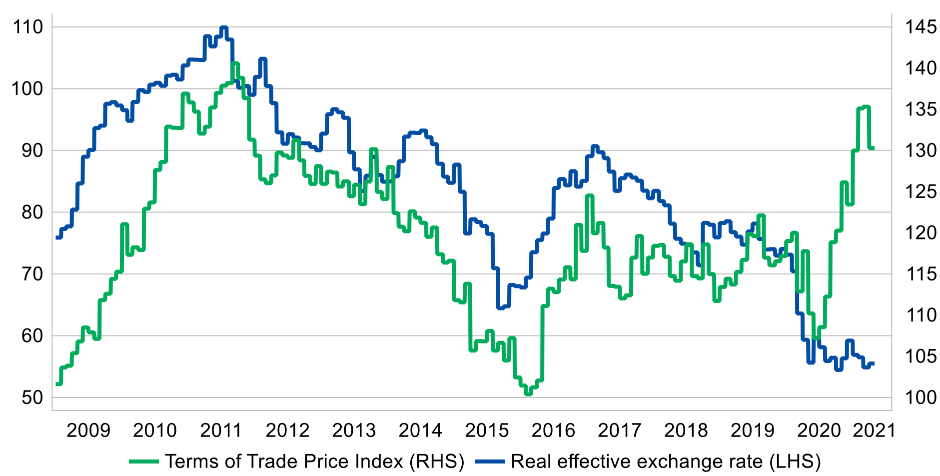
Key market views

- **Currency—**In our view, the BRL remains well supported by the continued improvement in Brazil's terms of trade as well as attractive interest-rate differentials. The currency is clawing back some of its losses against the USD, and the pair has traded heavily for much of Q2, and we expect this trend to extend into the fourth quarter. Although we're not expecting a full retracement of the H1 2020 rally, we believe the BRL could strengthen toward the 4.50 level against the greenback.
- **Equities—**We expect Brazilian equities to benefit from the cyclical tilt of the MSCI Brazil Index, which is likely to be supported by the global reopening. The strength in commodities will act as a tailwind to the materials and energy sectors that make up approximately a third of the index.[5]

Risks to our view

- **COVID-19 has hit Brazil more severely than other countries**—The country has one of the world's highest infection/mortality rates. Although things seem to be improving, there remains the risk of resurgence. Timely vaccine distribution will be critical for Brazil to win its battle against the pandemic.
- **Geopolitics**—Next year's general election adds more uncertainty into the mix.
- **Brazil's fiscal position**—Coronavouchers are scheduled to end in July but may be extended. While the program can alleviate hardship amid the pandemic, concerns about Brazil's fiscal strength are growing.

Correlations between the BRL and Brazil's terms of trade are weakening



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

4 "[As Interest Rate Surge, Brazil Corporate Bond Market Reawakens](#)," Bloomberg, as of May 5, 2021. **4** MSCI, May 2021.

> **"We expect Brazilian equities to benefit from the cyclical tilt of the MSCI Brazil Index, which is likely to be supported by the global reopening."**

Mexico

Big picture

Mexico's macroeconomic outlook continues to be challenged as domestic headwinds remain relatively elevated in an environment characterized by fiscal austerity and political uncertainty. The recent midterm elections removed a significant amount of tail risk for markets and international investors; however, talks of a cabinet shuffle among key government officials[1] have created a new set of variables for market participants to consider.

Externally, the United States' reopening has so far failed to deliver a significant boost to Mexico's manufacturing sector, as evidenced by relatively low PMI readings,[2] which are hovering just above the neutral level at 50. Global financial conditions remain accommodative, while the domestic policy mix is largely consistent with fiscal austerity, albeit with relatively easier monetary policy calibration. Banxico has adopted a dovish stance relative to its regional peers in the Pacific Alliance. The Mexican peso's relative underperformance can be most clearly observed against the Brazilian real (BRL).

Markets eyeing near-term decoupling from the United States (YoY%)

Source: Macrobond, Manulife Investment Management, as of June 11, 2021. YoY refers to year over year.

1 "Mexican President hints at possible cabinet changes after election," Today, June 3, 2021. **2** IHS Markit, June 1, 2021.

"The recent midterm elections removed a significant amount of tail risk for markets and international investors; however, talks of a cabinet shuffle among key government officials have created a new set of variables for market participants to consider."

What we're watching

- **Fed tapering and global financial conditions—**Conditions are accommodative as a result of the Fed's easy stance. This remains a critical consideration for Mexico given the large foreign-owned share of the country's government debt. Fed tapering continues to pose a key risk and could generate disruptive spillovers to many emerging markets, including Mexico.
- **Banxico—**Mexico's central bank began normalizing its monetary policy settings in late June, delivering a widely unexpected, and narrowly supported 25 bps interest-rate hike.[3] Policymakers, however, are suggesting that they still view inflation as being transitory in nature, which should limit both the speed and magnitude of tightening that will continue to set Mexico apart from its regional peers.

Key market views

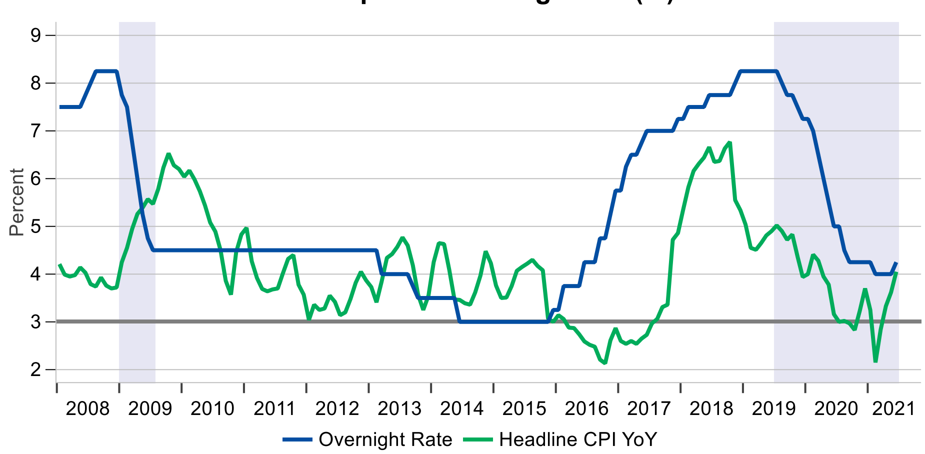
- **Currency—**From a technical perspective, the psychologically important 20.00 level has been a critical anchor for the Mexican peso (against the USD). The currency pair has traded heavily in response to the recent midterm elections, creating the possibility of a full retracement of the 2020 rally.
- **Rates—**Banxico's surprise June interest-rate hike was combined with a shift in the central bank's assessment of the economy's balance of risk to neutral.[3] As such, we believe the speed and magnitude of future rate hikes will likely remain muted relative to its peers.

"Policymakers, however, are suggesting that they still view inflation as being transitory in nature, which should limit both the speed and magnitude of tightening that will continue to set Mexico apart from its regional peers."

Risks to our view

- **Economic decoupling from the United States—**This remains an ongoing concern as the U.S. economy reopens. Economic growth has so far failed to surprise to the upside, and we see this as a critical risk into H2 2021.
- **Domestic policy uncertainty—**Uncertainty in its domestic policy remains an ongoing issue given proposed changes to key cabinet positions.

Banxico remains neutral despite above-target CPI (%)



Source: Bloomberg, Macrobond, Manulife Investment Management, as of June 28, 2021.

Source: Macrobond, Manulife Investment Management, as of June 25, 2021. YoY refers to year over year. The gray areas represent recessions. CPI refers to Consumer Price Index.

3 "Monetary Policy Statement," Banxico, June 24, 2021.

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 pre-existing 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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