Manulife Investment Management

Q1 Asset Allocation Update and Market Outlook

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KEVIN: Welcome to Manulife Investment Management's first quarter market outlook for 2022 and our asset allocation update. My name is Kevin Headland, I'm the Co-chief Investment Strategist at Manulife Investment Management. I'm joined, as always, today by Jamie Robertson, Senior Portfolio Manager and Head of Canadian Asset Allocation, as well as Head of Global Tactical Asset Allocation with Manulife Investment Management, based out of Toronto.

Today, I'm going to take a quick look back at 2021 and look at what might be in store for 2022. I'll then hand it over to my colleague, Jamie Robertson, who will discuss his team's asset allocation positioning through the quarter and what he sees in 2022 and how to best prepare the portfolios.

2021 was actually a very strong year for equity markets following the 2020 strong year, as well. We were in a normalization phase of markets and we continue to be in that normalization phase of the market. We like to characterize 2022 as kind of a road trip. We're packing the family into the car; we're going on a road trip with a destination in mind. But at the same time, with all road trips, we know there's going to be pit stops along the way. There's going to be some unexpected pit stops and some expected pit stops.

The actual investment landscape over the last couple of years has also been a lot like a road trip; we've had detours and bumps along the way. You know, March of 2020 marked the one-year anniversary of the pandemic, or the peak of the pandemic, and global markets continued their recovery through 2021, fuelled by vaccine rollouts, economic reopening and strong consumer demand. In the second half of the year, rising inflation and supply chain issues made headlines. And in the last weeks of December, COVID-19 cases soared once again due to the Omicron variant.

Over the course of 2021, the S&P 500 rose 26.9%, marking its third straight positive year. The S&P TSX Nasdaq and MCI-EFI also finished strong, gaining 21.7, 21.4 and 8.8%, respectively. And as we settle into a new year with the realization that it will take some time yet for the world to get a handle on the pandemic and facing the possibility of rising interest rates, it's natural to feel nervous about the state of things, but the growth and inflationary environment remains favourable for investors.

When we look at things from a growth perspective, we are past peak, but economic growth remains resilient. Global economic growth and earnings will likely peak during the summer of 2022. And although economic activity is expected to slow and we'll face continued challenges, including supply chain disruptions, overall, the global manufacturing environment remains in a resilient position. Companies are predicting that production will be higher a year from now, and historically, a strong manufacturing sector provides a healthy environment for earnings. Inflation is also going to be enduring, but we expect it to moderate or become softer throughout the year.

The consumer price index, or CPI index in the U.S., recently measured prices over time, or year-over-year at 7%. We do believe that it's expected to decrease, but will remain above 3% through the summer and through the back half of this year. It will continue to be a concern throughout 2022, but will receive nowhere near the level of attention it's receiving today. We believe equity markets are in that normalization phase, as I mentioned earlier, and in this next stage of a post-recession recovery, earnings growth will moderate, but remain strong. They'll be the drivers of equity returns. Growth in a 10 to 15% range for earnings is very possible for U.S. equities, and while the S&P TSX earnings are expected to come down from recent elevated levels, they will remain attractive through at least the first half of 2022 on strong elevated oil prices.

Based on year-over-year earnings growth, return to the upper single digits, low double digits are expected for the S&P 500 Index from our team. Throughout the pandemic, a smart strategy has been to take advantage of asset allocation and dollar-cost averaging. That approach is still wise today. A correction in the near term is entirely possible, but we need to take this pit stop in stride and focus on the road ahead to make sure we arrive at our destination. A well-balanced portfolio will be paramount.

I think this is a spot to stop at and hand it over to Jamie Robertson to share his views on asset allocation and what his team has been doing so far and where things are going in 2022. Jamie, over to you.

JAMIE: Thank you, Kevin, and thank you everyone for joining us today. I'm happy to report that the Manulife multi-asset portfolios are continuing to track in line with our objectives and with the outcomes that we're trying to achieve. So what are those outcomes? Well, very simply, you know, when I think about the growth portfolio, our expectation is that we'll be able to generate equity-like returns with lower levels of volatility. And in the case of the conservative portfolio, we are looking to generate returns that are in excess of the fixed income markets with a similar level of volatility, and that's exactly what we've been able to achieve. How have we done that? Well, it all starts with portfolio construction.

The Manulife multi-asset portfolios rely on what I believe is quite a unique portfolio construction, the components of these are very compelling. 80% of the portfolios are made up of Manulife's active managers that I am sure that most people on this call are familiar with and have a lot of confidence in. So we're talking about Sandy Sanders running our U.S. equities, we're talking about Conrad Dabiet, running Canadian dividend income. We've got Moore running international equities, as well as Brookfield running our infrastructure exposures. On the fixed income side, Dan Janis runs our strategic income and Roshan Thiru runs our Canadians bonds. So you've got really the best of Manulife active managers as a big component of this portfolio.

We also augment that with 10% of the portfolio being dedicated to the Manulife ETFs that are managed by DFA, Dimensional Fund Advisors. So these are strategic beta ETFs and they are another potential source of alpha force as they tilt their portfolio more towards smaller companies, more profitable companies and cheaper companies, and that's certainly been a big component over the last little while. And then finally, we've got that opportunistic sleeve of the portfolio, our opportunistic portion of the portfolio that our team manages, and really what we're trying to do here is be very targeted in trying to find asset classes that we believe have the ability to generate additional return for the portfolio, or we'll use that as a means to de-risk the portfolio. So this is the construction that is extremely important to the outcomes that we're trying to achieve.

The other part of it is our investment process. Our investment process involves, as you see on this slide, generating 5-year expected return forecasts for a wide variety of asset classes. And if people have heard me in the past, we use 5-year for a couple of reasons, number one being is that a 5-year time horizon is probably a pretty good time horizon when thinking about a strategic asset allocation. But equally important is the fact that 5 years is the shortest period of time, according to our research, over which you can expect to see some sort of mean reversion in valuations. So a market that has got very expensive valuations would have the tendency over that 5-year period to normalize to get back to its longer term average. But what you see on this slide I think is quite stark, and actually has not really changed that much over the last few quarters that I've been speaking with you.

On the right-hand side, you see our expected returns forecast from the fixed income side. So you're seeing returns that are pretty muted, and in some cases actually negative. And the reasons for that is very simple; we are starting at an extraordinarily low level of not only nominal interest rates, but also spreads in some of our more favoured credit products. So although we are expecting to see modest returns from the fixed income side, we certainly won't see anything like we saw, say 10 years ago, when you'd expect to see 4 or 5%.

On the equity side, the story remains pretty much the same. So if you look at this graph, you can see that, you know, Canadian equities, both large and small, as well as emerging markets, stand out as some of our most attractive asset classes with returns in excess of six-and-a-half percent. Again, U.S. equities on a forward-looking basis have only an expected return of around .6, and that's because that green bar, which is what the valuation component is, has got an extraordinarily large drag on expected returns on a 5-year time horizon.

So how did we get here in terms of what these expected returns are looking like? Well, at this particular point, the S&P is currently 80% above its 100-month moving average. One of the things that we try to think about, particularly in our tactical portfolios, is what is the most relevant timeframe for us to be able to frame what's going on in the markets? And I look, in this case, at the 100-month moving average as a moving average that encompasses almost 10 years of price returns, but more importantly, over the large swath of history, has been a moving average that has contained, or has been quite close to what the market has produced. Every once in a while, you'll see that the prices of the S&P get maybe 5 or 10 or maybe 15% above or below that moving average, but we're now a full 80% above that moving average, so it's quite an extraordinarily stretched situation.

The reason for that is that since the end of the global financial crisis, the U.S. has increased at an annualized rate of about 16%; that is an incredible run. Emerging markets, on the other hand, which have better fundamentals from a growth perspective, have better fundamentals from a demographics perspective that will sustain that growth, have only returned about 7% per year. So as a result, you're looking at about 66% underperformance of the EM since the end of the global financial crisis up until today. And that explains why at this point in the cycle we expect to see emerging markets have much more attractive return potential than we find in the U.S. And a side note is, what we're seeing here is Canada has experienced a very similar dynamic where we've seen a massive underperformance.

So we are indeed in a situation where the U.S. market is historically expensive relative to both EM and Canada, and that means that it's a compelling opportunity to allocate capital there in the event that once this mean reversion process starts to come to the fore. So just a level set where we came into this year and it very much aligns with what Kevin has just been saying. When we think of 2022, we think of it as a year that's going to have 2 distinct halves. The first half is going to be characterized by the higher inflation that Kevin just referred to. This is due to the supply chain issues that are proving to be stubbornly persistent, and as Kevin said, you know, we've just seen the U.S. CPI print at 7%, the highest in decades, and around 5% for Canada. At the same time, we're going to see growth is going to cool off a little bit from the torrid pace in 2021, as global PMIs will retreat from their highs while remaining in expansionary territory.

The lagged impact of the China growth slowing will also have an impact, as well as the last wave of Omicron that's coming through at this particular point. So let's call the first half stagflation, for lack of a better term. What we'll see in the second half will be quite different. It will actually pivot to be quite the opposite situation. Inflation will cool substantially as it trends back towards more benign towards the end of the year, which would be sort of in that two-and-a-half to 3% area, and that would be in line with what market expectations are. Supply chains will slowly resolve themselves; those issues will improve, and as a result of that, we'll get a global inventory rebuild. The Capex will start to come through, and as well, we'll see a growth pickup as more of us return to the office. Let's hope that that's actually what happens.

So when we think about it, the second half will be more of a Goldilocks scenario. But that view, which I think was quite easy to get your head around, did not prevent the year from starting off like gangbusters as market perceptions and expectations changed very, very quickly and very dramatically. Rates surged as soon as the market opened on the first trading day of January, and two things were afoot. The first was the growing perception that despite the impending surge in COVID cases, that this would probably mark the worst of the pandemic and that we could look forward to a more normal future in the second half of this year. But at the same time, the Feds' messaging got quite a bit more aggressive.

With the caveat that the employment situation would have to remain healthy, they indicated that they would start tightening earlier, more aggressively and would contemplate starting to shrink the balance sheet. So at the beginning of the year, the market had attached basically about a 60% probability of a Fed tightening in March. It is now over 100% for a 25% basis point tightening, and at this point, there is even talk in some market expectations that it could be as much as 50 basis points. And every meeting this year is perceived to be a live meeting in so far as we could see, constant raises as throughout the year.

At this particular point, the market is pricing in 2% on short-term interest rates at the end of next year, and that's an expectation that has jumped by 60 basis points in just a few weeks. So what happened in the markets was value surged, energy, which I will speak about in a few minutes, did very, very well, and defensive sectors and countries advanced across the globe, and this led to a large sell-off in long duration tech and growth stocks.

So in light of the view that perhaps interest rates may be moving up at this point, how do we navigate our way through that? Well, we have a number of levers at our disposal. The first is that we will continue to adhere to building portfolios with a broad level of diversification. We will diversify across fixed income asset classes, we'll diversity across equity asset classes, we'll diversify across styles, as well as regions. So diversification is clearly going to be something that is going to help us navigate our way through it. We have active management in the portfolios, and this is particularly important on the fixed income side where our managers are able to manage the duration as well as seek out value wherever they may find it in the fixed income markets.

We can rebalance the portfolios to take advantage of opportunities, and as well, of course, we have our opportunistic sleeve. And I'd like to share with you a few things that we see evolving in the opportunistic sleeve, and I think that the opportunistic sleeve is very, very well-positioned at this particular point. The first exposure is oil. This is a simple thesis and it's one that we've had for over a year. We've been pretty active in this exposure as we moved in and out of it in the course of last year, but still managed to capture the entire 70% increase in XCG. And what we're seeing here is really a case of, as much as we would like to see the world's reliance on fossil fuels to decline, the reality is that we are years away from a peak in oil demand, and oil demand in the world this year could very well grow potentially faster than expected, and that demand is being met with a chronic underinvestment in the oil patch.

Investors have demanded capital discipline, and this has meant that excess cash flow has been devoted to debt reduction, dividends, buybacks, with capital investment pulling up the rear. In fact, capital investment in the oil patch is at levels as 50% below where it was just 4 or 5 years ago. The result is, these companies have transformed themselves into cash flow juggernauts and will continue to be so anywhere above 60 or 65 dollars in oil, and we're currently at 85. So, as you can see, we took advantage in the second week of January to trim our exposure by about half. We did that for the simple reason that over a 2-week period, that particular sector outperformed the broader markets by over 20% in 2 weeks. We felt that given that degree of outperformance, it would be worthwhile for us to trim the exposure, but we will maintain it until we start to see more exuberance on the sentiment side, and we're certainly not anywhere near that at this particular point.

So by extension, another area that we like from a country perspective is Canada, and recent performance has been very encouraging. The TSX has outperformed year-to-date other broader indexes by about 5%. We like the valuation of the Canadian index, we like the dividend component of it, and also, we like the sector makeup of the TSX, with financials, a very attractive sector from our perspective, energy, as I just mentioned, as well as materials. So we believe that there is a long runway for the TSX to have a sustained period of outperformance relative to other markets around the world.

The final exposure in the opportunistic sleeve that I would like to highlight is our European exposure. And this, again, fits well into the value trade, and although this is taking longer to play out, we still like the underlying dynamics of the market, and we believe that once COVID is behind us, we'll start to see some greater momentum coming out of that space, as well. So we're going to continue to monitor this situation, and certainly we'll give you updates as we see the situation unfold.

The results for the portfolios continue to be consistent and robust, and we're delivering on our objectives. You can see that since inception, that they are solidly in the first quartile, and the returns really across the board have been very attractive with the conservative portfolio generating over four-and-a-half percent, and the growth portfolio generating over 840, so exactly in line with what our outcomes and what are expectations are. So going forward, I'm very optimistic about the portfolios for 2022. They are very, very well-diversified, we are well-positioned to navigate through what will be a year of potential risks, but also one where I believe we'll see lots of opportunities. So I thank you for your support in these portfolios, and really believe that we are well-positioned to do very well again in 2022. And with that, I'm happy to pass it over to Kevin in the event that he has any questions.

KEVIN: Thanks so much, Jamie, and as always, it's a great summary of your process in your portfolio and you've continued to generate some great returns in a very challenging environment, I would say, especially on the fixed income side. And talking about the fixed income side, we're seeing rising rates, we expect the Federal Reserve to raise rates this year, Bank of Canada raise rates, higher yields tend to be challenging for fixed income. Perhaps you can talk a bit about why investors should continue to own fixed income in their portfolio and perhaps where you think the best opportunities are right now in your fixed income.

JAMIE: Well, thanks Kevin. That's certainly the question around fixed income is one that we get a lot. And I guess I would start off by saying this: is that fixed income is still going to be an important component of any well-diversified global portfolio. The diversification benefits have been proven time and time again to be a stalwart when you run into periods of time when you might see a correction. We also, from the portfolio construction standpoint, you know, we have managers who have the ability to modify their duration in a very meaningful way, they do have the ability to go to cheaper asset classes, and they have the ability to respond to opportunities as they present themselves in the market.

So I know that there's a lot of consternation around the potential for higher interest rates, and certainly if we were running a portfolio with a duration of 10 years or 30 years, you know, those are portfolios that clearly would be damaged by a move up in interest rates. But really, when you're running portfolios with shorter duration with a higher credit perspective, you continue to have the ability to generate attractive levels of income, which will certainly be a bolster for the portfolios, as well as that diversification benefit. So I realize that this whole issue of rising interest rates is a point of concern for advisors, but really, we believe that it's still a key component of a well-diversified portfolio, and we continue to be happy with the exposures that we have through our active managers.

KEVIN: Thanks, Jamie, and I like to think that it's important to remember why we own fixed income in a portfolio, it's for the defence downside protection during volatilities to smooth out the ride. And also, it's important that when we talk about fixed income, especially in your portfolios, it's not about broad indices, it's about active managers. And I think in fixed income, especially in 2022, I think flexibility will be key and I think that's sort of providing active managers the best opportunity to meet the expectations for you and the team.

Speaking of flexibility, I think it also plays a part with emerging markets. You talk about emerging markets being a source of opportunity, but it's also important to pick your spots. And perhaps you can talk a bit about why you like emerging markets despite the short-term potential risks and why it still plays an important part in the portfolios.

JAMIE: Well, I think that emerging markets is, again, is one of those markets that I think garners a lot of attention and I think that we are, you know, very pleased to maintain a level of exposure to emerging markets. And I think we would be inclined to add to them if we started to see some sort of life coming out of them and, really, we're starting to see that now. But when I think about it, you know, you're talking about a major part of global financial markets, or global equity markets, that have growth dynamics that are far superior on a longer-term basis than what you see in the developed world. You've got valuations that are much more attractive and you've got a persistent underperformance that is certainly not going to be sustainable for the long run.

Certainly, when you see what happened, for instance, in China, China got a lot of attention last year, when you start to see an asset class as important to global markets as, say China was where, you know, pundits are asking whether, you know, this is a market that is even investable, you know, that's showing a level of negative sentiment that I feel is more indicative of an opportunity than a risk. So we watch these markets very carefully. Certainly, just anecdotally, we're starting to see that there seems to have been some support coming into these markets of note, we're going through a little bit of a sell-off here. Here we are in the mid-week, third week of January and we see U.S. markets are down by about 5%, and we've got emerging markets are flat.

So you can see that, you know, running that diversified portfolio, and particularly having exposure to some of these markets to provide better valuation really does benefit the portfolio. So emerging markets has been an area of focus for us for a number of years. We still believe that they provide a more attractive relative value to the U.S., and we think that they'll be a big contributor to portfolios over the next few years.

KEVIN: Thanks so much, Jamie, and I think that's also very important to understand the short-term nature of price movements in emerging markets versus longer-term fundamentals and, as you said, the diversification benefits that provides in a well-diversified portfolio. So I think it's a great place to stop, I think we really did a great summary our outlook for 2022, as well as how you're structuring the portfolios to take advantage and also protect clients in this tough environment that we're facing in 2022, but still positive environment, which is nice to see. So on behalf of Jamie Robertson, Senior Portfolio Manager and Head of Canadian Asset Allocation, this is Kevin Headland. Thank you for joining us for our first quarter market outlook and asset allocation update.

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