Q3 Asset Allocation Update and Market Outlook

Philip Petursson, Chief Investment Strategist at Manulife Investment Management and Jamie Robertson, Senior Managing Director, Senior Portfolio Manager and Head of Asset Allocation Canada & Global Head of Tactical Allocation at Manulife Investment Management

Philip Petursson: Hello, and welcome to Manulife Investment Management's third-quarter Market Outlook and Asset Allocation Update. My name is Philip Petursson. I am the Chief Investment Strategist at Manulife Investment Management, and I am joined 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, we're going to be discussing the market outlook for the remainder of 2021, as well as a bit of a review of the first half of 2021. And then, I'll be handing it over to my colleague, Jamie Robertson, who will discuss his team's asset allocation positioning through the quarter and what he sees through the remainder of this year and perhaps into 2022. So, to start, let me set up the viewpoint of the global economy. Growth has been led by the U.S., as it continues through its reopening from the COVID lockdowns of last year. This has been supported by the broader economic reopening across the States and, as we are starting to see it emerge around the world, as a result of the COVID-19 vaccine distribution. We have seen stronger consumption, and we expect to continue to see stronger consumption through 2021. This is fueled by consumers with excess. It's almost pent-up demand for goods and services. The recovery, we believe, is starting to give way to a sustainable economic environment. We've seen a recovery in the manufacturing sector – not only in the United States and Canada, but around the world. As mobility opens up and the lockdowns lift, we expect the services sector to catch up to the manufacturing sector's recovery. And in this environment, average market returns are expected, over the next couple of years, with what we believe to be upside risk. Or, rather, we believe the economic momentum is sustainable, and as we look at the data, we don't see any evidence of a meaningful slowdown in economic activity through this year or through 2022. And that does set up for an attractive environment for equity markets. Looking at equity market returns specifically, the S&P 500, the U.S. benchmark for stocks, gained 8.2% in the second quarter, leading to a 14.4% return for the first half of 2021. Similarly, the S&P/TSX Composite Index was up 7.8% in the quarter and 15.7% for the first half of the year. Now, in part, the TSX Composite growth was due to an increase in oil prices themselves, which, as measured by the West Texas Intermediate price per barrel of crude, was up 24% in the second quarter and 51% over the first half of the year. The global economic recovery is expected to bring continued high demand for commodities and oil itself, contributing to higher TSX profitability, we believe, through the remainder of 2021. Specific to the United States, the U.S. economy bottomed in the summer of 2020 and has shifted from contraction well into recovery. Since last August, the U.S. ISM Purchasing Managers' Index – otherwise known as the PMI – showed a material increase in manufacturing activity on a month-over-month basis. And our economic indicators suggest that 2021 will continue to see this earnings growth environment that has driven equity markets higher, not only to earnings level going back to 2019, but we think that we can see corporate earnings, surpass the level of 2019. And this, again, will be driven by the release of pent-up demand and excess personal savings. So again, with the strength on the S&P 500 gaining just over 8% in the quarter, moving forward, we believe that momentum in the equity markets begets momentum. And for that reason, we do think that, through the remainder of this year and into 2022, we can continue to see stronger returns for equities – not only in the United States, but Canada and around the world – with, we think, the risk being to the upside. Now, this doesn't preclude the possibility for correction. There is always a possibility for correction, or a pullback in markets of greater than 10%, at any time. These tend to be rather unpredictable. But aside from that, we would really view any market weakness as an opportunity to build into or increase an equity position, as we continue to see strong economic fundamentals support improved earnings growth and valuation, in the context of higher earnings growth, at a reasonable level. Elsewhere around the world, if we think about broader global indices, areas that we find of interest include the Emerging Markets Index, but the broad international index, as measured by the MSCI EAFE Index, was up 4.4% in the second quarter. This led to a 7.3% gain for the first six months of the year. The International Monetary Fund projects that many regions around the world, especially emerging and developing Asia, could grow faster than the U.S. in 2021 and 2022. And on a year-over-year basis, global exports for the five largest exporters – which include South Korea, China, the United States, Japan, and Germany – seem to be improving in a meaningful way, with China being the leader in this export growth recovery. On the fixed-income side, we do have to pay attention to inflation. And over the near term, while we have exceptionally low interest rates and they are likely to remain low around the world, including Canada and the United States – and we don't believe that central bankers around the world, and in particular the Bank of Canada or the Federal Reserve, are in a rush to raise their benchmark rates – at some point, central bankers will have to shift from being accommodative to tightening up, in terms of fiscal stimulus. Or of monetary stimulus, rather. What we have seen over the course of the last year is that the Fed's expansion of the monetary base through its quantitative easing program, in addition to the fiscal stimulus programs by the federal government in the United States, injected trillions into the U.S. economy. This had the impact of steepening the yield curve in the first quarter of the year. Since then, we have seen the yield curve – as measured by the U.S. 10 Year Treasury yield – flatten a little bit, as longer-term yields have come down and short-term yields have risen. However, we do believe that over the longer term, higher inflation – which has, as of the end of June, shown a year-over-year increase of 5.4% – may give way to higher interest rates. And it's these higher interest rates that we believe investors need to pay attention to, in the context of fixed-income portfolios. In that regard, we continue to believe that investment-grade corporate bonds, as well as high-yield bonds, specifically with shorter durations, may be favoured over longer-duration sovereign bonds. And, in particular, we think that credit defaults will favour investment-grade and high-yield corporate bonds, as defaults will remain low, through the recovery, as economies continue to open up and companies continue to do well. As always, we do believe that security selection is very important and credit analysis is of paramount importance, with respect to this, and we do rely on our fixed-income managers to build reasonable portfolios, given the environment that we're in. Overall, though, if I had to sum up where we've come from, in the first half of 2021, it is that the rapid reopen thesis that we laid out in the first quarter has followed through. Equity markets have been quite favourable and, we believe, will continue to be favourable through this year and into 2022, whereas fixed-income markets may face a little bit more of a challenging environment, as we shift from a very low interest rate environment to a higher interest rate environment, which tends to cause headwinds for fixed-income returns. We can go further into this, though. At this point, what I would like to do is bring in Jamie Robertson to share his views on asset allocation and what the team has been doing. Jamie, over to you.

James Robertson: Well, thank you, Philip. And a great job of summarizing the key market developments, the critical issues that we're facing in the markets, as well as some of those major risks that may be out there, and just the emerging narratives of what we're seeing. The asset allocation portfolios continue to track very, very much in line with our expectations. They've had a very solid performance. And these portfolios really achieve those results by standing on some very strong foundations, for 90% made up of active managers, represented by MIM's best equity and fixed-income portfolio managers, as well as the segment of the portfolio that's managed by Dimensional Fund Advisors in our ETFs. We also have that opportunistic sleeve, that allows us to apply a very rigorous process that helps us to identify points of risk, as well as windows of opportunity. And we do this with a very well-resourced team – we have over 35 investment professionals around the world – but we also have a strategic process that ensures that, within that strategic timeframe, we are pointing the portfolios towards achieving the highest risk-adjusted returns possible. We're trying to get the best risk-adjusted, highest Sharpe ratio returns, by allocating to asset classes that provide those attractive returns. And one of our key components of that process is an exercise that we go through four times a year – so, we've actually just finished it quite recently, and we're about to embark on it in the next little while – where we do expected return forecasts for a wide variety of asset classes and over a five-year time horizon. And, of course, we use a five-year time horizon for a couple of reasons. The first is that five years is probably an appropriate time horizon from a strategic standpoint, and it is also appropriate because our research has shown that five years is the shortest period of time over which you can expect to see some mean reversion valuations. And I would say that valuations are a lousy timing mechanism, but over a five-year period, you will start to see markets that are very expensive become less expensive, and you'll find markets that are very cheap will become more reasonably valued. And I can just point to 2008 and '09, when valuations got very, very cheap. You know, five years later, you basically had a situation where valuations had gotten back to normal and a little bit above average. So, we go through this exercise and here, on this slide, you can see what those expected return forecasts are, as of June of this year, at the end of June. And starting from the left, you can see... Largely in line with some of Phil's comments, which is that we tend to be gravitate towards Canadian Large Cap and Canadian Small Cap stocks, and a couple of other asset classes that are interesting to lesser, emerging markets and global infrastructure. And the reason for this is that, really, those are asset classes that have attractive return characteristics from the perspective of income generation. They also have attractive growth characteristics and they don't have the same sort of valuation headwind that the U.S. market will have over the next five years. And you can see, from the third column over, our expected returns from U.S. Large Cap over the next five years is about 3%. So, less than half of what it would be in Canada or some of the other markets. If you cast your eyes to the far right-hand side of the screen, you can see some of the returns that we're expecting from the fixed-income side, and this is very much in line with Phil's comments: that as the economy continues to expand, we're going to start to see a move up in interest rates, and this is going to dampen returns on an ongoing basis. So, when we look at Canadian investment-grade bonds, or U.S. investment-grade bonds, we're talking about pretty de minimis returns: less than 1%. Even if we go into some of our more popular asset classes, such as U.S. High Yield and Emerging Market Debt, we're not getting anywhere near what we have had historically, but still, on a relative basis, they are very attractive. U.S. High Yield bonds, at 1.8%, will have the restraint of the fact that valuations, or spreads, are very, very low, on high yield bonds, relative to sovereign-rate bonds. And that will be offset because obviously, our expectations are that defaults will be lower than average, on a go-forward basis, and recoveries will be higher. So, after all is said and done, if you just cast your eyes upon this graph, you can see that we really do have a preference for equity markets at the expense of fixed-income markets. One word of caution, I would say, and that is that we often get people who look at these and ask us the question: "How much credibility do you have in telling people you can forecast equity and fixed-income returns within 10 basis points over a five-year basis?" And my comment to that is that you are absolutely correct. I don't know whether U.S. Large Cap will return 0 or 3 or 6% over the next five years, but I do know that when you take into consideration valuation, dividend yields, and relative growth, the U.S. is much less attractive to be over the next five years than, say, Canada, and EM, and other markets. Even Europe, which is about 5%. So, it's the ordinal rankings here that's important from the perspective of… When we build these portfolios and we input what these expected returns are, and we take into consideration what the standard deviations are, and we take into consideration how these asset classes correlate with one another, that is what gives us that optimized portfolio where we're getting the best risk-adjusted returns. So, these don't move materially on a month-to-month basis or a quarter-to-quarter basis, but they are a very, very good guidepost to where we're going and how we build portfolios over that five-year time horizon. We rely on a number of resources to guide us, as we go through our process, and I want to share one of those with you this quarter. And on the next slide you can see, what we have is the Multi-Asset Solutions Team's business cycle gauge. And yes, the business cycle is very much alive. The business cycle, as you just start on the left-hand side of the screen, really does have four distinct phases. So, at the end of a cycle, the economy enters into a downturn, and this is typically owing to an exogenous shock. It can be coming from higher real interest rates choking up growth, or simply a natural cooling-off of whatever economic excesses occurred, either on the credit side or on the economic side. The economy falters, and then, it goes into a repair phase, and that's the line that you see in the green. And that repair phase is generally characterized by a little bit of a response from monetary authorities, in the way of lower interest rates, and fiscal authorities as well, if they start to expand the budget deficit to stem that weakness. The economy starts to repair, and then it makes its way into the recovery phase, which is normally associated with probably the best equity gains, particularly in the emerging markets. Not necessarily in the developed markets, but emerging markets do very, very well, through this recovery stage. And the next phase from this graph, which we have just hit, is the expansion phase. And this is an expansion phase. This is almost like a "Goldilocks", from where we are right now, which is that equity performance continues to be very robust, quite above average, particularly in the developed markets, and it's actually the best period for developed market equity returns. And if all phases were exactly alike, our job would be simply to focus solely on the 10 indicators that go into this model and position the portfolios appropriately. But they don't all play by the same book, and I believe that you're going to start to hear that we're in an expansion stage, and you're certainly going to hear some debate, in the coming quarters, about this particular business cycle, because the contraction was so sharp and so pronounced, and actually was a result of government shutdowns. And I think a lot of the questions are going to be: "Is this overall cycle going to be compressed?" And I would think that the evidence, just as Philip was referring to earlier, is that this cycle could be prolonged and sustainable. Saving levels are at extraordinarily high levels. We see CapEx plans, on the part of companies, are approaching almost double digits. And there is certainly pent-up consumer demand as a result of the restrictions that have been put in place, as well as this massive amount of savings that has built up. So, the last expansion lasted over four years, and it's definitely just too soon to predict how long this will last. But I believe it will be sustainable because it appears, now, that the Fed seems to be refraining from pulling away too much liquidity. We've been back and forth a little bit, and whether they're going to taper or even get to the point where they're tightening – and that would be certainly an obstacle – but that seems to be allayed at this particular point. The other obstacle might very well be the base effect and the fiscal drag that we're going to have to contend with. The massive amount of fiscal stimulus that was put into the economy over the last 18 months just naturally will suffer from base effects. But we would expect markets to continue to do well, and certainly expect equities to outperform the fixed-income markets. And particularly, areas of interest would be the growthier parts of the market. The cyclical value areas have done very well so far. And certainly, we would expect financials to do well in this environment. So, how do we capitalize on this? Well, certainly, what we'll do is we will maintain healthy equity weights, and we'll opportunistically identify asset classes that we feel are attractive. And the first example of that that I'd want to share with you is, really, the issue of U.S. financials. So, as you can see here, we initiated a position in U.S. financials over a year ago, and have added earlier on this year. And at this point of the cycle, financials should generally outperform. And in this instance, we find them particularly attractive because their valuations are very, very attractive. Their performance relative to the broader market over the last 10 years has been very, very weak, and they trade at a significant discount to the overall market. They will benefit from the ability to raise dividends, increase buybacks, and they're going to have a tailwind, going forward, of very favourable credit conditions, which is in stark contrast to where we were just a year ago. And I think that the most telling aspect, in my view, of how well-supported this sector is, is that, generally speaking, it's viewed to be: it does very well when interest rates are rising, and it's generally viewed to be doing well when the yield curve is steepening. And really, over the last three or four months – since March 30th, when interest rates hit their highs – you've had a very substantial rally in interest rates, probably more than a lot of people would've been expecting, and a significant flattening in the curve. And during that time, financials have held up very well. They're still outperforming the broader market so far this year in a very substantial way. So, we believe that as we move into this expansion phase, and as we start to see a slight increase in interest rates or a more sustained, durable increase in interest rates, that financials are a very, very good place to be, and we have a position, opportunistically, to take advantage of that rotation into U.S. financials. Another example of what we've been focusing on, in the opportunistic sleeve, is a more regional question, and that is on the next slide: we really feel that Canadian equities, at this point, are really in a sweet spot. To us, there are a number of factors that are all coming together at the same time, with regard to the Canadian market. First of all, we've been talking over the last six months or so about how attractive we believe the energy space is. We are seeing crude oil prices that are above $70 and certainly, above-$70 Canadian energy stocks will do extraordinarily well. There will be massive cash flow generated by those companies over time. Materials is another significant area of the Canadian market that will benefit from what people are referring to as the "commodity supercycle", but clearly, there's going to be some increase in materials prices, going forward. And we also have a very well-valued financial sector. So, you've got all of our key sectors in Canada that are having attractive valuation characteristics, as well as attractive growth characteristics. And when you think about what's going on in Canada, six months ago, we would've said that we were falling behind the U.S., in terms of vaccination rates. And here we are, in early July, and Canada stands out across the globe as one of the countries that has the highest level of vaccinations. As well, we're starting to see some interest in the Canadian market, we're starting to see foreign flows come back for the first time in quite some time, and that's being manifested, not only in the performance of the TSX, but also with the stronger Canadian dollar that we've seen. So, we believe that, again, this is a very interesting area where it's got the ability, in the Canadian marketplace, to take advantage of some of the reopening that's going to go on, this whole commodity issue, the higher commodity prices, as well as very, very attractive valuations. So, we really think that the Canadian equities is another very interesting place for us to be, in the opportunistic sleeve. So, on the next slide, I love to show this slide because this shows exactly why I believe that an investor and an advisor should have their clients invested in an asset allocation solution, such as the Growth Portfolio. Because really, what it does is it comes into this whole issue of what we're trying to achieve in these portfolios. On the Conservative Portfolios, what we're trying to do is achieve above-fixed-income returns for a similar level of risk than the fixed-income market. And in the Growth Portfolio, we're trying to generate equity-like returns with lower levels of risk. And the way that we get those lower levels of risk is that we have much less downside capture. When the markets turn very, very negative, these portfolios will go down less, and there's no better example of that than March of last year, in 2020. So, when the markets were down 35%, these portfolios were down just about 60% of that. And as a result of that, they also bounced back much faster. And I have zero expectation that when the markets are really running hard, when there's a little bit of exuberance and when we haven't had a correction, that these portfolios, will be able to keep up. And you certainly see that in that whole period of 2019, and you're starting to see it now, and that sort of dovetails well with Philip's comment that, yes, we could see a correction at any time. So, as the overall markets race ahead, we won't keep up. But certainly, when that inevitable bump happens, these portfolios will perform very, very well. So, I would always point out to someone saying, "Tell me why you should invest in an asset allocation solution," this is it. You get very close to equity-like returns, with much lower standard deviation returns – for those who are more statistically-inclined – and with a higher Sharpe ratio. They're better risk-adjusted returns in the overall market, while providing very attractive returns. And on the next slide, you can see, just from a performance standpoint, that that's exactly what these portfolios have. Since inception, which is May of 2017 – so, we're just past our four-year mark – you can see that the Growth Portfolio has generated, in the lower right-hand corner, after fees, a little over 8%. That puts it into very attractive returns, from an investor's perspective, and equally so from the perspective of our pure rankings, relative to our competition. And you can see that with each bucket of level of risk, there's a slight diminution in returns, but when you're looking at it, you're talking about... The Conservative Portfolio has generated around 4 and a half, which is very good from the perspective of generating that stable level of income. The Moderate Portfolios, over 5 and a half, and the Balanced Portfolios, it's 7. So, these have been recognized by Morningstar as being 4- and 5-star funds and, really, a large part of that is that lower downside capture that we exhibit, that higher Sharpe ratio, that lower standard deviation returns. So, just to summarize. I mean, it's been an interesting year so far. I think that the market is heading forward. We could certainly encounter one of those out-of-the-blue type of corrections, but I think we set up very, very well for the coming six-to-18 months. We're into a good part of the economic cycle, and I think that given how markets have run so far, this is an excellent time to be looking at an asset allocation solution, as a possibility for investors. So, with that, I'm happy to pass it back to Philip and field any questions that he might have.

Philip Petursson: Thank you, Jamie. That was a great review, as always. I just have a couple of questions. One, we did touch on it, in terms of the fixed-income environment. I mentioned it, you mentioned it as well, but let's just go over that again because this is probably the one area where I am receiving the most number of questions, just because of the environment that we're in right now – which is a very low interest rate environment – and where we're likely headed, with the continuation of the economic recovery this year and into next year. So, how do you... If you could just summarize again your view of the fixed-income environment and what you're doing in the portfolios, to manage to that environment?

James Robertson: Well, certainly, the fixed-income market has been the market that's surprised most market participants, in terms of how big the move was, early in the year. You think back to the beginning of the year and, basically, interest rates almost doubled, in the course of that first quarter. We had 10 Year notes that basically went from the beginning of the year at 90 Basis points, up to almost 180 Basis points. That move was so much more dynamic, so much more extreme. I think that took a lot of people by surprise and we were positioned for that, in terms of being a little bit short-duration, but I think that move was quite surprising. Of course, at that point, everyone was concerned about inflation, everybody was concerned about an economy that was going to generate 8 or 9% real GDP growth in the U.S., this year. And lo and behold, what happened is that the market, the fixed-income market, will turn around and surprise you at any given time, and we've seen really a pretty substantial rally in interest rates. Interest rates have moved remarkably lower into this environment, and I think that it just so happens to coincide with some of the biggest CPI prints that we've seen in many, many years. So, that's certainly a bit of a head-scratcher for a lot of participants. But I think the key factor, here, is that as we head into this expansion phase, there will just naturally be pressure on interest rates to move up. And I believe that they'll continue to move up, but I think they're going to do so in a more gradual fashion. At the same time, with the strong economy, that does create a very benign environment for credit. Credit spreads are very, very narrow, but certainly, I don't see any reason why we can't maintain those levels of credit spreads. I just don't see that those spreads are going to come in in a very, very material way. So, how have we positioned ourselves with the portfolio? Well, certainly, we rely on our active managers – Roshan Thiru with Canadian bonds and Dan Janis with Strategic Income – who have the ability to overweight credit, which they've certainly been doing, and to navigate around the whole duration question. In terms of the up sleeve, you know, we did have core bonds, we had some longer-duration bonds earlier on in the year, which was a slight drag on performance. But as the interest rates continue to move lower, we've taken advantage of that to diminish that longer-duration position and move into shorter credit and more equities. So, to us, I think we're very well positioned for what I would perceive to be a bit of a volatile fixed-income market, because that's clearly what we're seeing now. There's a lot of supply coming into the market, both on the sovereign side, the investment-grade side, and the high-yield side. So, the market will have to digest that. But I would certainly expect to see that interest rates will continue to migrate higher. And given the fact that when we went from 90 Basis points to 180 Basis points earlier in the year, and the equity market was able to sustain that, leaves me to believe that for the foreseeable future, interest rates will not be a major deterrent to the overall equity market nor to the overall economy. So, I would agree with you. I expect to see... Certainly, in our five-year forecast, we expect to see a gradual increase in rates, and I just don't see it as being a major, major risk to our achieving our clients' objectives with these portfolios.

Philip Petursson: And then, lastly, Jamie, just your thoughts on the outlook through the remainder of this year and perhaps to the end of 2022. What are your thoughts, though, in terms of the outlook over the course of the next, say, 6 to 18 months?

James Robertson: I think that over the next 6 to 18 months, I think the market will continue to do what it has been doing for quite a while, which is to surprise us to the upside. I would never sit there and say that we can't necessarily anticipate time or predict a correction coming in. The overall economic backdrop is very, very positive for interest rates, for equity markets in general. I don't see a major risk that we're going to have... You know, the Fed is not going to turn around and take away the proverbial punch bowl, at this particular point. We are at all-time highs. And yes, there have been some significant flows into equities, but I don't see any of the frothiness, outside of particular names or outside of very "fringey" or "meme" asset classes, that would indicate that there is any real overexuberance, shall we say, in the equity market at this particular point. So, I do think that we are going to continue to see steady returns on the equity side. And if anything, I think that the risk would be that the markets would be much stronger than people would expect. I just look at the way that the market seems to have these very, very shallow retracements. They seem to be met with a wall of buying, and I would suspect that that is the scenario that we're into. The market will get comfortable with the whole idea that we're in expansion, the market will get comfortable with the fact that the Fed is going to be reasonably benign, and I think that on balance, we're going to continue to see attractive equity returns from that part of the capital markets.

Philip Petursson: Jamie, I think that's a great summary and it sets up very well for what we should expect over the course of the next 18 months. We're still early in this recovery, we've got a ways to go, and I think that's going to be reflected. The positives, as we continue to see momentum improve and economies open up, will be priced-in to the equity markets. And as you highlighted in the prior question, you're aware of and managing the fixed-income markets, given the environment that we're in and where we're headed, to the benefit of our unit holders. So, I think that's a great place to stop, here. On behalf of Jamie Robertson – again, Senior Portfolio Manager and Head of Canadian Asset Allocation – this is Philip Petursson. Thank you for joining us, for our third-quarter Market Outlook and Asset Allocation Update.

James Robertson: Thank you so much!

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