

Q4 | 2019 **Global Macro Outlook**

Key themes on the economy and capital markets from our asset allocation macro strategy team



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Key macro themes for Q4 2019



Global central banks move further down the path of coordinated easing, with very few exceptions. Attempts to “normalize” interest rates are thwarted and a greater share of global bond slips deeper into negative-yield territory. We view this as the beginning of more aggressive easing as central banks fight weak inflation levels and deteriorating global growth.



Trade tensions have escalated and global manufacturing is struggling amid heightened uncertainty. We don’t expect this risk to dissipate in Q4 and are particularly concerned about the strength of the U.S. dollar (USD)—a function of its safe-haven status—and its impact on global financial conditions.



Asia remains caught in the crosscurrents of trade tensions and an increasingly active stimulus program from China. However, we believe Chinese stimulus won’t be as effective at propping up growth within the region this time around. In the current environment, we expect that those Asian economies with friendly foreign investment policies will fare better than others, which can lead to opportunities.



A tale of two economies—that’s the narrative playing out in the United States as manufacturing activity slows while consumer spending stays strong. Although manufacturing may only represent a small segment of the U.S. economy, it’s a primary driver of earnings growth. Divergence between the two suggests that the economy and the markets could tell two very different stories in the coming months.



Europe remains plagued by global trade tensions, which have pushed key segments of the continent’s economy into recession territory. While a great deal of bad news has already been priced into the European story, we continue to wait for an inflection point ... that just never seems to arrive.



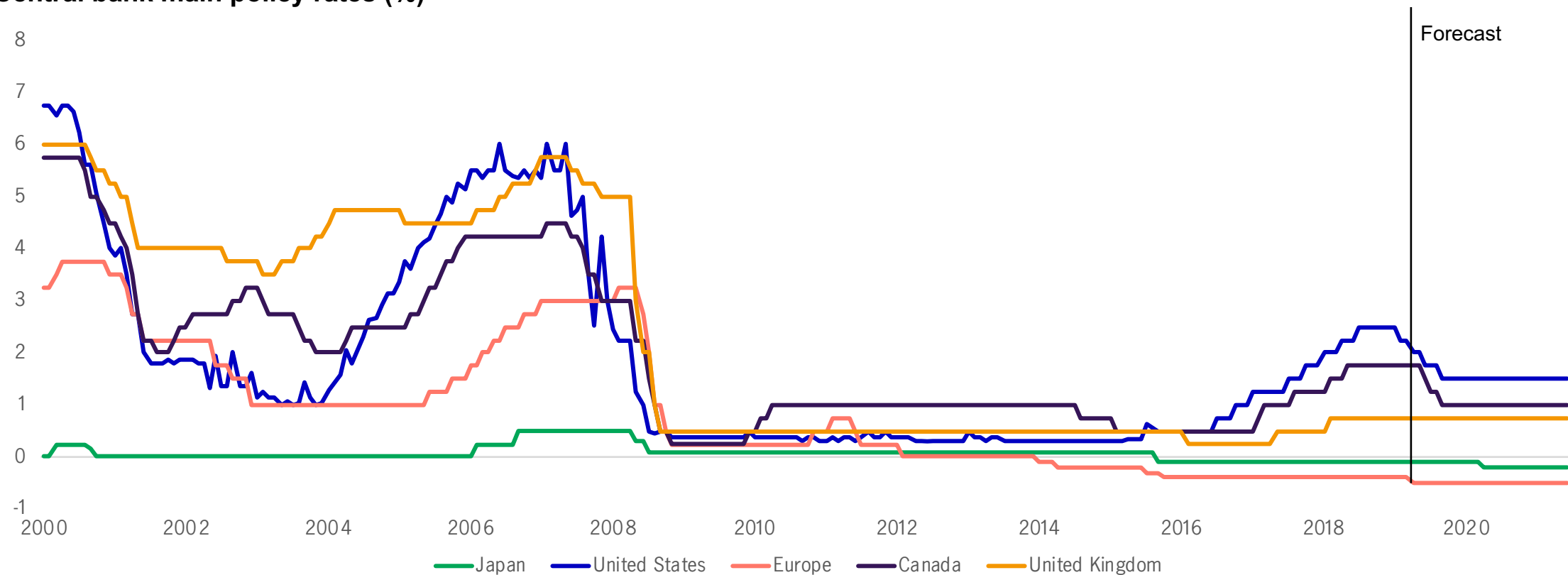
In our view, the Bank of Canada is the G10’s most hawkish central bank as it hit the brakes on introducing interest-rate cuts. The bank’s action contrasts sharply with almost every major central bank in the world. However, we believe rate cuts remain on the cards as U.S. weakness bleeds into the Canadian economic landscape, potentially hurting the Canadian consumer.

**Global central banks are
firmly in an easing cycle**

Global central banks are in full easing mode

The global easing cycle is now in full swing: The U.S. Federal Reserve (Fed) has cut interest rates by 50 basis points (bps) so far in 2019 and we expect the bank to cut rates by another 50bps in the coming six months, with the possibility of further stimulus. The third quarter also saw rate cuts from the European Central Bank (ECB) and its peers in most emerging and developed markets. Once again, monetary policy is used to offset the pain caused by a global manufacturing recession, downside risks to growth emanating from late-cycle dynamics, and ongoing shocks arising from trade tensions. We expect most global central banks to keep interest rates low and avoid rate hikes for at least two years as they seek to push inflation back to, and even above, their respective targets.

Central bank main policy rates (%)

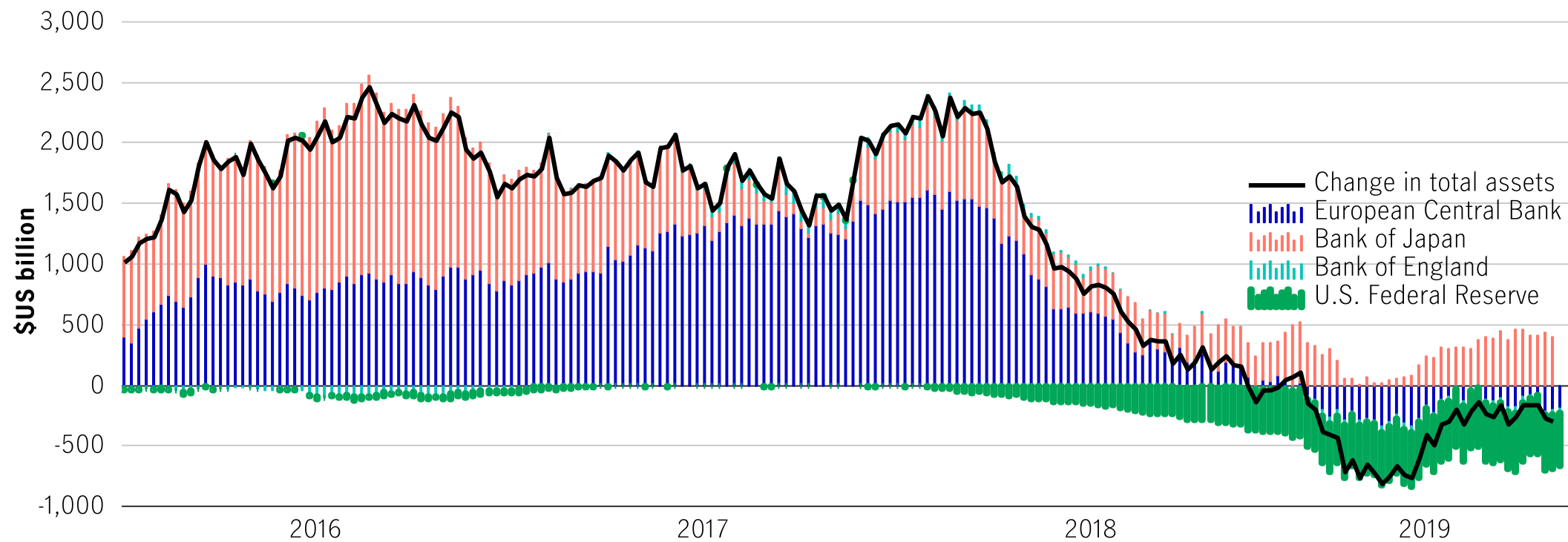


Global central bank balance sheets are on the cusp of expanding again

We think it's important to monitor global central bank balance sheets throughout the fourth quarter, which we believe will become expansionary again after a brief attempt at normalization in late 2018/early 2019. In September, the ECB announced its fourth round of quantitative easing, and we expect the Fed to begin a natural expansion of its balance sheet again in the near future in response to short-term funding issues in the repo market.

Similarly to rate cuts, the re-expansion of global central bank balance sheets will provide additional liquidity to the global financial system. However, its impact on real growth is likely to be increasingly limited as the theory of marginal utility kicks in.

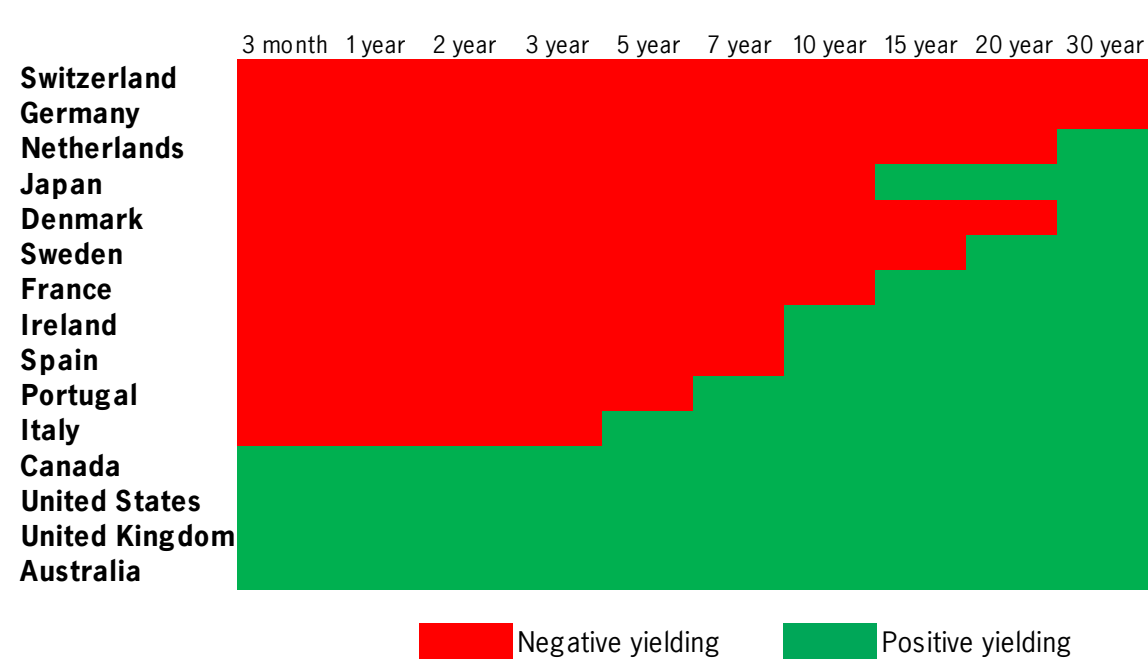
Global central bank balance sheets



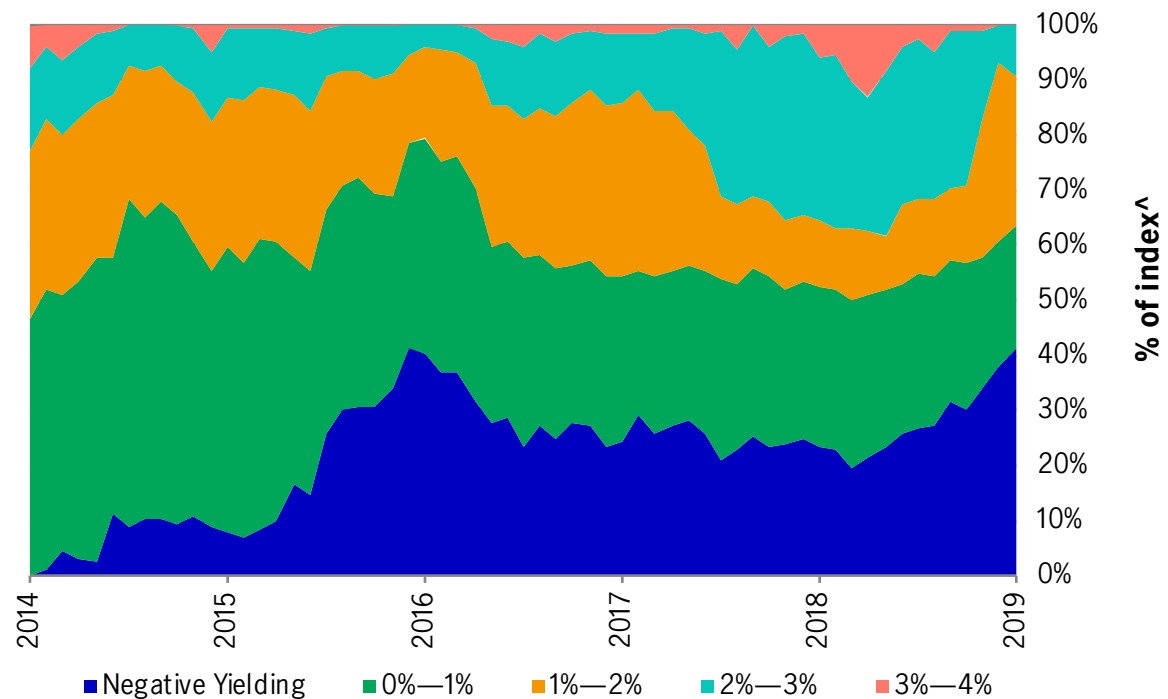
Global interest rates are now increasingly negative

Further cuts to benchmark interest rates and market anticipation of additional cuts have pushed an even greater share of global bond yields into negative territory, which is likely to create a variety of long-term distortions. In the immediate term, however, increasingly low and negative rates imply the search for yield will continue to be a dominant theme for fixed-income investors. Specifically, we believe this will continue to translate into demand for U.S. assets, keeping the USD elevated. Note that we continue to favor emerging-market debt in this environment as a key source of positive-yielding assets.¹

Global sovereign yields—select countries²



Global government bond yields³



¹ These are the views of the asset allocation team, as of September 15, 2019. Individual portfolio management teams may have different views. Opinions are also subject to change without notice. ² Refinitiv Datastream, Manulife Investment Management, as of September 19, 2019. ³ Global government bond yields, as of August 15, 2019. ⁴ ICE BofA ML Global Government Index.

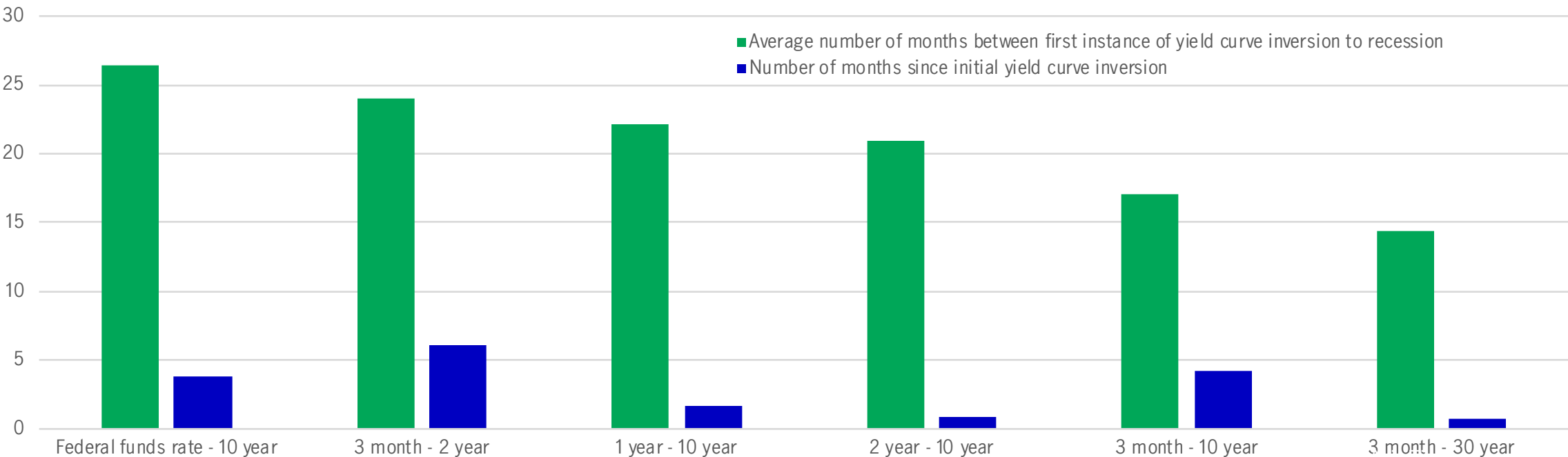
The U.S. yield curve is firmly inverted

Every major segment of the U.S. yield curve has inverted by the end of the third quarter. Though some segments steepened slightly at the beginning of September, we remain concerned that the extreme flatness of the yield curve could be problematic for credit channels. The correlation between yield curve inversions and impending recessions could prompt businesses and households to reduce spending, thereby leading to a “self-fulfilling prophecy.”

While we take these concerns seriously, we would note that (i) the current yield curve is likely to be a less effective signal than it’s been in the past because the term premium has been distorted by central bank balance sheet activity, and (ii) traditionally, there are long lags between the moment at which a yield curve inverts and when a recession occurs—the lead time could be as long as two years. Ultimately, the flat yield curve tells us what we already know to be true: We are in a late cycle, which typically means limited growth ahead and minimal inflation on the horizon. Regardless of whether we’re headed toward a technical recession, this points to a difficult macroeconomic environment.

Lead time between yield curve inversion and recession (months)

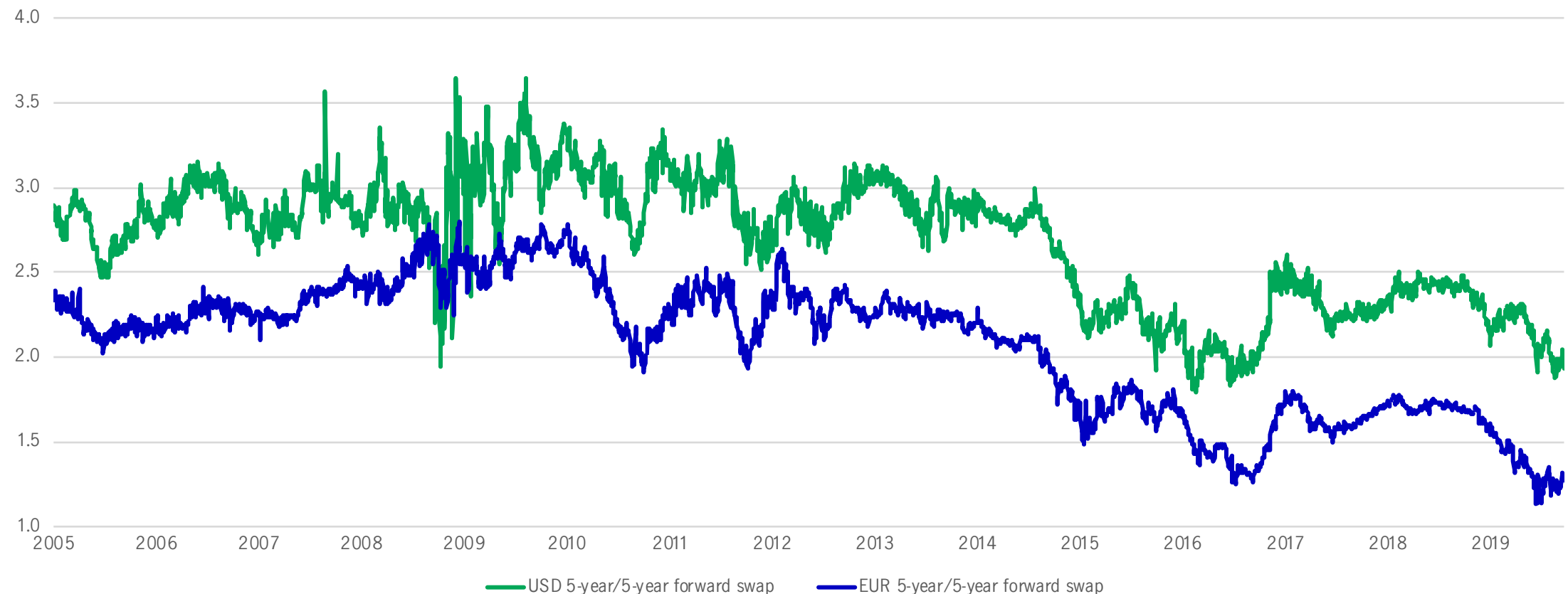
January 1970 to August 2019



Inflation expectations have de-anchored

While trade tensions and weak global growth activity have given global central banks a good reason to lower rates, we're of the view that weak inflation expectations are worrying many central bankers. Inflation expectations in the United States and Europe appear to have become de-anchored from 2% as central banks persistently miss their inflation targets. Critically, central bankers' inability to raise inflation expectations despite interest-rate cuts suggest monetary policy is moving too slowly and/or isn't perceived as being effective at raising inflation over time. Either way, if central bankers want to see a steeper yield curve, they'll have to convince the market that rate cuts and quantitative easing can revive inflation.

Market-based measures of inflation (%)

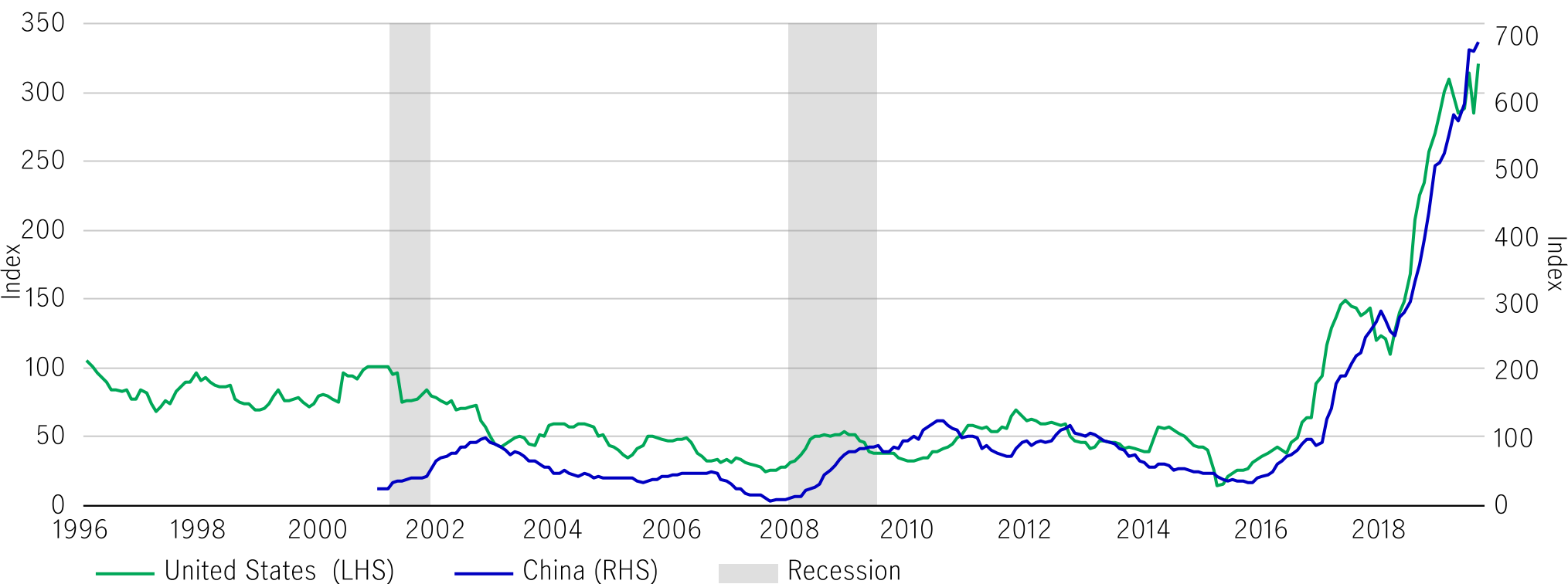


**Trade tensions continue
to shock the global
economy**

The global economy is now facing more tariffs and more uncertainty

In our Q3 chart pack, we wrote that we expected trade tensions to de-escalate in the second half of 2019. Instead, tensions heightened in August as the Trump administration announced plans to impose additional tariffs on the remaining nontariffed goods imported from China, which included an important category that had until then been mostly shielded from the trade war—consumer products. China responded with retaliatory tariffs. While the timelines for actual tariff implementation remain in flux, and trade tensions repeatedly escalate and then ease, the key issue of *uncertainty* surrounding future trade relationships between the United States and its key trading partners—China, Europe, and Japan—remains. Indeed, economic uncertainty indexes tracking trade policy uncertainty are at a multidecade peak.

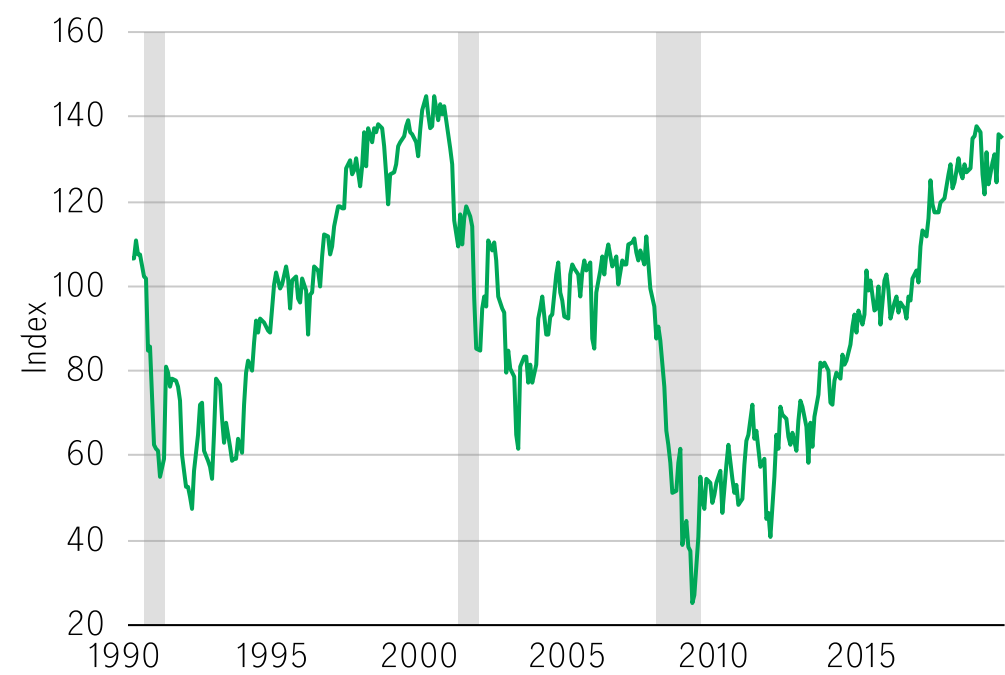
Economic Trade Policy Uncertainty Index—12-month moving average



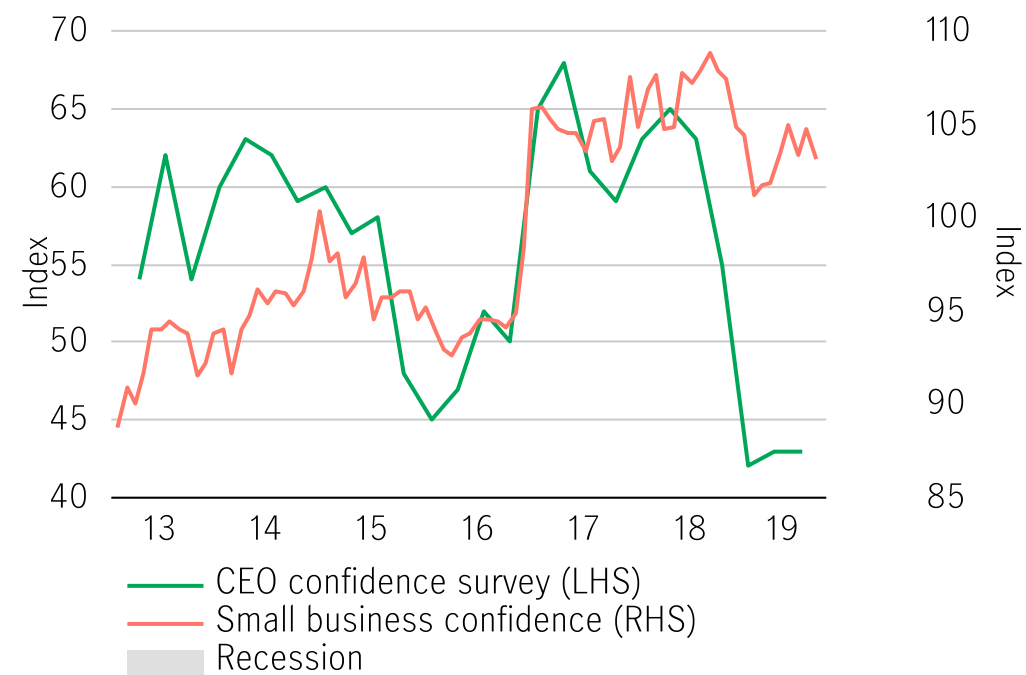
Trade policy uncertainty is hampering business confidence

Our ongoing and biggest concern related to trade uncertainty is the impact it has on business and consumer confidence. Crucially, the secondary effects of these shocks are difficult to measure. Consumer goods have so far been (mostly) shielded from tariffs which, in our view, have helped to insulate households even as small businesses and CEOs become increasingly bearish. When the latest round of tariffs is implemented in the fourth quarter, we expect consumer confidence to struggle to recover/reaccelerate. Conversely, should a trade deal be reached in Q4 (not our base case), the potential surge in business confidence in the United States could represent an important upside risk.

U.S. consumer confidence (Conference Board measure)¹



U.S. CEO and NFIB Small Business Confidence²

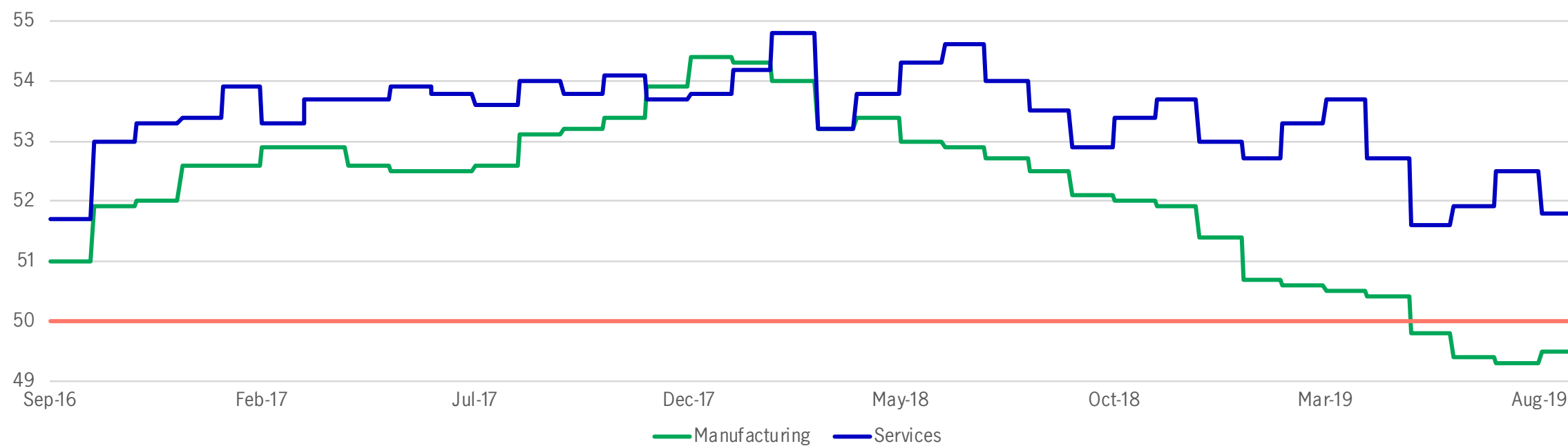


¹ Refinitiv Datastream, Manulife Investment Management, as of September 15, 2019. ² Refinitiv Datastream, The Conference Board, Manulife Investment Management, as of September 15, 2019. LHS refers to left-hand side, and RHS refers to right-hand side.

Trade tensions are hurting manufacturing ... even if services remain protected

Extremely elevated trade tensions and the prospect of pending tariffs have created an important divergence between the manufacturing segments of the global economy and the services sector. The Global Purchasing Managers' Index, which measures the health of the manufacturing sector, has now slipped below 50.0, signifying contraction. Interestingly, services have remained relatively immune to the downturn. The divergence between the two has also created a divide between manufacturing-based economies such as Germany—which may very well enter a recession in 2019/2020—and the United States, a services-based economy that continues to produce trend growth. The critical risk for the 2020 outlook is whether the current global manufacturing recession bleeds into the global services sector, pulling it into contraction territory as well. We don't view this as our base case, but we're monitoring it closely.

Global Manufacturing and Services Purchasing Managers' Index

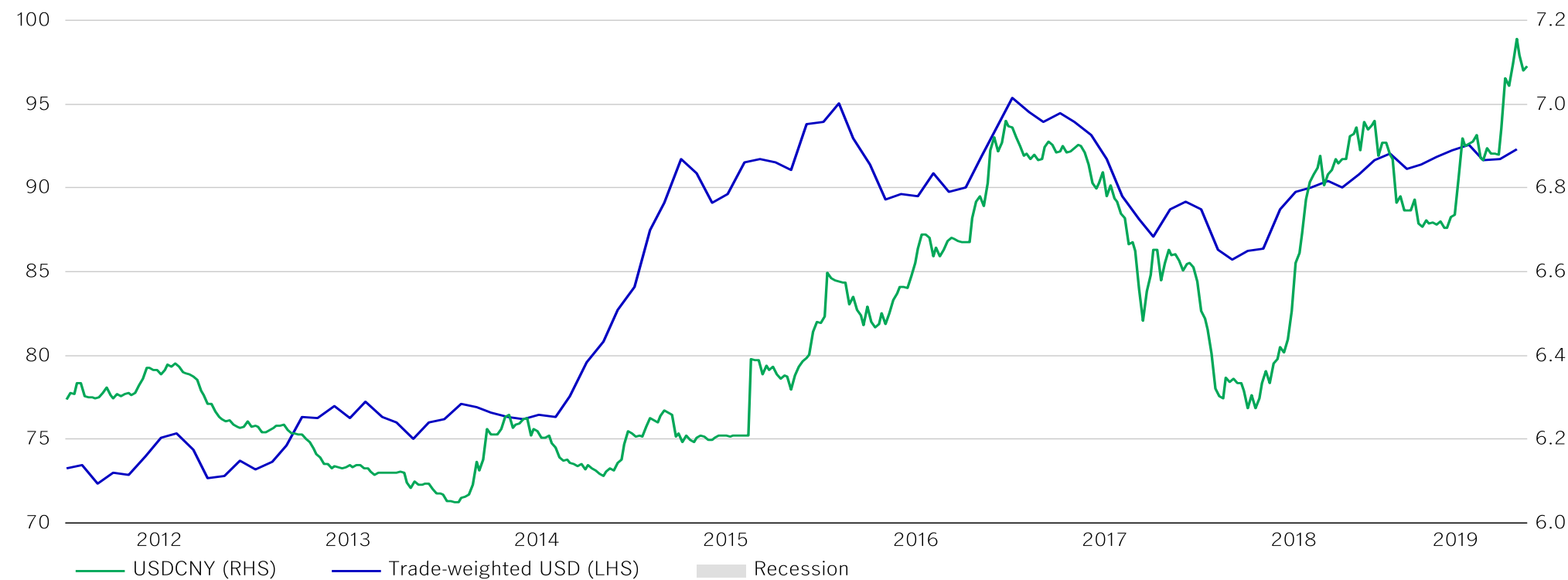


The strengthening U.S. dollar is a global risk worth monitoring

The Chinese yuan (CNY) depreciated past the “psychologically important” 7.0 level in August. We expect the CNY to continue to weaken as the Chinese economy weakens, with policymakers seeking to offset the sting of additional tariffs. It’s also worth noting that general uncertainty and the search for yield have led to continued strength in the U.S. dollar.

While a strong USD is typically deflationary for the United States and hurts U.S. manufacturing profits, it’s also increasingly important to global financial conditions. A strong USD acts as a form of tightening for the global financial system. After all, half of global trade invoices and two-thirds of emerging-market debt is denominated in the greenback. In addition, two-thirds of official foreign currency reserves are held in USD, and two-thirds of global securities are issued in the currency.¹ From our perspective, continued strength in USD is an important risk heading into 2020.

USDCNY vs. broad-trade weighted USD²

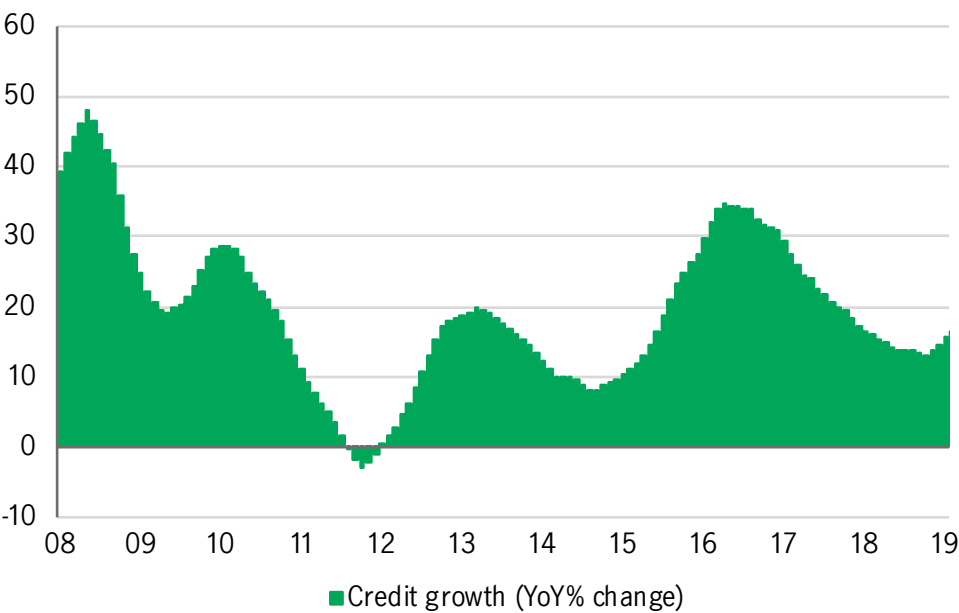


Asia: between trade tensions and Chinese easing

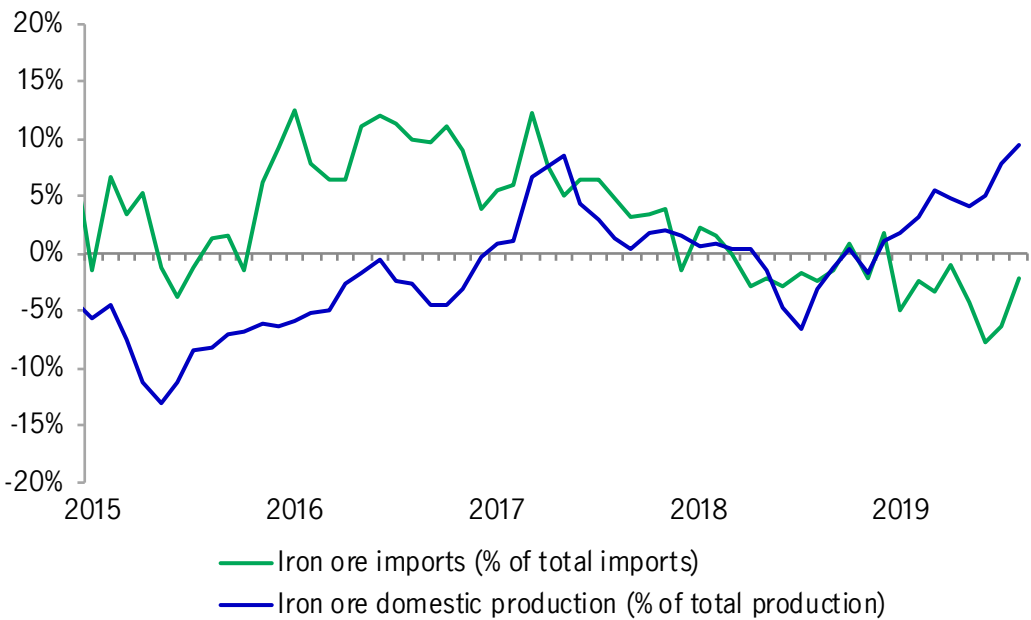
Chinese stimulus: less impactful than previous rounds

China’s current easing cycle began in early 2018. Despite what appears to be a litany of easing measures, the actual credit impulse is small; credit growth remains much lower than previous easing cycles and reduced credit efficiency suggests Beijing needs to do *even more* this time round to reboot domestic demand. Aside from weak local demand, Chinese import growth has also slowed due to a large real *effective depreciation* of the exchange rate. But the most powerful driver of China’s slower import growth is “onshoring” (when China substitutes foreign imports with its own goods) as a part of the country’s long-term strategy to achieve supply chain self sufficiency. This suggests that the positive impact any forthcoming Chinese stimulus will, in all likelihood, remain in China.

Credit growth, % of GDP¹



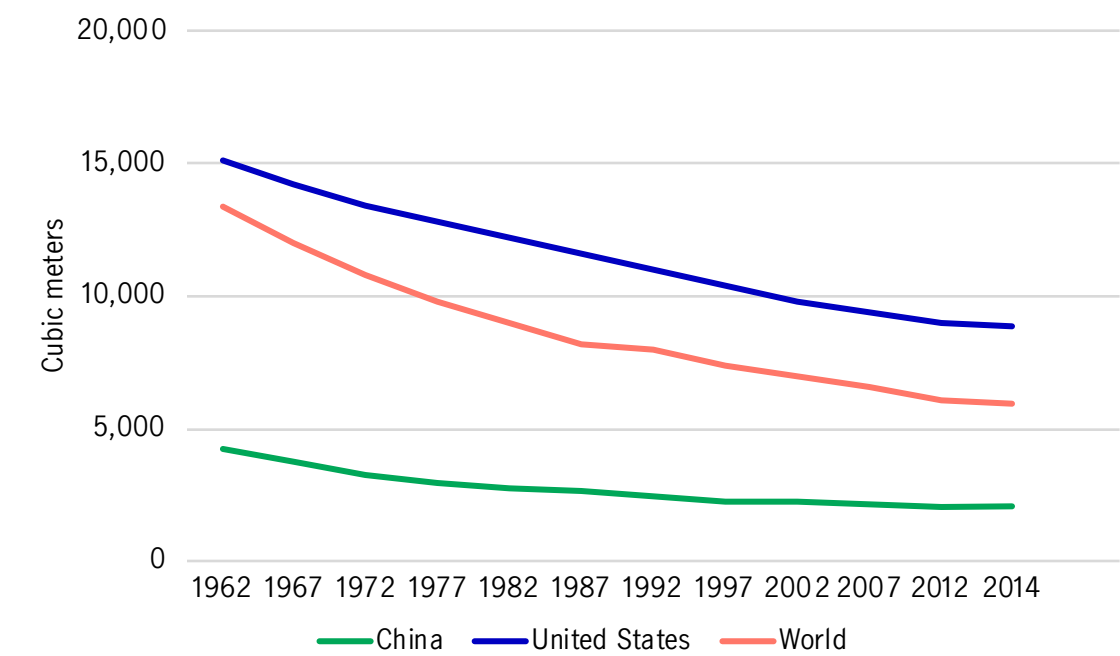
China is onshoring its supply chain²



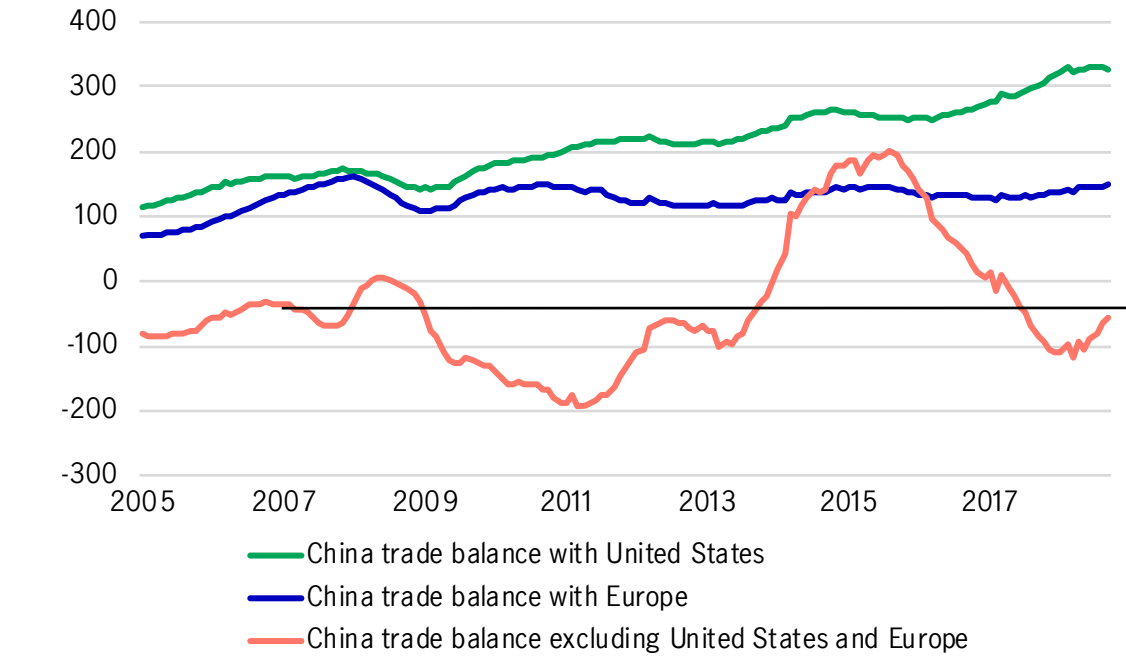
China stands to lose the most in a trade war

When it comes to trade wars, the economy with a trade surplus typically has more to lose than one with a trade deficit. In a sense, the current dispute has come at a particularly inopportune time for China: It has yet to achieve high-tech dominance or food security—China’s available water supply per person is around one-third of the world’s per capita average¹—and its economy is in the throes of a severe structural slowdown as a result of extravagant debt, misallocated capital, and a deteriorating demographic structure. Compounding matters, the country is facing a growing USD shortage, which potentially explains the increased levels of capital controls, forced liquidation of foreign assets and a recent decision to lift quotas on foreign portfolio holdings. The ongoing trade war can exacerbate the situation if China can’t earn USD from its exports.

Renewable internal freshwater resources per capita¹



China’s trade balance, 12-month rolling sum (US\$, billions)²



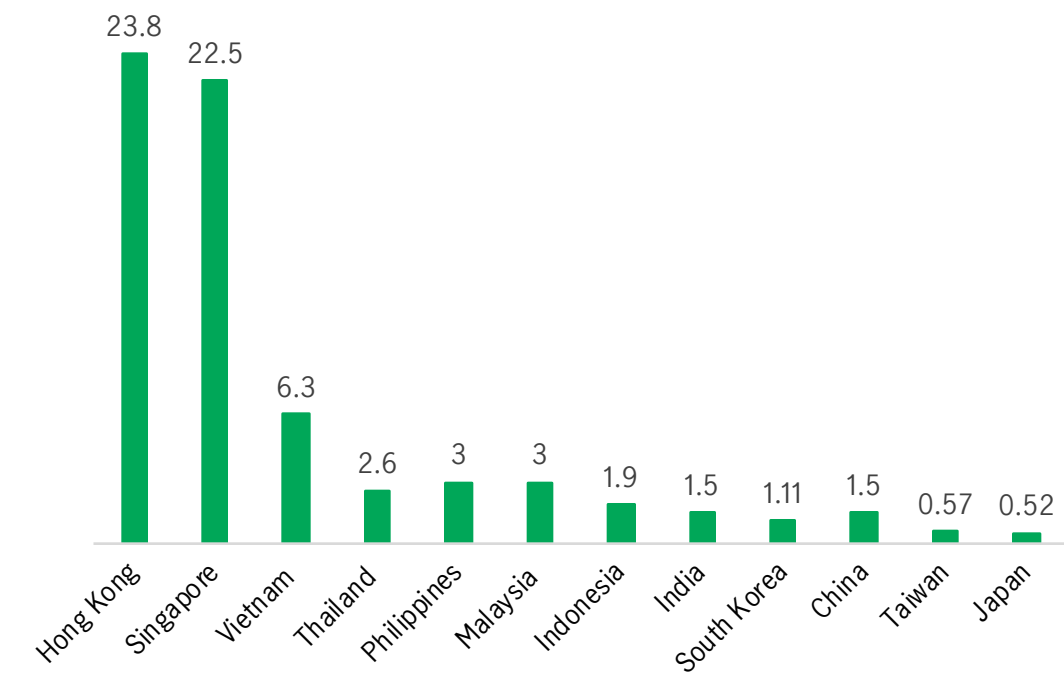
Asia: winners and losers from the trade war

While there can be no winners in a trade war, we believe some Asian economies will do *relatively* better than others through two channels:

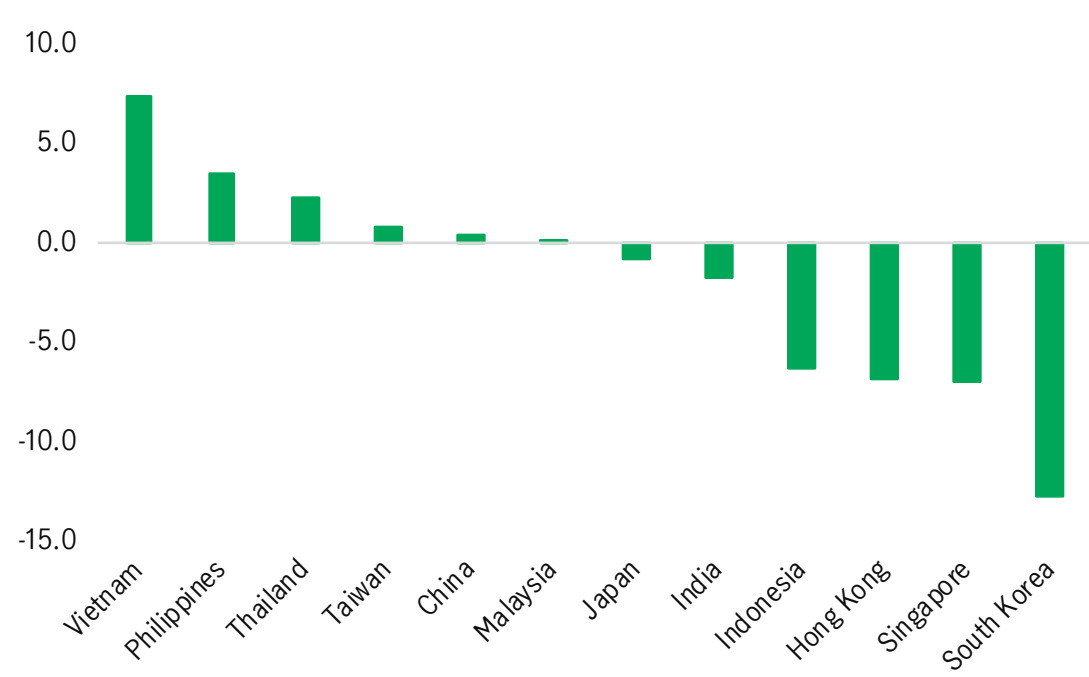
- 1 Production relocation:** Economies manufacturing goods that are most similar to Chinese exports and those with friendly foreign direct investment (FDI) policies should become attractive locations for companies looking to relocate production out of China.
- 2 Import substitution:** Economies with the capacity to replace U.S. and Chinese imports through geographic proximity/comparative advantage will likely be poised to benefit from the dispute.

In our view, Vietnam, Philippines, and Thailand stand out as the main beneficiaries from inward FDI and trade diversion thanks to production competitiveness. South Korea, on the other hand, could be among the hardest hit as its economy is deeply entwined with China and the United States. Its somewhat restrictive regulatory framework is also likely to deter FDI.

Inward FDI as a % of GDP in Asia¹



Export growth (YoY % change, 3-month moving average)²

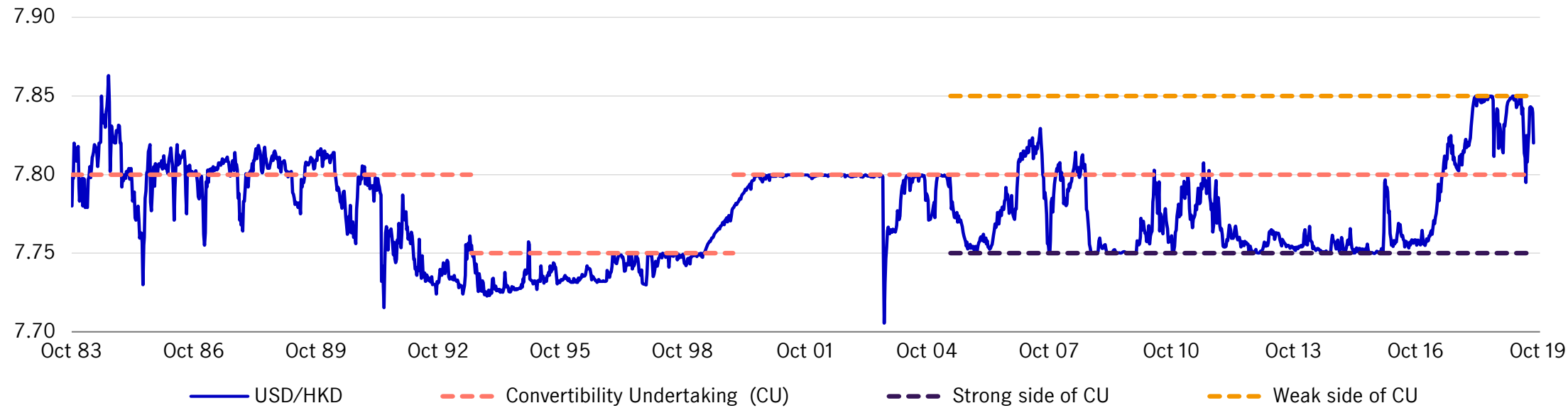


¹ World Bank and Bloomberg, Manulife Investment Management, as of December 2018. ² Bloomberg, Manulife Investment Management, as of September 10, 2019. YoY refers to year on year.

Hong Kong dollar: is the peg sustainable?

Few will argue that the concept of “one country, two systems” has always underpinned Hong Kong’s economic success and financial stability. However, that very concept appears to be under threat, and so too the Hong Kong dollar peg. In the immediate term, there’s a risk that Hong Kong could fall into a technical recession. Ratings agencies Moody’s and Fitch revised their ratings/outlook for Hong Kong downward in September, citing China’s growing influence. Meanwhile, the U.S. Congress is advancing the “Hong Kong Human Rights and Democracy” bill while evaluating whether to revoke Hong Kong’s special economic status and place sanctions on those who undermine its autonomy. If realized, this could have significant implications for the Hong Kong’s financial stability—not to mention the rest of emerging Asia—that could lead to a change in its linked exchange rate system which essentially ties the Hong Kong dollar’s (HKD’s) value to the USD. Defending the HKD peg comes at a cost: Whenever the Hong Kong Monetary Authority (HKMA) intervenes to defend HKD at the weak end of the currency’s trading band, it has the net impact of pushing interest rates higher, thereby negatively affecting the economy and local asset prices.

USD/HKD and history of adjustments



Source: Bloomberg, Manulife Investment Management, as of September 10, 2019. Convertibility undertaking refers to an undertaking by a central bank, in this case, HKMA, to convert domestic currency into foreign currency and vice versa at a fixed exchange rate. A trading band around either side of convertibility undertaking was introduced in May 2005. According to [HKMA](#), under the strong-side convertibility undertaking, it undertakes to buy USD from licensed banks at a rate of 7.75 HKD/USD. Under the weak-side convertibility undertaking, the HKMA undertakes to sell USD at a rate of 7.85 HKD/USD.

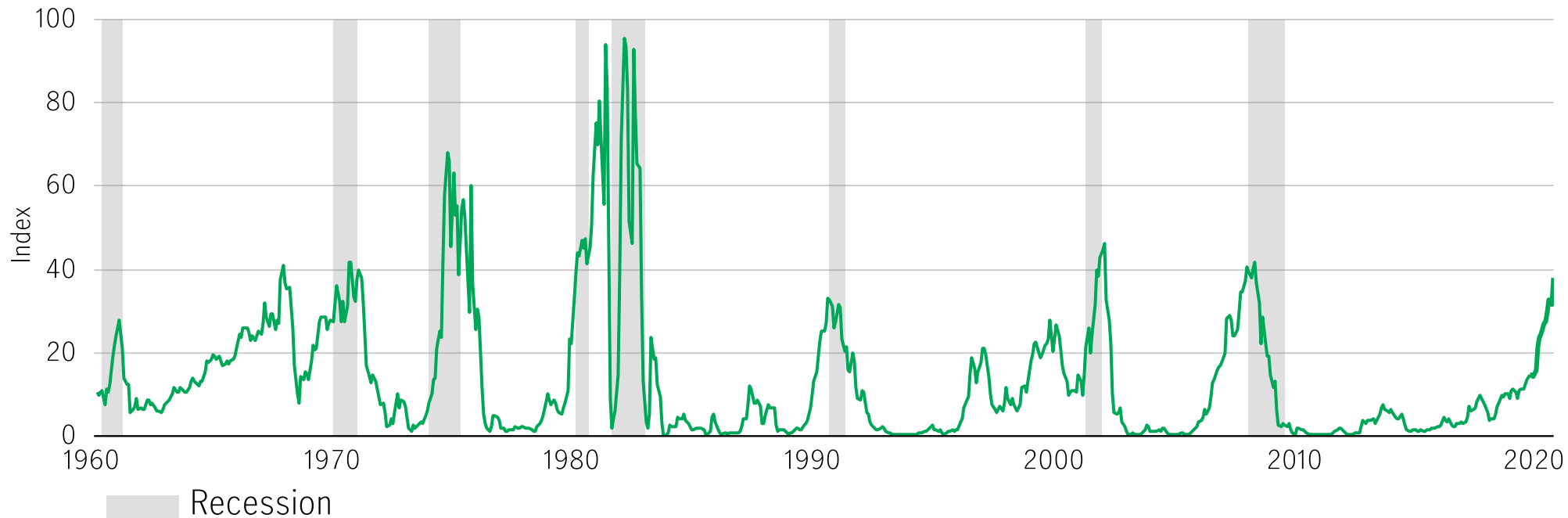
United States: a tale of two economies

The probability of a recession is rising

The odds of a U.S. recession for the next 12 months continue to rise. Recession probability indicators that derive value from the U.S. yield curve (e.g., the Federal Reserve Bank of New York's measurement) place those odds at nearly 40%—their highest level since 2008. However, we don't have a formal recession call in our forecast. Instead, we believe U.S. growth will slow to around 1% in the first half of 2020: weak but not recessionary. We view this slowdown as a function of three factors: (i) headwinds created by trade tensions and tariffs, (ii) the lagged effects of previously higher interest rates, and (iii) the reduced amount of federal fiscal spending in the pipeline.

That said, we stress that a crucial distinction should be made between the macro picture and market movements, and we suspect that while we might enter a period of middling growth (one that's neither spectacular nor deeply troubling), the markets could face greater volatility in the months ahead.

Probability of a recession within 12 months (Federal Reserve Bank of New York measurement)

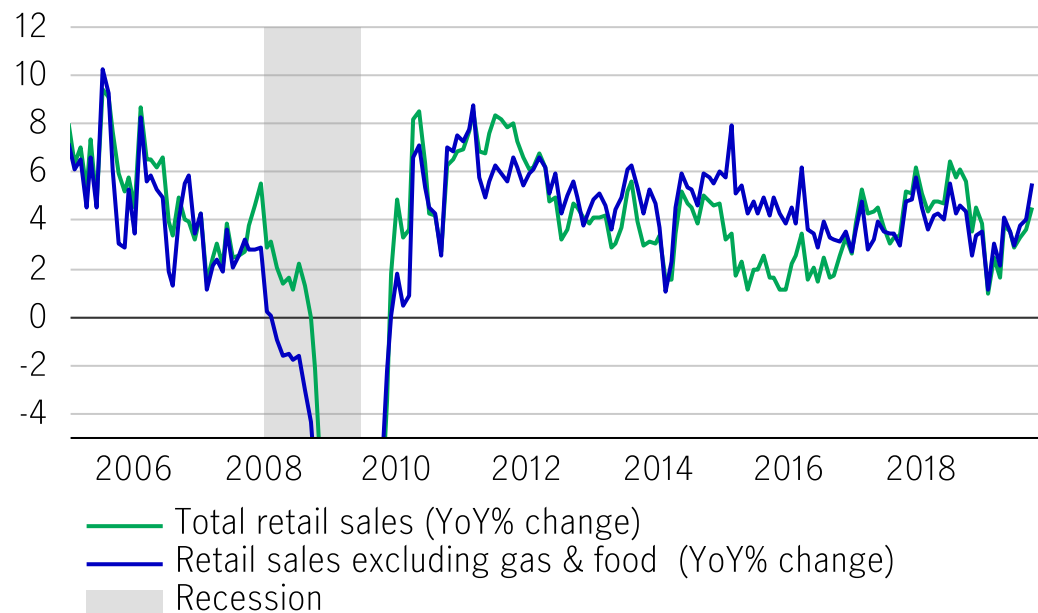


The bright spot in the global economy: the U.S. consumer

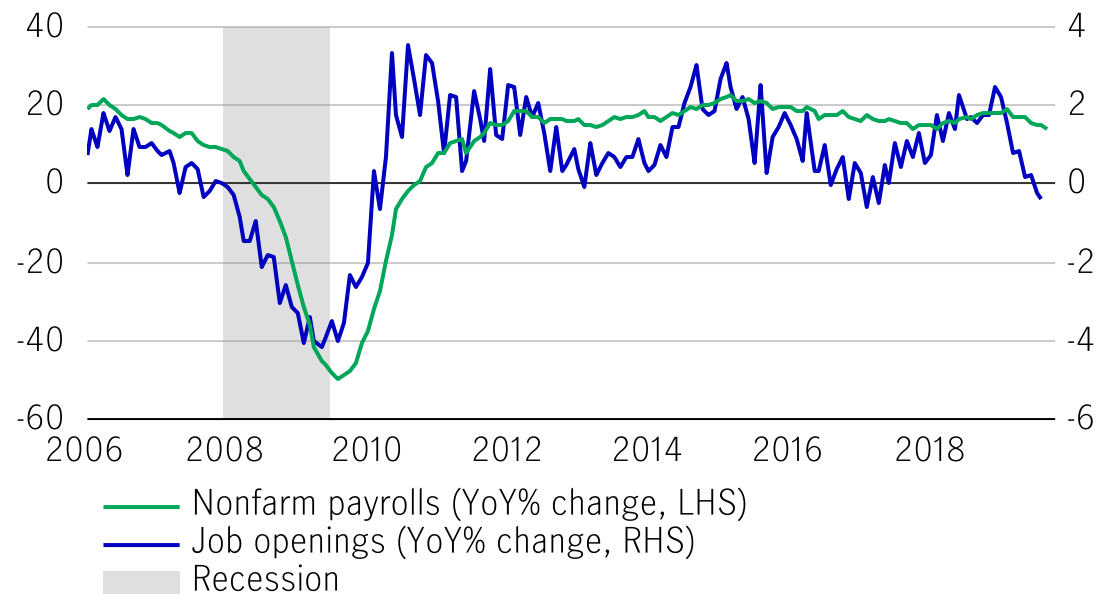
The U.S. consumer remains the stalwart of not only the U.S. economy but also the global macro landscape. Despite heightened trade tensions and elevated probabilities of a recession, U.S. consumer spending accelerated in Q3. The fundamentals supporting the U.S. consumer appear solid: the U.S. household's balance sheet is relatively healthy, savings levels remain robust, wage growth is moderately strong at around 3.3%, and unemployment remains near all-time lows.¹ More recently, declining interest rates have also provided a sizable lift to U.S. housing and we expect the positive impact to flow through to Q4 spending activity as well.

However, the pace of job gains began to slow through the third quarter. This could be because the United States is running out of workers to hire as the economy is likely already at full employment. Yet, our concern remains: Posted job openings have been declining sharply and are now falling on a year-over-year basis. This may be a temporary blip, but further weakness in hiring could threaten the “strong U.S. consumer” narrative.

U.S. retail sales activity¹



U.S. nonfarm payrolls vs. job openings²

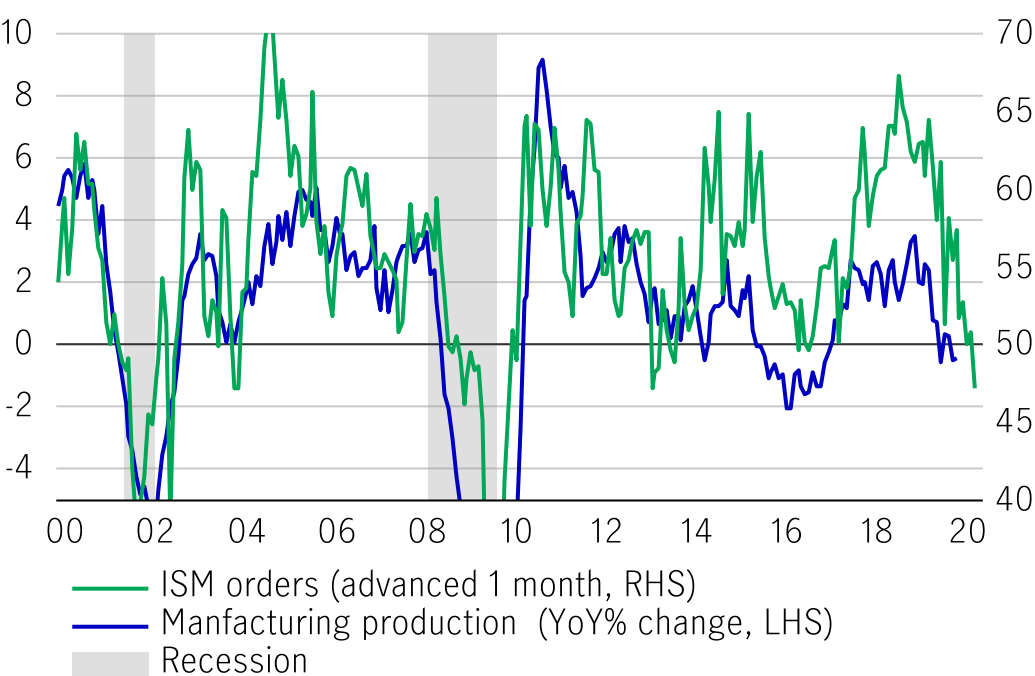


The bad news: storm clouds gather above the manufacturing sector

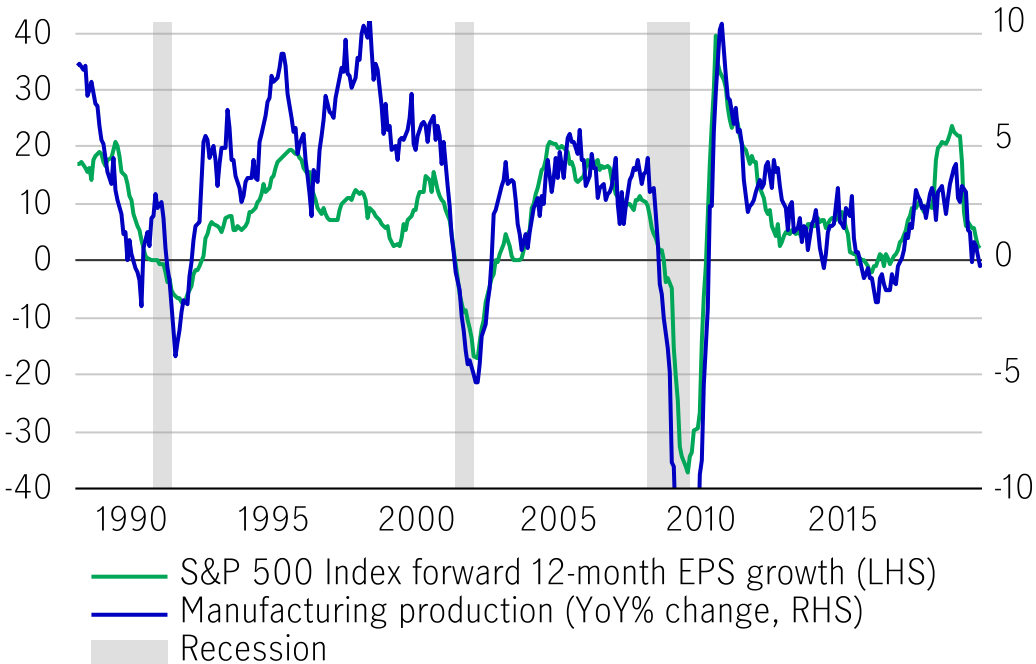
Not all sectors of the economy are expected to weather the current trade-related uncertainty nearly as well as the consumer. Unsurprisingly, prolonged uncertainty is having a material effect on the decision-making function of U.S. businesses—specifically those relating to hiring and capital investments. Manufacturing activity is now contracting and leading indicators suggest it'll continue to decelerate into year end.

Note that while industrial production represents only about 10% of the broader U.S. economy (far less than the U.S. consumer, who's responsible for roughly two-thirds of the economy), the manufacturing sector has a disproportionately large effect on earnings, specifically, the S&P 500 Index companies. Our concern is that while the underlying economy might “muddle through” the next few quarters, investors could feel decidedly less comfortable than the broad macro data would suggest.

U.S. manufacturing production and ISM orders¹



S&P 500 Index EPS has a 4:1 ratio with manufacturing²



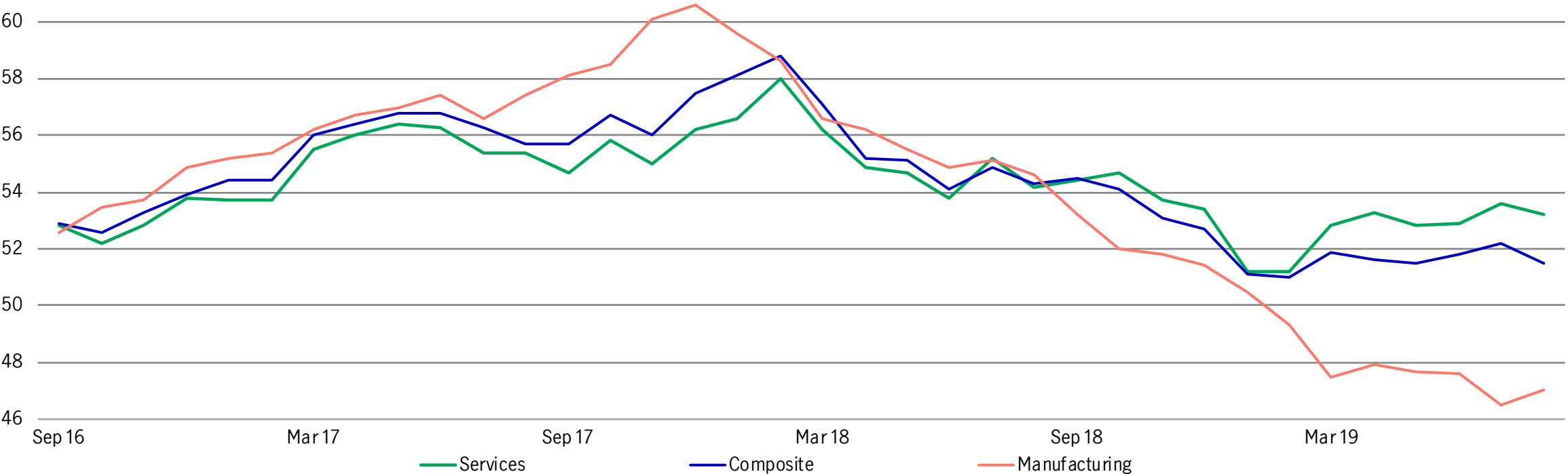
¹ Refinitiv Datastream, Manulife Investment Management, as of September 15, 2019. ² Refinitiv Datastream, Manulife Investment Management, as of September 6, 2019. EPS refers to earnings per share. LHS refers to left-hand side; RHS refers to right-hand side. YoY refers to year on year.

No light at the end of the tunnel for Europe (yet)

European manufacturing data remains weak

For the last several months, investors have tried unsuccessfully to time an inflection point in Europe which, so far, has yet to materialize. In many ways, Europe can serve as a microcosm for the global economy’s woes: Manufacturing activity continues to contract and yet the services sector remains healthy. In this case, the relatively benign—if not robust—state of the European services sector can be attributed to an improving employment market, higher wages, low inflation, and firmly anchored interest rates, which continues to support consumer spending.

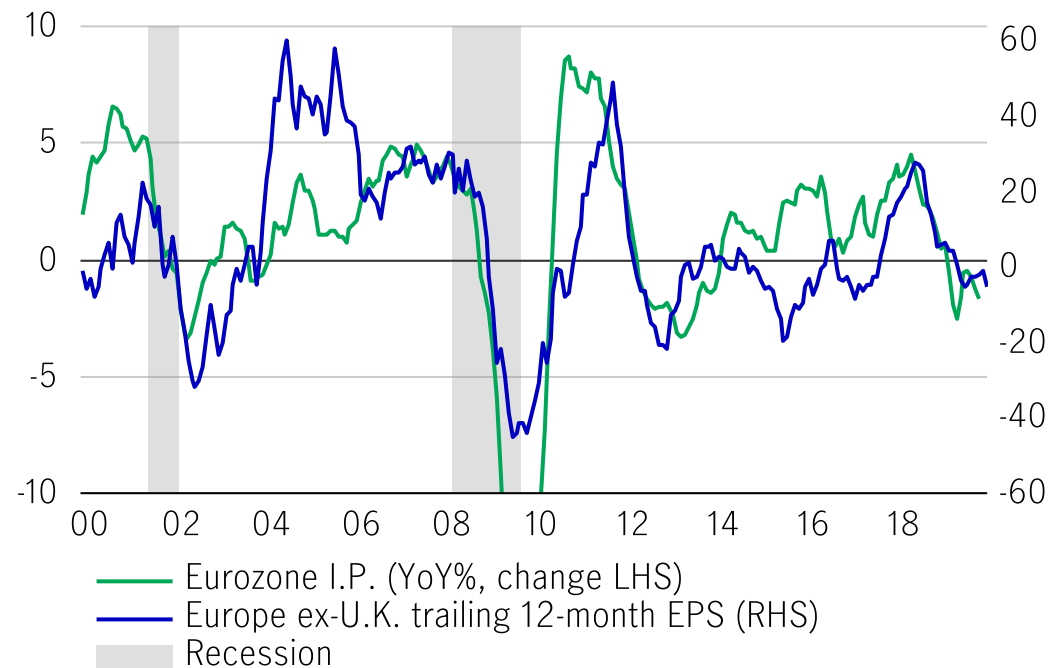
European Purchasing Managers’ Index (PMI)



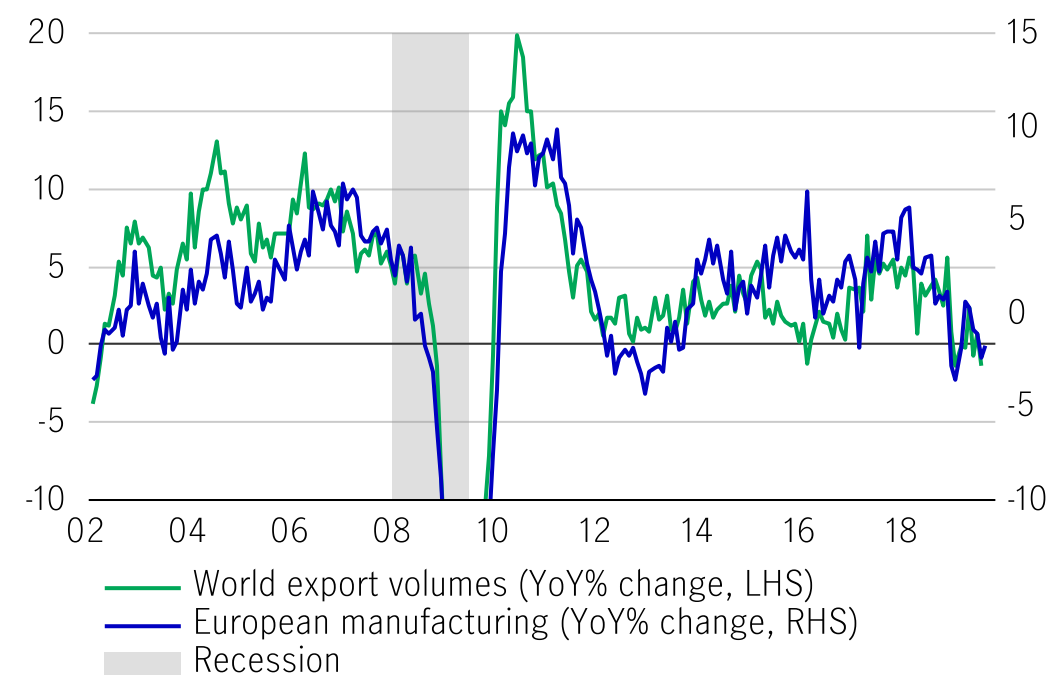
European industrial production matters to markets

Just like in the United States, the manufacturing sector remains critical to Europe. The MSCI Europe ex-U.K. Index's earnings growth continues to be tightly linked with European industrial production, which is, in turn, a function of global trade. For this reason, we struggle to build a bullish case for European equities until we see a meaningful stabilization in either trade tensions or Chinese growth. In our base case, neither of these upside risks will materialize before the end of 2019.

MSCI Europe ex-U.K. Index vs. European industrial production¹



Global exports vs. European industrial production (%)²

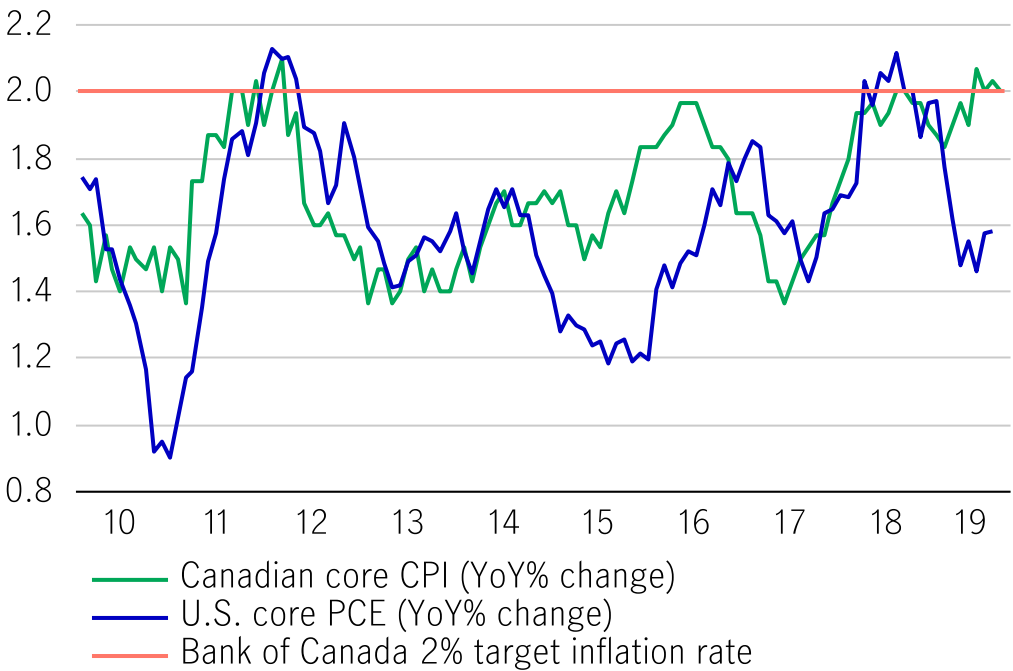


Canada: G10's most hawkish central bank

The Bank of Canada is stalling on rate cuts

Almost every major global central bank is now firmly in easing mode except the Bank of Canada, which elected not to cut rates in September and indicated in its [policy statement](#) that policy remains appropriate. In our view, there's justification for the bank's decision: For one, inflation remains at or above target and has significantly diverged from U.S. core inflationary pressures. In addition, the country is also already benefiting from lower global interest rates as it imports a substantial share of its bond market price action from the United States: The five-year change in Canada's 5-year yield—a widely used proxy for mortgage rates—is already back in negative territory, supporting Canadian housing despite the absence of an interest-rate cut in Canada.

Canadian core inflation (%)



5-year % change in the government of Canada 5-year yield

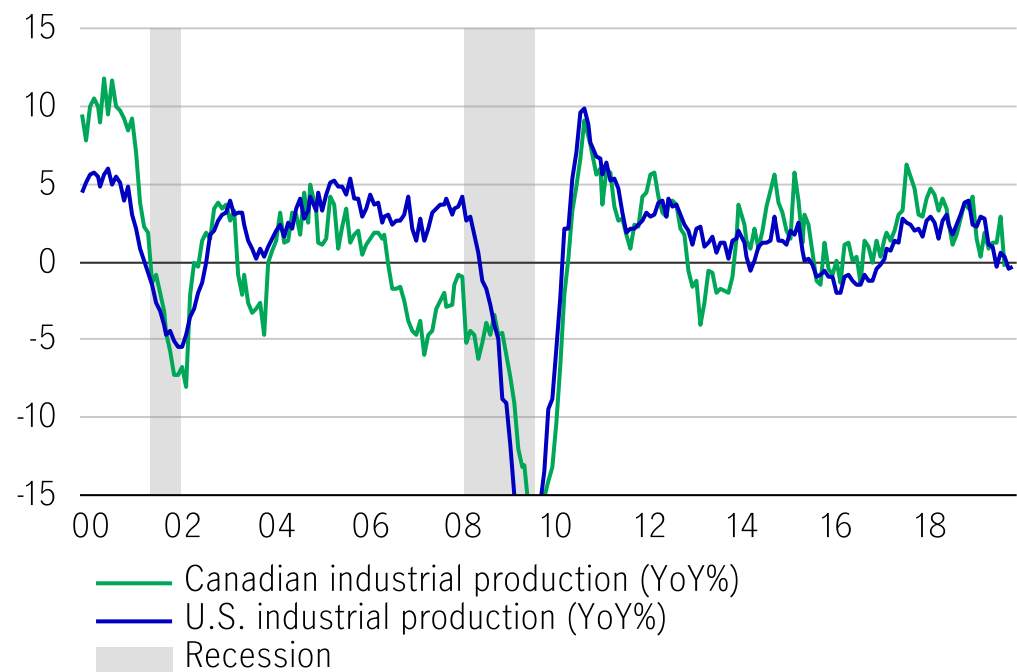


Canada is already benefiting from lower global bond yields

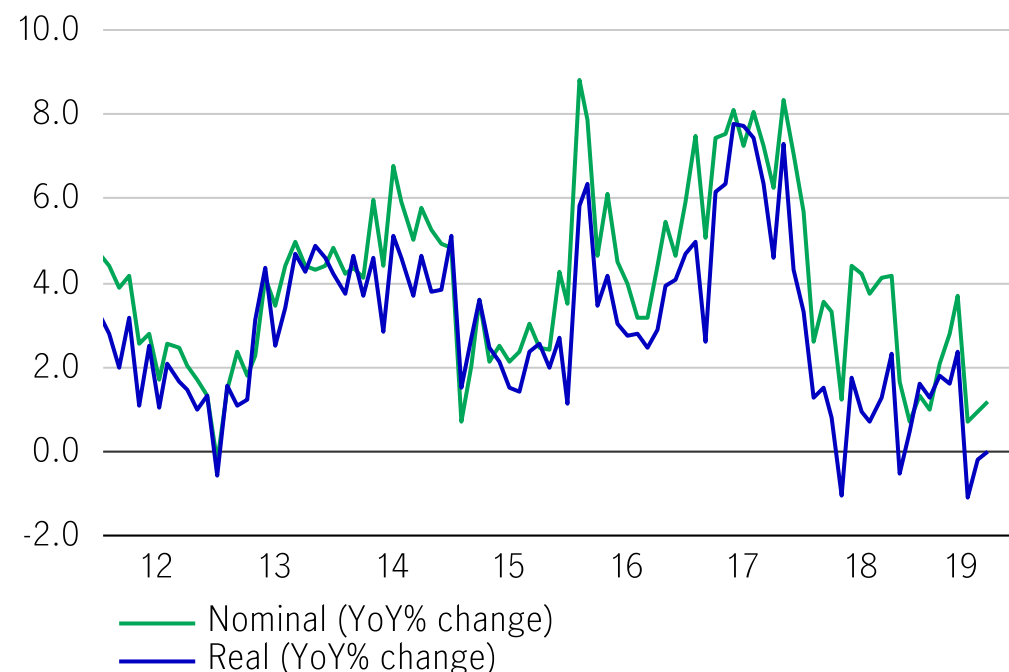
While the Bank of Canada might be able to keep rates on hold for the time being, we believe the central bank will be forced to lower rates within the next 12 months. Canada remains inextricably tied to the United States—as U.S. manufacturing activity slows, so will Canadian manufacturing and trade. Indeed, as the U.S. economy dips toward 1% GDP growth, we expect Canadian growth to suffer a similar, if not worse, deterioration.

In addition, despite a strong labor market, Canadian household spending has already materially slowed and retail sales has been weak for most of 2019. Indeed, in the event of a growth shock, we expect the Canadian consumer to be less resilient than their American counterparts and in greater need of support from monetary policy in 2020.

Canadian vs. U.S. industrial production¹



Canadian retail sales¹



Important information

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Manulife Investment Management

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Definitions

ICE BofA ML Global Government Index	The ICE BofA ML Global Government Index tracks the performance of investment grade sovereign debt publicly issued and denominated in the issuer's own domestic market and currency. To qualify for inclusion in the Index, a country must (i) be an OECD member; (ii) have an investment grade foreign currency long-term sovereign debt rating (based on an average of Moody's, S&P and Fitch); (iii) have at least \$50 billion (USD equivalent) outstanding face value of Index qualifying debt to enter the Index; (iv) have at least \$25 billion (USD equivalent) in outstanding face value of Index qualifying debt in order to remain in the Index; (v) be available to foreign investors; and (vi) have at least one readily available, transparent price source for its securities.
Economic Trade Policy Uncertainty Index	The Trade Policy Uncertainty Index is developed by a group of academics whose objective is to measure a broader set of economic risks beyond the financial markets. It is not possible to invest directly in an index.
Conference Board Consumer Confidence Index	The Conference Board Consumer Confidence Index is a monthly measure of consumer attitudes and buying intentions. It is not possible to invest directly in an index.
U.S. NFIB Small Business Optimism Index	NFIB stands for the National Federation of Independent Businesses, a nonprofit organization that advocates on behalf of small businesses in the United States. The monthly NFIB Small Business Optimism Index is compiled from a survey of its members and is widely used as a measure of business confidence. It is not possible to invest directly in an index. All economic and/or market performance data is historical and is not a guarantee of future outcomes.
CEO confidence survey	The CEO confidence survey is produced by The Conference Board, and is based on a survey of approximately 100 U.S. CEOs in a wide variety of industries. It provides an overview of their attitudes and expectations in regard to the overall state of the U.S. economy and their own industry.
Purchasing Managers' Indexes (PMI)	Purchasing Managers' Indexes (PMI) are used as a leading indicator of the economic health of a country's manufacturing sector (Manufacturing PMI) and services sector (Services PMI). Manufacturing PMI measures the health of the manufacturing sector based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment. The Services PMI is the equivalent for the services sector, covering transport and communication, financial intermediaries, business and personal services, computing and IT, and hotel and restaurants. It is not possible to invest directly in an index.

Definitions

ISM Manufacturing index and ISM New Orders Index	The Institute for Supply Management (ISM) manufacturing index monitors employment, production, inventories, new orders, and supplier deliveries. The ISM New Orders Index reflects the levels of new orders from customers. It is not possible to invest directly in an index.
S&P 500 Index	The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index.
MSCI Europe ex-U.K. Index	The MSCI Europe ex-U.K. Index tracks the performance of publicly traded large- and mid-cap stocks across 14 developed markets in Europe, excluding the United Kingdom. It is not possible to invest directly in an index.
Consumer Price Index (CPI)	The Consumer Price Index (CPI) is a comprehensive measure used for estimation of price changes in a basket of goods and services representative of consumption expenditure in an economy. It is not possible to invest directly in an index.
Core PCE Index	The Core Personal Consumption Expenditure (PCE) Index measures the prices paid by consumers for goods and services, excluding more volatile food and energy prices. It is not possible to invest in an index.



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