Manulife Investment Management

1H Market Intelligence

Turning the corner —2023 market outlook

“Wherever you get to is better than where you started. To stay on the road is a massive achievement.”

– Anthony Joshua

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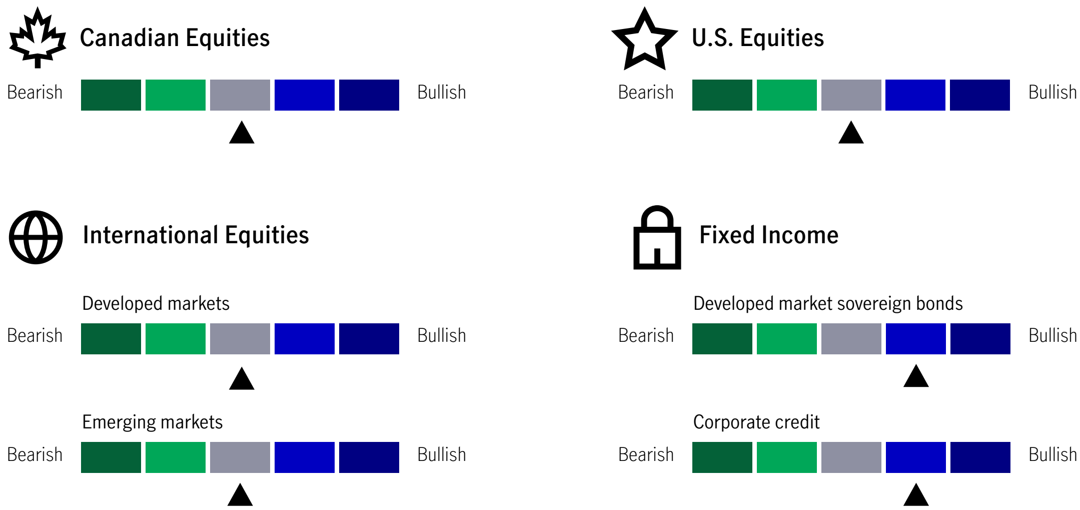
Capital Markets Strategy team's outlook—a snapshot



Source: Capital Markets Strategy, as of December 31, 2022.

"Good riddance" is the feeling many investors have towards 2022. Other than cash, there were very few areas to preserve capital. The S&P 500, S&P/TSX Composite, Nasdaq Composite, and MSCI EAFE Indexes were down 12.4%, 5.8%, 27.8% and 7.9% respectively, in Canadian Dollars, including dividends. The carnage wasn't only isolated to equities. Bonds, which typically provide downside protection when equities sell off, were down 11.7%, 13.0% (USD), and 16.3% (USD) as measured by the FTSE Canada Universe Bond, Bloomberg US Aggregate, and the Bloomberg Global-Aggregate Total Return Indexes. The year 2022 was one for the record books. Since 1926, 2022 has been the only year where the S&P 500 and U.S. Treasuries bonds were both down more than 10%![1]

Indeed, 2022 can be classified as the year of multiple unexpected negative surprises. The primary surprise was higher stubborn inflation and central banks' reactions to it. Using the U.S. as an example, we started 2022 with expectations that the U.S. Federal Reserve would raise rates by approximately 1% at most. But stubbornly higher inflation has resulted in an increase to 4.5% by end of year. Second, an unexpected conflict in Ukraine in February added fuel to the inflationary fire by impacting energy and food prices. And finally, China's ambitious zero-COVID policy resulted in large-scale shutdowns of major city centers—including Shanghai and Beijing, which delayed the full opening of supply chains, negatively impacting global economic growth.

We've been referencing Brad Paisley's quote throughout the year: "If you make the mistake of looking back too much, you aren't focus enough on the road in front of you." In our 2023 outlook, we lay out a framework for how we believe the coming year will unfold.

[1] Historical Returns on Stocks, Bonds and Bills: 1928–2021

Global economy

The global economy faced several unexpected headwinds in 2022, including high inflation, fastest tightening of central bank interest rates in 40 years, challenges to supply chains, conflict in Ukraine impacting commodity and agriculture prices, and zero-COVID policy in China causing bottlenecks in supply chains to name a few. Not surprisingly, these challenges are having impact on global growth going into 2023.

The Purchasing Managers' Indexes (PMIs) from countries across the globe provide advance insight into the private-sector economy by tracking variables such as output, new orders, employment, and suppliers' lead times. A reading above 50 indicates that the manufacturing output is growing while a reading less than 50 signals that it's contracting. Said differently, green is good, yellow is neutral, and red is bad.

The global economy slowed materially going into 2023 and we believe that the weakness will continue as economic uncertainties are fully absorbed into the various economies. Historically, a weakening manufacturing environment suggests a challenging economic and earnings growth environment is forthcoming.

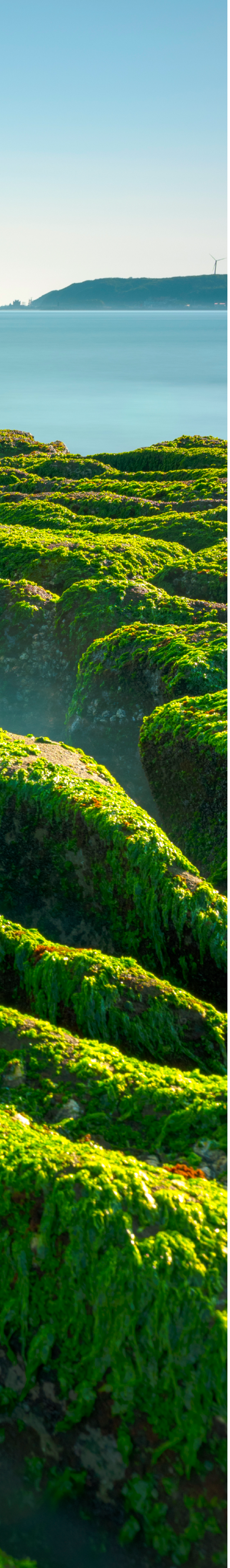
	November 2020	December 2020	January 2021	February 2021	March 2021	April 2021	May 2021	June 2021	July 2021	August 2021	September 2021	October 2021	November 2021	December 2021	January 2022	February 2022	March 2022	April 2022	May 2022	June 2022	July 2022	August 2022	September 2022	October 2022	November 2022
JPMorgan Global PMI	53.8	53.8	53.6	54.0	55.0	55.8	56.0	55.5	55.4	54.1	54.1	54.2	54.2	54.3	53.2	53.7	52.9	52.3	52.3	52.2	51.1	50.3	49.8	49.4	48.8
United States	56.7	57.1	59.2	58.6	59.1	60.5	62.1	62.1	63.4	61.1	60.7	58.4	58.3	57.7	55.5	57.3	58.8	59.2	57.0	52.7	52.2	51.5	52.0	50.4	47.7
Canada	55.8	57.9	54.4	54.8	58.5	57.2	57.0	56.5	56.2	57.2	57.0	57.7	57.2	56.5	56.2	56.6	58.9	56.2	56.8	54.6	52.5	48.7	49.8	48.8	49.6
Mexico	43.7	42.4	43.0	44.2	45.6	48.4	47.6	48.8	49.6	47.1	48.6	49.3	49.4	49.4	46.1	48.0	49.2	49.3	50.6	52.2	48.5	48.5	50.3	50.3	50.6
U.K.	55.6	57.5	54.1	55.1	58.9	60.9	65.6	63.9	60.4	60.3	57.1	57.8	58.1	57.9	57.3	58.0	55.2	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5
Eurozone	53.8	55.2	54.8	57.9	62.5	62.9	63.1	63.4	62.8	61.4	58.6	58.3	58.4	58.0	58.7	58.2	56.5	55.5	54.6	52.1	49.8	49.6	48.4	46.4	47.1
Germany	57.8	58.3	57.1	60.7	66.6	66.2	64.4	65.1	65.9	62.6	58.4	57.8	57.4	57.4	59.8	58.4	56.9	54.6	54.8	52.0	49.3	49.1	47.8	45.1	46.2
Holland	54.4	58.2	58.8	59.6	64.7	67.2	69.4	68.8	67.4	65.8	62.0	62.5	60.7	58.7	60.1	60.6	58.4	59.9	57.8	55.9	54.5	52.6	49.0	47.9	46.0
France	49.6	51.1	51.6	56.1	59.3	58.9	59.4	59.0	58.0	57.8	55.0	53.6	55.9	55.6	55.5	57.2	54.7	65.7	54.6	51.4	49.5	50.6	47.7	47.2	48.3
Italy	51.5	52.8	55.1	56.9	59.8	60.7	62.3	62.2	60.3	60.9	59.7	61.1	62.8	62.0	58.3	58.3	55.8	54.4	51.9	50.9	48.5	48.0	48.3	46.5	48.4
Spain	49.8	51.0	49.3	52.9	56.9	57.7	59.4	60.4	59.0	59.5	58.1	57.4	57.1	56.2	56.2	56.9	54.2	53.3	53.8	52.6	48.7	49.9	49.0	44.7	45.7
Ireland	52.2	57.2	51.8	52.0	57.1	60.8	64.1	64.0	63.3	62.8	60.3	62.1	59.9	58.3	59.4	57.8	59.4	59.1	56.4	53.1	51.8	51.1	51.5	51.4	48.7
Czech Republic	53.9	57.0	57.0	56.5	58.0	58.9	61.8	62.7	62.0	61.0	58.0	55.1	57.1	59.1	59.0	56.5	54.7	54.4	52.3	49.0	46.8	46.8	44.7	41.7	41.6
Poland	50.8	51.7	51.9	53.4	54.3	53.7	57.2	59.4	57.6	56.0	53.4	53.8	54.4	56.1	54.5	54.7	52.7	52.4	48.5	44.4	42.1	40.9	43.0	42.0	43.4
Greece	42.3	46.9	50.0	49.4	51.8	54.4	58.0	58.6	57.4	59.3	58.4	58.9	58.8	59.0	57.9	57.8	54.6	54.8	53.8	51.1	49.1	48.8	49.7	48.1	48.4
Australia	55.8	55.7	57.2	56.9	56.8	59.7	60.4	58.6	56.9	52.0	56.8	58.2	59.2	57.7	55.1	57.0	57.7	58.8	55.7	56.2	55.7	53.8	53.5	52.7	51.3
Japan	49.0	50.0	49.8	51.4	52.7	53.6	53.0	52.4	53.0	52.7	51.5	53.2	54.5	54.3	55.4	52.7	54.1	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49.0
China (Caixin)	54.9	53.0	51.5	50.9	50.6	51.9	52.0	51.3	50.3	49.2	50.0	50.6	49.9	50.9	49.1	50.4	48.1	46.0	48.1	51.7	50.4	49.5	48.1	49.2	49.4
South Korea	52.9	52.9	53.2	55.3	55.3	54.6	53.7	53.9	53.0	51.2	52.4	50.2	50.9	51.9	52.8	53.8	51.2	52.1	51.8	51.3	49.8	47.6	47.3	48.2	49.0
Taiwan	56.9	59.4	60.2	60.4	60.8	62.4	62.0	57.6	59.7	58.5	54.7	55.2	54.9	55.5	55.1	54.3	54.1	51.7	50.0	49.8	44.6	42.7	42.2	41.5	41.6
Vietnam	49.9	51.7	51.3	51.6	53.6	54.7	53.1	44.1	45.1	40.2	40.2	52.1	52.2	52.5	53.7	54.3	51.7	51.7	54.7	54.0	51.2	52.7	52.5	50.6	47.4
Indonesia	50.6	51.3	52.2	50.9	53.2	54.6	55.3	53.5	40.1	43.7	52.2	57.2	53.9	53.5	53.7	51.2	51.3	51.9	50.8	50.2	51.3	51.7	53.7	51.8	50.3
Malaysia	48.4	49.1	48.9	47.7	49.9	53.9	51.3	39.9	40.1	43.4	48.1	52.2	52.3	52.8	50.5	50.9	49.6	51.6	50.1	50.4	50.6	50.3	49.1	48.7	47.9
Singapore	46.7	50.5	52.9	54.9	53.5	51.8	54.4	50.1	56.7	52.1	53.8	52.3	52.0	55.1	54.4	52.5	52.9	56.7	59.4	57.5	58.0	56.0	57.5	57.7	56.2
India	56.3	56.4	57.7	57.5	55.4	55.5	50.8	48.1	55.3	52.3	53.7	55.9	57.6	55.5	54.0	54.9	54.0	54.7	54.6	53.9	56.4	56.2	55.1	55.3	55.7
Brazil	64.0	61.5	56.5	58.4	52.8	52.3	53.7	56.4	56.7	53.6	54.4	51.7	49.8	49.8	47.8	49.6	52.3	51.8	54.2	54.1	54.0	51.9	51.1	50.8	44.3
Turkey	51.4	50.8	54.4	51.7	52.6	50.4	49.3	51.3	54.0	54.1	52.5	51.2	52.0	51.2	50.5	50.4	49.4	49.2	49.2	48.1	46.9	47.4	46.9	46.4	45.7
South Africa	50.3	50.2	50.8	50.2	50.3	53.7	53.2	51.0	46.1	49.9	50.7	48.6	51.7	48.4	50.9	50.9	51.4	50.3	50.7	52.5	52.7	51.7	49.2	49.5	50.6
Saudi Arabia	54.7	57.0	57.1	53.9	53.3	55.2	56.4	56.4	55.8	54.1	58.6	57.7	56.9	53.9	53.2	56.2	56.8	55.7	55.7	57.0	56.3	57.7	56.6	57.2	58.5
Russia	46.3	49.7	50.9	51.5	51.1	50.4	51.9	49.2	47.5	46.5	49.8	51.6	51.7	51.6	51.8	48.6	44.1	48.2	50.8	50.9	50.3	51.7	52.0	50.7	53.2

Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy, as of November 30, 2022.

As the table below highlights, historically, there are many warning signs of an upcoming recession. As we started last year, positive inflation trends were the only sign that was present. To start 2023, there are three of the typical signs indicating a recession. In our view, it's not a question of whether we experience a recession but the magnitude. We believe a recession in the United States will likely be mild, while there is a risk that a recession in Canada and Europe will likely be worse.

Signs of a recession	Present today?
Inverted yield curve	Yes
ISM Manufacturing PMI below 45	Neutral
Positive inflationary trends	Yes
Tighter financial conditions	Neutral
Housing starts declining	Neutral
Labour market weakening	No
Leading economic indicators negative	Yes

Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy, as of November 30, 2022.

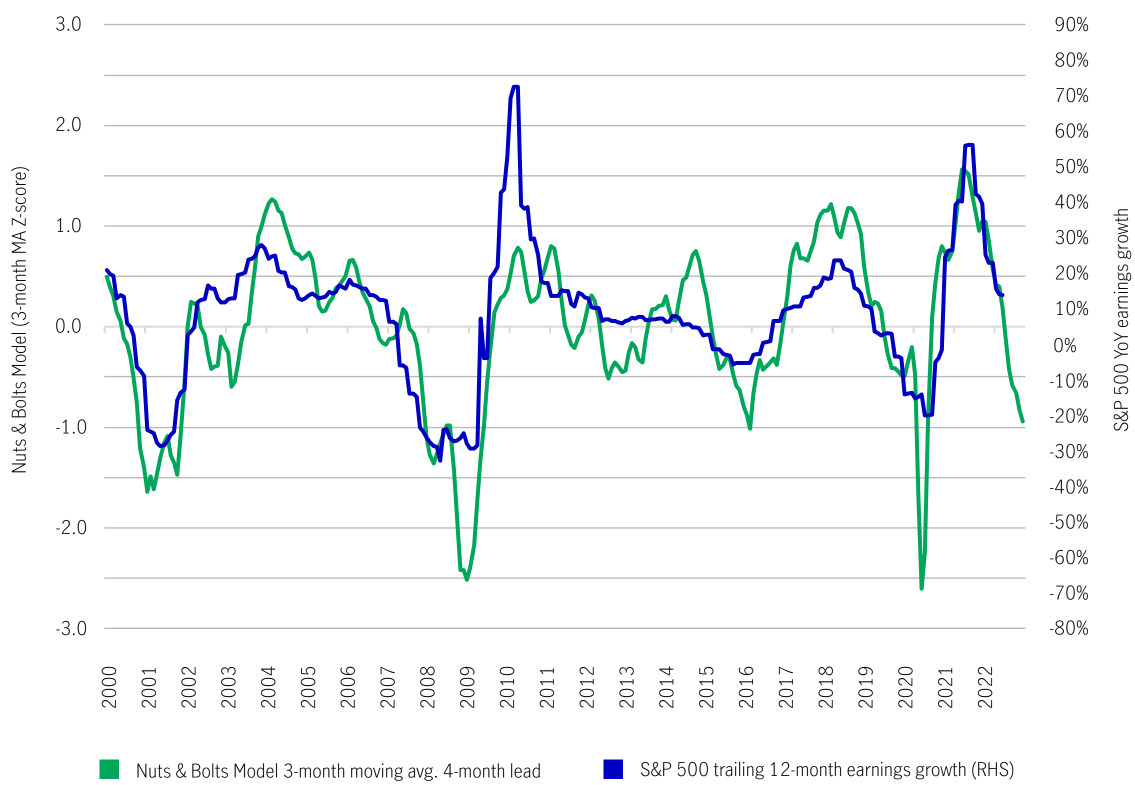


Patience is a virtue when it comes to this equity market

It was an extremely challenging year for equity markets around the world. Throughout much of the year, we saw valuations collapse from elevated levels, as central banks began to raise interest rates in an attempt to tame inflation. The positive news is that we believe we're nearing the end of central bank tightening in North America. However, we wouldn't say that we're out of the woods just yet. In our view, the last hurdle for the equity markets is negative earnings growth.

Our proprietary Nuts & Bolts Model indicates that negative earnings growth is becoming more likely in Q1 2023. Other macro models and sentiment indices confirm this theme of negative earnings growth as a weaker economy will eventually feed through to corporate earnings. The last time the model bottomed at this level was in 2016 and the S&P 500 earnings growth was –5% on a trailing 12-month basis.

Nuts & Bolts Model vs S&P 500 trailing 12-month earnings growth
2000–current



Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy, as of November 30, 2022.

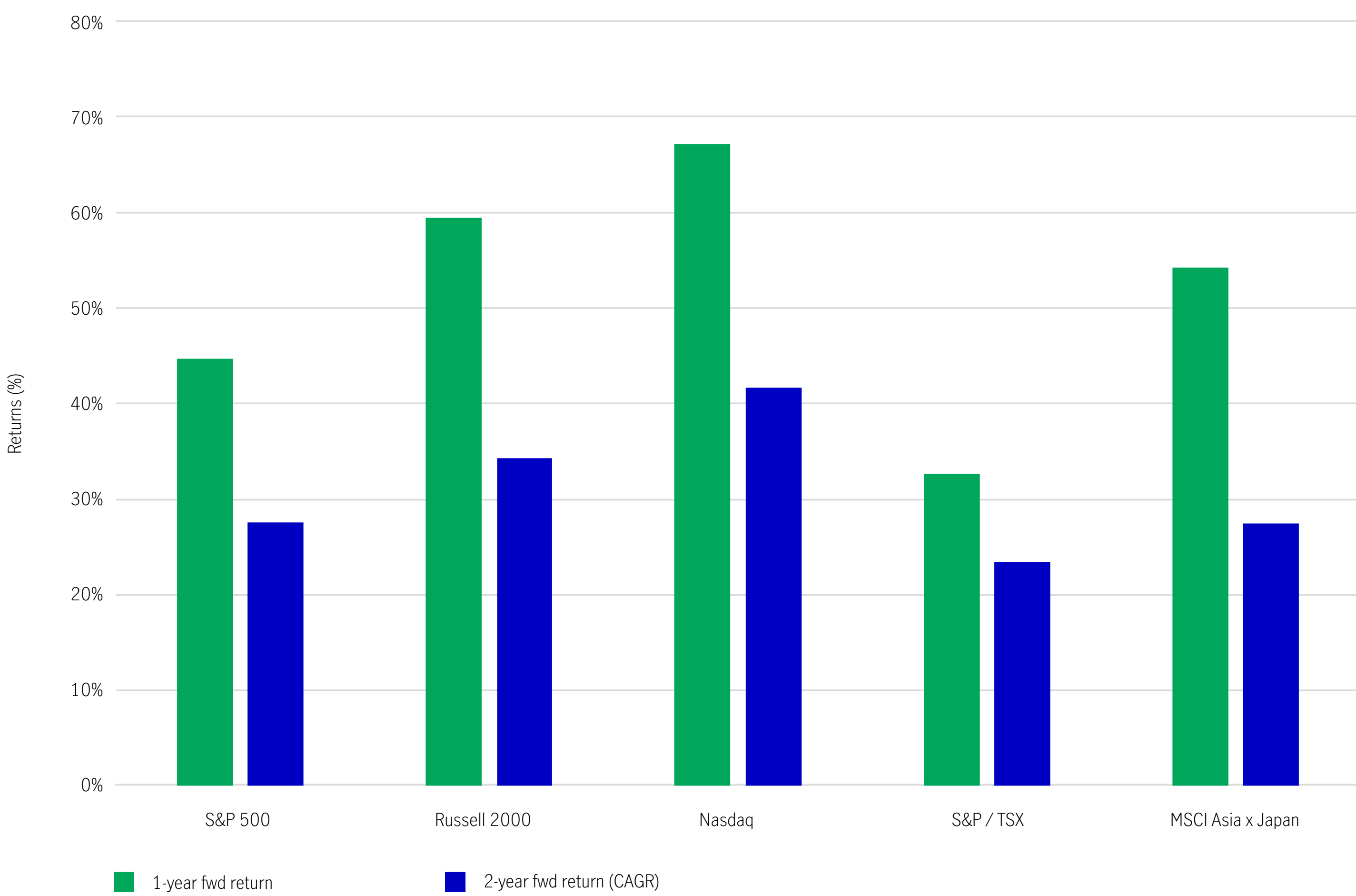
However, we caution not to see this as an overly negative outcome, as market valuations are much more in line with their longer-term average. This provides much more downside cushion than earlier in 2022. Further, it's expected that there could be a wide range of possible earnings outcomes from an individual company perspective. This could provide a larger differentiation in performance for companies, which could benefit active management.

We anticipate a choppy equity market environment over the near term until there's more clarity from an earnings perspective. Once that happens, equity markets may be favourable.

While the causes and degree of the selloff for each bear market are unique, once the bear market has tired and reached its bottom, history does provide insight as to which asset classes are most likely to sprint out of the gates. We looked at the one-year and two-year annualized forward returns from the bottom for the S&P 500, S&P MidCap, Nasdaq Composite, S&P/TSX Composite, and MSCI AC Asia ex Japan Indexes during previous bear markets since 1990 (there's no data for S&P MidCap before the 1990s). For reference, there have been seven: COVID-19 pandemic, 2018, European debt crisis, Global Financial Crisis, the dot-com burst, Asian currency crisis, and 1990 recession.

The Nasdaq Composite and S&P MidCap Indexes have historically performed better from market bottoms compared to other equity market indices. From our perspective, an ideal outcome would be the S&P MidCap space as its valuations are more attractive, it's more focused on the US economy, and provides better diversification.

Forward returns (1 and 2 years) after a market bottom during bear markets since 1990
(COVID-19, 2018, European financial crisis, Global Financial Crisis, dot-com burst, Asian currency crisis, 1990 recession)



Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy, as of November 30, 2022

Flexibility in fixed income is key

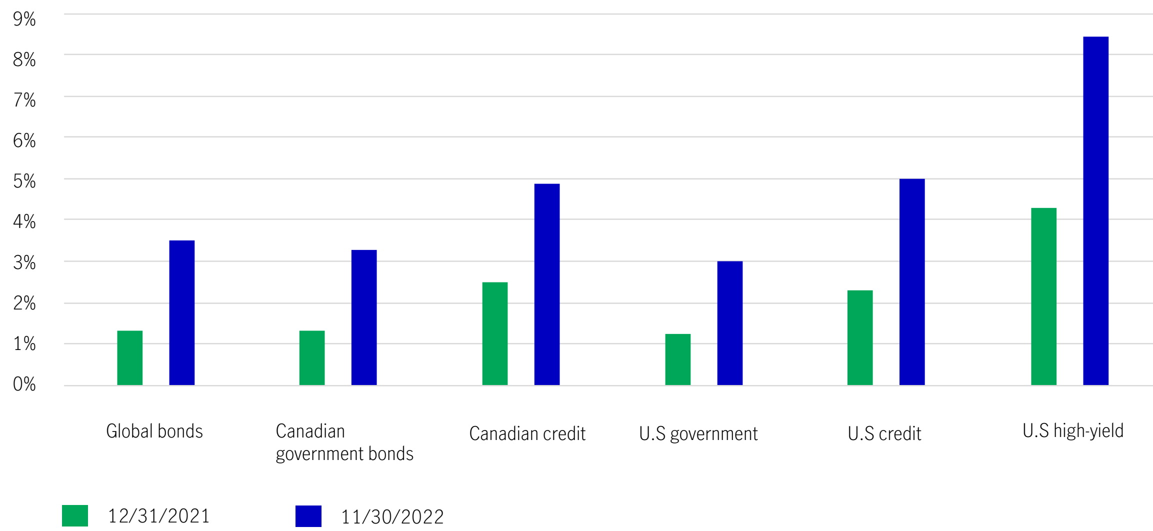
When we look at the opportunity set for bonds moving forward, we describe it in three phases: the sweet spot, duration is your friend, and take on risk. For a more detailed description of these three phases, read our recent investment note, "**The three phases of fixed-income investing.**"

Phase one – the sweet spot

Phase one is the current phase that fixed-income investors find themselves in. Yields across most, if not all, fixed-income instruments, regardless of maturity, type, or credit quality, have moved materially higher since the beginning of this year. In this phase, we believe investors should focus on the yield provided by the bond or "clipping the coupon." There's no free lunch, and to obtain a higher yield, an investor must take on some sort of additional risk, whether it be duration, credit, or even liquidity.

In phase one, investors are essentially being paid to wait until there's more clarity on the U.S. Federal Reserve's planned interest rate hikes and the health of the economy. This approach helps mitigate both duration risk from yields continuing to move higher and credit risk if we see default expectations increase in lower-quality bonds.

**Various fixed-income asset class yield-to-worst
12/31/2021 vs 11/31/2022**



Proxies that represent these asset classes: global bonds – Bloomberg Global Aggregate Bond Index, Canadian credit – FTSE Canada Universe Bond Index, Canadian government bonds – FTSE Canada All Government Bond Index, U.S. government bonds – Bloomberg US Treasury Index, U.S. credit – Bloomberg US Corporate Bond Index, U.S. high-yield – Bloomberg US Corporate High Yield Bond Index.

Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy, as of November 30, 2022.

Phase two – duration is your friend

As we transition into the first half of next year, as noted above, we expect economic conditions to weaken materially, and we're likely going to see a recession in both Canada and the U.S. We're also likely to be near the end of the interest-rate tightening cycles of the Bank of Canada and the Fed.

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

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

U.S. 10-year Treasury yield
1976 – November 2022

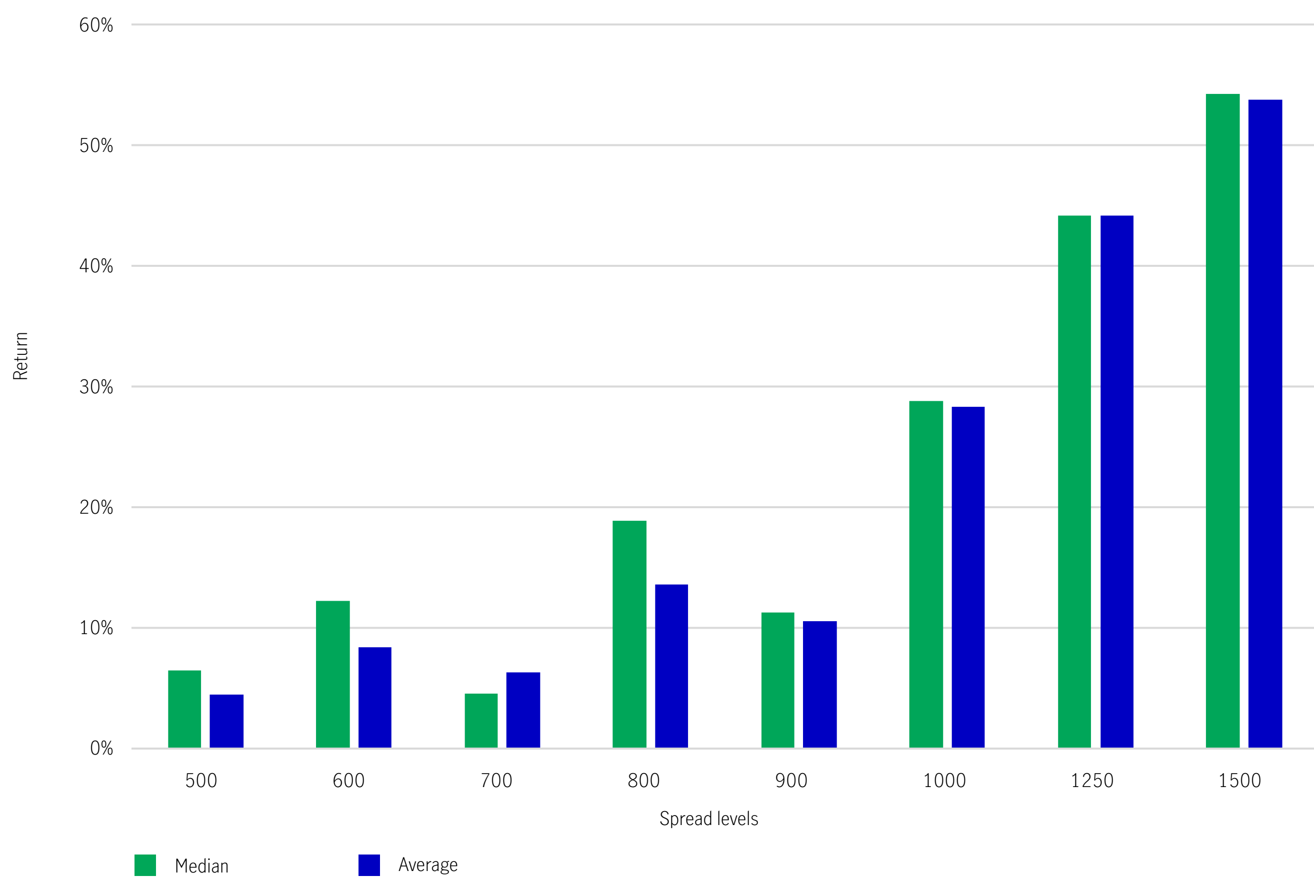
Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy, as of November 30, 2022.

Phase three – take on risk

The final phase of the opportunity in fixed income is taking on risk when markets have fully priced in a recession. Typically, when that happens you see high-yield corporate bond spreads widen and factor in an elevated risk of defaults. The number of defaults is often overexaggerated and active managers with deep credit research capabilities can take advantage of dislocations between the expected default risk and the actual one. In our view, taking on credit risk can potentially lead to strong returns in fixed-income portfolios, as high yield has historically performed well over the 12 months following the trough in performance. Since inception of the US High Yield Index in December 1996, during recessions, high-yield spreads have averaged 1006 basis points. Historically, when US High Yield spreads are greater than 1000 bps, forward 12-month returns have averaged 28.8%.

In phase three, taking on credit risk may be beneficial for investors. During recessions, the markets tend to expect a higher level of defaults than what actually occur, resulting in larger spreads. When the market realizes the error of its ways, spreads tend to tighten, which drives returns in high-yield bonds higher.

High-yield bond 12-month returns following spread levels at month end (1997 – current)



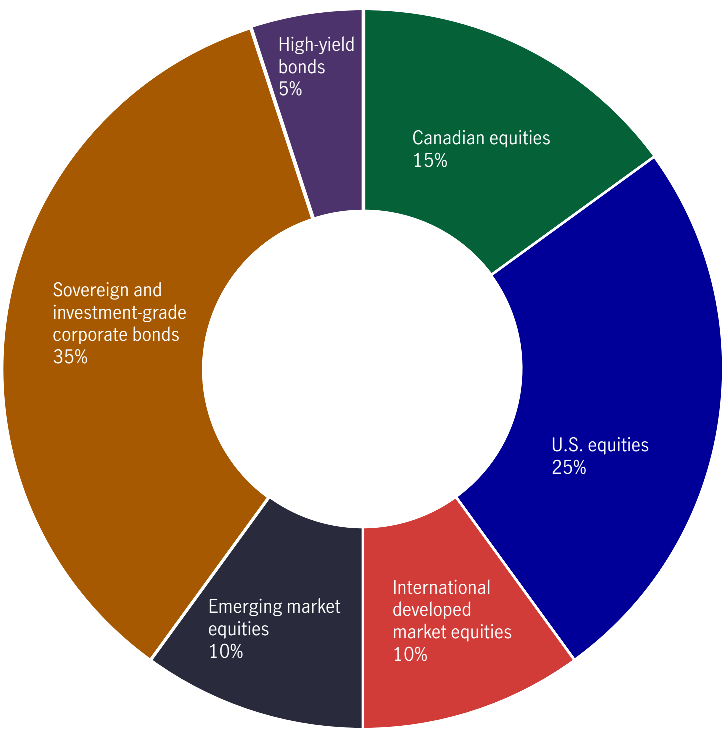
Source: Bloomberg, Manulife Investment Management, Capital Markets Strategy, as of November 30, 2022.

These three phases of fixed income by no means covers all the opportunities that exist, and likely oversimplify a very complex asset class. But they do try to illustrate the multiple opportunities that active fixed-income managers have at their disposal during different economic and market environments. What investors experienced this year was extremely rare and we believe now more than ever we must focus on the road in front of us to make sure we remain on the path to our end destination, whatever that may be.

Illustrative portfolio

In keeping with our process, with reasonable current equity valuations but an increasing risk of a shallow recession at minimum within the next 12 months, we‘re slightly altering our asset allocation by reducing our U.S. equity exposure by 5% in favour of fixed income. As of December 31, 2022, the Capital Markets Strategy Model Portfolio is back to a neutral posture at 60% equity and 40% fixed income. The portfolio is well balanced across equity geographies. Throughout the past couple of years, we've been advocating rebalancing portfolios to target asset allocations and dollar-cost averaging into this market. We continue to emphasize that approach today.

CMS Model Portfolio by asset class as of December 31, 2022



Source: Manulife Investment Management, Capital Markets Strategy, as of December 31, 2022.

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

2023—looking ahead

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

As we settle into a new year with the realization that the global economy is slowing, geopolitical risks remain heightened, inflation is falling (albeit slowly), and the Federal Reserve is nearing the end of its interest-rate hike cycle, it can be easy for investors to still feel quite nervous about the state of things. However, as we've outlined, despite these setbacks, we think the opportunity is ripe for the patient and flexible investor to take advantage. There'll be more twists and turns and bumps along the way, but we need to remain focused on the road ahead to make sure we arrive at our destination.

Endnote

Important disclosure:

Investing involves risks, including the potential loss of principal. Financial markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. The information provided does not take into account the suitability, investment objectives, financial situation, or particular needs of any specific person.

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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 preexisting 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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