John Hancock INVESTMENTS

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As of December 31, 2018

Global Market Outlook

Growing together while splitting apart

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Key takeaways

- Economic growth in most major economies is set to slow in a synchronized fashion in 2019, a reversal of the near-harmonious growth we saw a year or two ago.
- Equity markets are likely to be the biggest threat to growth, not monetary tightening efforts by global central banks.
- The U.S.-China trade war remains a concern: The odds of escalation outweigh the likelihood of de-escalation.
- Keep your portfolio diversified by asset class and by global geographic region.

Asset class views As of December 31, 2018

	UNATTRACTIVE	SLIGHTLY UNATTRACTIVE	NEUTRAL	SLIGHTLY ATTRACTIVE	VERY ATTRACTIVE
Equities					
U.S. large cap	○	○	●	○	○
U.S. mid cap	○	○	●	○	○
U.S. small cap	○	●	○	○	○
International	○	○	●	○	○
Emerging markets	○	○	○	●	○
Fixed income					
U.S. government	○	○	●	○	○
U.S. corporate	●	○	○	○	○
U.S. high yield	●	○	○	○	○
Emerging markets	○	○	○	●	○
Floating-rate bank loans	●	○	○	○	○
Alternatives					
Commodities	○	○	●	○	○
Global REITs	○	○	●	○	○
Absolute return	○	○	○	○	●

Megan E. Greene
Global Chief Economist

"If there's an immediate danger to the U.S. economy, it would be the equity markets."

Growing together while splitting apart

In late 2017, inboxes everywhere were inundated with outlooks heralding 2018 as the year of global synchronized growth. The message about synchronization holds true for 2019, too, minus the rosy fanfare. While 2018 was initially characterized by growth accelerating globally, we believe 2019 will involve most major economies slowing down. It will be a synchronization all the same, but toward long-run potential GDP—which is quite a lot lower than the above-trend GDP growth we saw in 2018. In the meantime, political risks abound and could affect economies significantly as international and national unity frays, dragging on trade and investment and causing financial asset price volatility in some regions.

Calls for a recession in 2020 may be too bearish

In a recent press conference, U.S. Federal Reserve (Fed) Chair Jerome Powell declared, "There's really no reason to think that this cycle can't continue for some time, effectively indefinitely."[1] This business cycle is already the second longest on record for the United States, and there's a growing consensus among economists that it will finally end in 2020.[2]

These calls for a recession in 2020 may be too bearish. Many economists are focusing on 2020 because the United States faces a fiscal cliff at the end of 2019 when the benefits of tax cuts and increased federal spending dwindle. While a divided Congress means any additional fiscal boost heading into an election year will be politically difficult, both parties may agree on additional infrastructure spending, which could breathe new life into the economy and extend the recovery.

Threats to economic growth reside in the rise of market volatility

For many, the biggest threat to the economic recovery in the United States—and globally—is the Fed. Beginning in 2019, global central bank liquidity is set to shrink for the first time since quantitative easing—QE—began, led by the Fed, given its interest-rate hikes and balance sheet shrinkage.[3] Ten of the past 13 fed funds rate hiking cycles have ended in a U.S. recession. The central bank will tighten policy too far, too fast, in order to head off inflation, the story goes, and kill the expansion.

In our view, the Fed is more likely to slow down its rate of normalization of monetary policy than hasten it. Chair Powell suggested as much in November when he indicated that rates were just below the range of estimates for the neutral rate.[4] We think the Fed will have to adopt a more dovish stance for two main reasons:

- First, the U.S. housing market has softened significantly in late 2018 and is likely to continue to do so because of higher mortgage rates, supply constraints, and tax code changes. On top of this, the government is likely to find agreement on reducing the price of drugs. Shelter and medical costs are the two heaviest weights in the inflation basket, and so we expect inflation to soften.
- Second, the Fed probably doesn't want to invert the yield curve for fear of the signal this would send about an impending recession. With the yield curve remaining flat, the Fed doesn't have much room to hike further on the short end.

Furthermore, if you take a step back and look at the hard data, there are few signs of overheating. Bank loan growth has decelerated from 2015 highs, and most investment has been in inventories rather than productivity-boosting capital expenditure. Similarly, retail sales growth has been rangebound, and the housing recovery has been tepid. For all the optimism businesses and consumers have expressed, they aren't deploying capital accordingly.

If there's an immediate danger to the U.S. economy, it would be the equity markets. Corporate earnings tend to slow late cycle, and they could be further compressed by trade wars, as companies can't expect to pass all of the resulting price increases on to consumers without fear of losing market share. S&P 500 Index earnings for the third quarter were up 25%, but analysts expect this to shrink to just 7% in the second quarter of 2019.[5] If share prices stagnate or fall further, it could crimp investment and confidence, slowing consumer spending.

Keep an eye on corporate debt levels

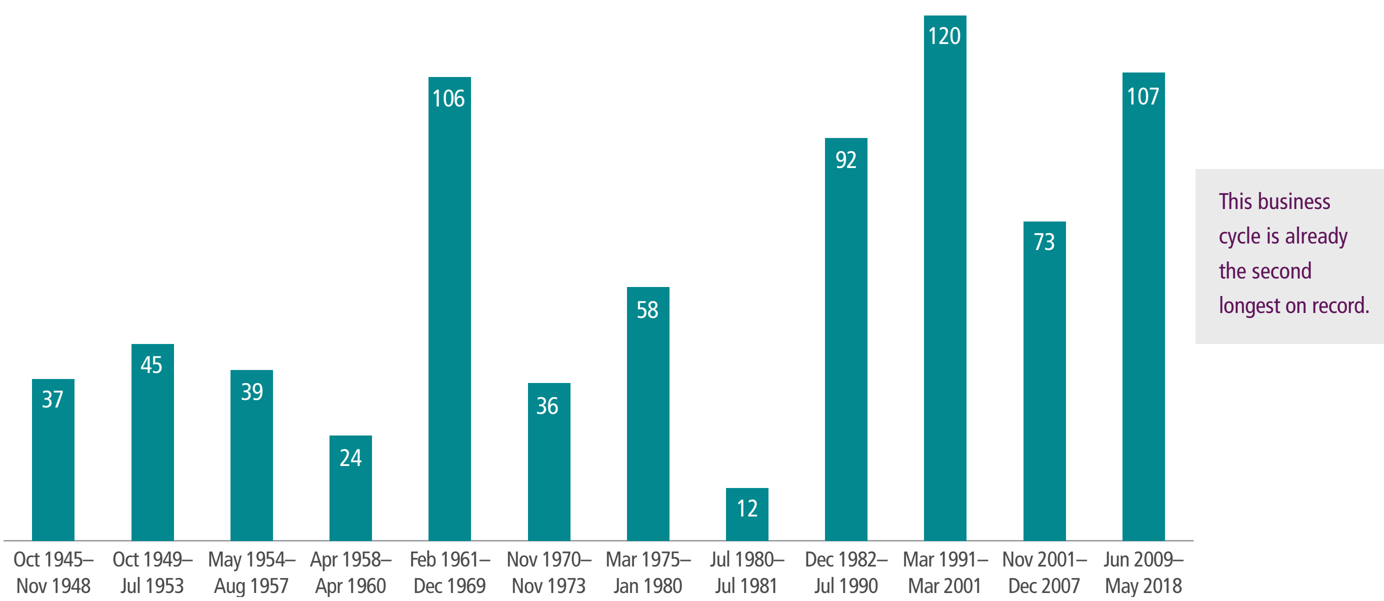
There's also some vulnerability in nonfinancial corporate debt—a risk I've been highlighting for over a year. Corporate debt to GDP remains above the levels seen just before the last three recessions; however, corporate debt to profits is well off historical highs. As long as interest rates remain low and profits high, companies shouldn't have too much trouble servicing their debt; but as rates rise, albeit slowly, and profit growth shrinks, some firms may see their debt downgraded. Given the abundant issuance of BBB debt since the 2008 global financial crisis, the high-yield, or junk, market could find itself flooded as investment-grade BBB issuers are downgraded to BB, the highest-quality tier of the non-investment-grade debt market.

The issuance of U.S. Treasury bills to finance the government's ballooning deficit, meanwhile, is keeping short rates up, while long rates once again decline. The five-year break-even rate—which represents investors' views on the annual inflation rate through 2023—has fallen from its 2018 high of 2.2%; low yields tend to support above-average multiples for equities, but the drop in 10-year yields has brought the debate about a yield curve inversion back to the fore.[5]

The sugar high we enjoyed in 2018 is therefore set to dwindle in 2019, and we'll probably fall back toward long-run trend growth of around 2% in 2020. The risk to this view is that the markets seem intent on a recession, which could become a self-fulfilling prophecy. In our view, the risk of recession is likely to rise particularly sharply from 2021 onward.

Economic expansions don't die of old age alone

Length of U.S. economic expansions since 1945 (months)



Source: National Bureau of Economic Research, May 2018.

U.S.-China trade war begins to bite

The United States is hardly alone in seeing growth slow in 2019. Growth in China began slowing in late 2017, and we expect it to continue slowing through part of this year despite a number of stimulus measures that have been implemented. The greatest threat to Chinese—and global—growth is an escalation of the trade war between the United States and China. Our view has long been that the trade war will get worse before it gets even worse still. Despite the temporary détente in the skirmish, struck at the G20 meetings in Buenos Aires, the odds of escalation still seem to outweigh the chances of de-escalation. There's been no progress on addressing the issues that lie at the heart of the trade war—intellectual property rights, forced technology transfers, and government subsidies of tech sectors. Both the United States and China want to be the world's leader in artificial intelligence, machine learning, and quantum computing, and neither side has any incentive to back down.

If the trade war escalates further, the United States could impose tariffs on virtually all goods imported from China, which would have a material impact on Chinese economic growth. Additional tariffs could also push inflation in the United States up since inflation also eats into corporate margins. Margins may also dwindle as companies reroute their global supply chains to circumvent tariffs. There's also likely to be a continued drag on investment activity because of trade. While capital expenditure picked up in the United States in early 2018 as a result of the change in corporate tax rates, many businesses have suggested they're now deferring and delaying their investment plans because of uncertainty around trade policy.

Trade could also put pressure on emerging markets, many of which experienced currency crises in 2018 as the U.S. dollar (USD) appreciated, not just relative to the Chinese renminbi (RMB), but also relative to most other currencies across the world. Emerging markets may enjoy some reprieve in early 2019 as investors digest the prospects of a more dovish Fed, but if the trade war escalates, we expect the People's Bank of China to step away from supporting the RMB and allow the currency to depreciate. A weaker RMB and stronger USD would squeeze emerging-market countries that have issued USD-denominated debt and those that invoiced their trade in the greenback.

Not all rate hiking cycles halt economic growth

Ten of the past 13 fed funds rate hiking cycles have ended in a U.S. recession

U.S. rate hike cycle	Economic outcome
Dec 2015–????	Unknown
Jun 2004–Jun 2006	Recession
Jun 1999–May 2000	Recession
Feb 1994–Feb 1995	Soft landing
Jan 1987–May 1989	Recession
Mar 1983–Aug 1984	Soft landing
Aug 1980–Dec 1980	Recession
May 1977–Mar 1980	Recession
Apr 1972–Sep 1973	Recession
Nov 1967–Jun 1969	Recession
Dec 1965–Sep 1966	Soft landing
Sep 1958–Sep 1959	Recession
Oct 1955–Aug 1957	Recession
Oct 1950–May 1953	Recession

Source: FactSet, as of 9/30/18. Past performance does not guarantee future results.

Global economies seem set for a synchronized slowdown

Global growth is set to synchronize again in 2019, but it will likely be a synchronized slowdown rather than an acceleration. This should come as no surprise: 2018 growth in most countries was well above long-run potential GDP growth. In the absence of a huge jump in productivity growth or in the labor supply, the above-trend economic growth we've seen recently should slow and converge with potential GDP growth. While there are some endogenous threats to growth in the United States, most potential headwinds to global growth derive from political divisions that affect economies and markets, particularly the trade war between Washington and Beijing.

Robert M. Boyda
Senior Advisor

"Life can only be understood backwards; but it must be lived forwards."—Søren Kierkegaard

In search of a lifetime investing narrative

After nearly five decades of dealing with the stock market—I was 12 when I started following the stock of my father's employer, a steel company—you'd think there would be some ease in crafting a single lifetime investing narrative, something that gathers the wisdom of the past as prologue to fabulous insight about the future. Sorry, but, at best, there are still a few more lessons piled on top of those shared in earlier missives—observations, ideas, thoughts on mistakes and missed opportunities, and, above all, insight from many of the great investors I've had the privilege of working with over many years.

Paraphrasing Kierkegaard, the reality about what drives capital markets is only understood looking back after all the facts are in: Call it the NARK, the Narrative After the Reality is Known. There's some comfort in putting together the details of the past into a coherent narrative. Take the global financial crisis 10 years ago. Knowing what happened won't erase the mistakes of complacency made during that period; understanding the story line may prevent a repeat in the future. The brute reality is that we earn our returns going forward, where the risks of the unknown often seem overwhelming. Said another way, it's easy to know what you should have done when it's over, but it's very difficult to know what to do at the moment while history is still being written.

In the end, they shoot the generals

Global equity markets outside of the United States have been in decline since February 2018. Emerging-market and European equities hit bear market territory, down more than 20% from their early 2018 highs. U.S. equity markets have followed suit, albeit not to the same extent. There's a way to look on the bright side of the U.S. equity decline: An old wartime saying repurposed for stock markets of the 1960s, '70s, and '80s, says that "in the end, they shoot the Generals." The analogy has to do with identifying the stalwart, best-performing stocks of the era—the generals of the time: General(s) Electric, Mills, Foods, Motors, and Dynamics—that would withstand a broader market meltdown until the very end, and then even the generals would fall. Updated, mega-cap tech stocks—such as the FAANGs: Facebook, Apple, Amazon, Netflix, Google—represent today's generals. And now even the FAANGs are falling. Until this past quarter, the U.S. equity market withstood the global decline, and now this general is falling too. A benign interpretation of the current decline suggests that with the fall of the stalwarts we must be near the end of the global equity decline; it's a nice idea, but it's not my base case, unfortunately.

Withdrawal of liquidity from the system marks the end of an era

For more than a decade, global interest rates have been suppressed by central bank interventions, with short-term rates anchored well below the rate of inflation and long-term rates held down by a massive experimental bond-buying program known as quantitative easing, or QE. Central banks around the world bought roughly $15 trillion of bonds, with all the cash used to purchase those bonds flooding into the global financial system. Easy credit has been available, extended at rates well below inflation, an extensive boon to corporate, government, and individual borrowers. But we appear to be at the end of the ultra-cheap money era. The exit from QE is likely to be messy, and risk assets may be at peril.

What's the same and what's different this time around?

In the short-term, equity markets are buffeted by emotions, which eventually give way to the weight of fundamentals such as earnings, growth, and valuation. After bouts of overenthusiasm, investors need to be prepared for volatility. A garden-variety correction of 10% or so is usually all it takes to adjust valuations. Not this time—we're already past that point. What's troubling is that there's so much financial stress in the system: U.S. consumers are already responding to higher rates as auto and home sales weaken. While U.S. consumer and U.S. mortgages were the epicenters of the last crisis, they probably won't be the culprits this time around.

This time, the focus of the financial issues should be on heavily leveraged U.S. corporations. Who can blame the captains of industry for borrowing heavily against their assets when the cost of money was so cheap? Who can blame them for using that money to buy things—their own company shares, for example? This narrative should have an eerie ring to it. Recall U.S. households borrowed against the value of their homes and used the money to buy things on the eve of the global financial crisis. That didn't work out so well. To understand the gravity of this situation, we already have at least one poster child for excess corporate borrowing against assets to buy back shares—it's one of the generals and one of the oldest components of the Dow Jones Industrial Average. Less than 20 years ago, this general was considered one of the world's premier credits. How the mighty have fallen.

There are two main differences between today's U.S. corporate borrowing binge and the consumer mortgage debacle of 2008, but each requires an important qualification. First, there's more transparency in rating corporate debt, although investors remain remarkably willing to hold a lot of junk bonds and bank loans. These low-rated credit assets are likely to be the first casualties of a debt problem, and a debt derating and sell-off will hurt market participants. Second, the U.S. banking system is in far better shape, with more high-quality capital. However, bank proprietary trading desks that have historically provided liquidity in downturns have been scaling back for a decade and won't provide the same buffer against large sell-offs that they once did. U.S. banks may be in far better shape than they were in 2008, but there's a lot of stress among global financials. European banks, in particular, appear to be in worse condition and seem especially vulnerable.

It was a disappointing year for U.S. stocks, the worst one in a decade

The S&P 500 Index, 2018

After an extended streak of gains since the 2008 global financial crisis, the market lost some of its momentum last year.

Source: finance.yahoo.com, 2019.

As investors, we look for some narrative that binds together this zig or that zag of the bond, stock, or commodity markets. When we're winning, the story doesn't seem to matter; when times get tough, suddenly we're looking for the deep underlying causes. The best narratives deliver a coherent explanation of today's action in both directions, trying to reveal something meaningful about tomorrow.

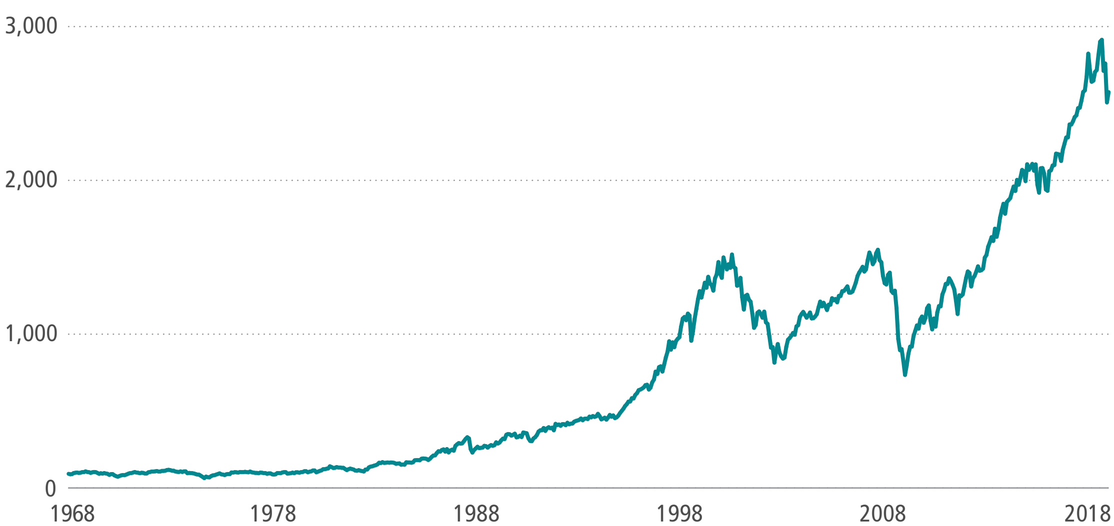
Resiliency and patience are investing virtues richly rewarded over time. For whatever fallout happens to come in the next few months—or even years—following this recent drop, recall that investors got through the last two bear markets, two of the nastiest on record, beginning in 2000 and then again in 2007. Each one roughly halved the value of equities from their prior peak. There have been many bear markets in my career: 1974/1975, the massive bond bear market of the late 1970s and 1980, the crash of 1987, and the 1990 real estate crisis, to name a few. This current downturn will pass. The economy and good corporate management have adapted and prospered these past several decades. For the record, the S&P 500 Index was below 100 when I first started looking at stocks in 1968 and was barely above 100 when my career began in 1979. It closed 2018 just above 2,500, a stellar run when viewed with long-range perspective. I doubt the equity market will do as well over the next five decades as the last five, but that story we will live forward—it hasn't been written yet. Finally, keep your portfolio diversified, as it will help steady the inevitable ebbs and flows of markets.

I leave you with this last goodbye, the last pair of lines from the last act of one of Shakespeare's last plays. Thank you. It has been a privilege to serve.

> *"As you from crimes would pardon'd be,*
> *Let your indulgence set me free."*
> —*The Tempest,* by William Shakespeare

The market has had a stellar run over the span of a half century

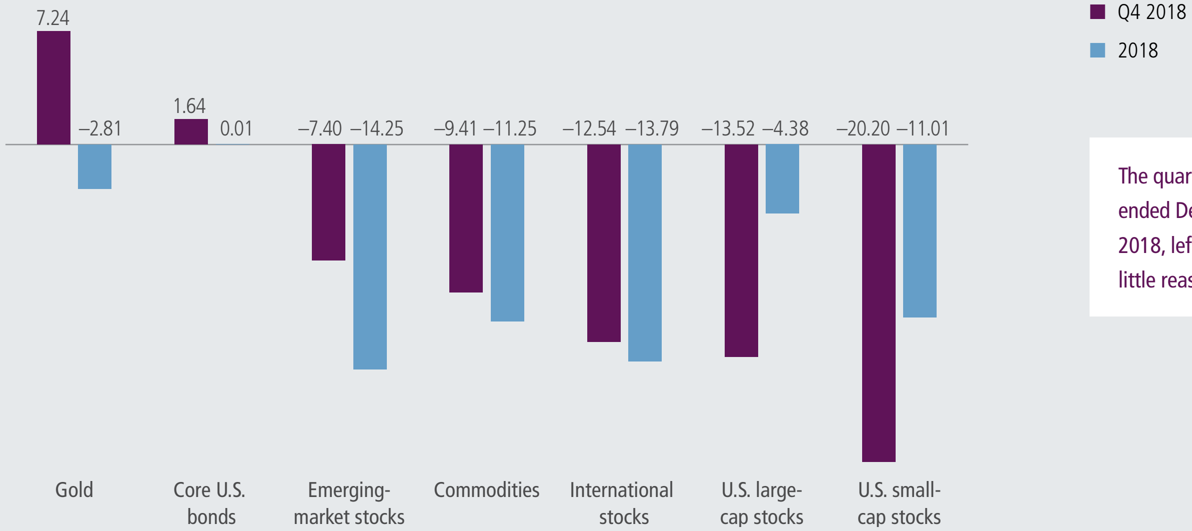
The S&P 500 Index, 1968–2018



It's unlikely that the next five decades will be as generous to equity investors as the last five.

Source: finance.yahoo.com, 2019.

Asset class returns As of December 31, 2018



The quarter and year ended December 31, 2018, left investors with little reason to smile.

Source: Morningstar Direct, 2019. Past performance does not guarantee future results.

1 "Fed Chair Jay Powell: U.S. may be in a different era for workers' wages despite economic gains," PBS, 10/3/18. **2** "The U.S. Economy Has Hit a Milestone," Bloomberg, 5/1/18. **3** "Tide about to turn for markets as easy-money decade ends," Reuters, 8/16/18. **4** "The Federal Reserve's Framework for Monitoring Financial Stability," U.S. Federal Reserve, 11/28/18. **5** Bloomberg, as of 12/5/18.

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Commodities are represented by the Bloomberg Commodity Index, which provides broadly diversified representation of commodity markets as an asset class. Core U.S. bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index, which tracks the performance of U.S. investment-grade bonds in government, asset-backed, and corporate debt markets. Emerging-market stocks are represented by the MSCI Emerging Markets Index, which tracks the performance of publicly traded large- and mid-cap emerging-market stocks. Gold is represented by the Bloomberg Gold Subindex, which provides a representation of gold as an asset class. International stocks are represented by the MSCI Europe, Australasia, and Far East (EAFE) Index, which tracks the performance of publicly traded large- and mid-cap stocks of companies in those regions. High-yield bonds are represented by the Intercontinental Exchange Bank of America Merrill Lynch (ICE BofA ML) U.S. High Yield Index, which tracks the performance of globally issued U.S. dollar-denominated, high-yield bonds. U.S. large-cap stocks are represented by the S&P 500 Index, which tracks the performance of 500 of the largest publicly traded companies in the United States. U.S. small-cap stocks are represented by the Russell 2000 Index, which tracks the performance of 2,000 publicly traded small-cap companies in the United States. It is not possible to invest directly in an index.

Diversification does not guarantee a profit or eliminate the risk of a loss.

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