Manulife Investment Management

Expect slower U.S. economic growth but not an equity bear market

The best way of being kind to bears is not to be very close to them

– Margaret Atwood

The U.S. economy surprisingly contracted by 1.4%, on a seasonally adjusted and annualized basis, for the first quarter of 2022. The consensus expectation for Q1 GDP, according to Bloomberg, was for a 1% gain, much slower than Q4 2021 GDP of 6.9%. While the number was negative, there were some positive components to the final number—such as strong imports, services, and purchases of durable goods (goods that can be kept for a period of time), which indicate a healthy consumer. A slowdown in U.S. economic growth has been long expected but the surprising negative period has led to increased chatter of a recession, broadly defined as two consecutive quarters of negative GDP growth and the potential of an equity bear market along with it.

Our take

While we were surprised at the negative announcement, we maintain our stance that atypical recession in 2022 remains a low-probability event. An economic slowdown is our base case, and it could lead to a pivot in the U.S. Federal Reserve's hawkish narrative, which would be positive for both equities and fixed income. Despite the surprise, it's not the time for a knee-jerk reaction when it comes to an investment portfolio.

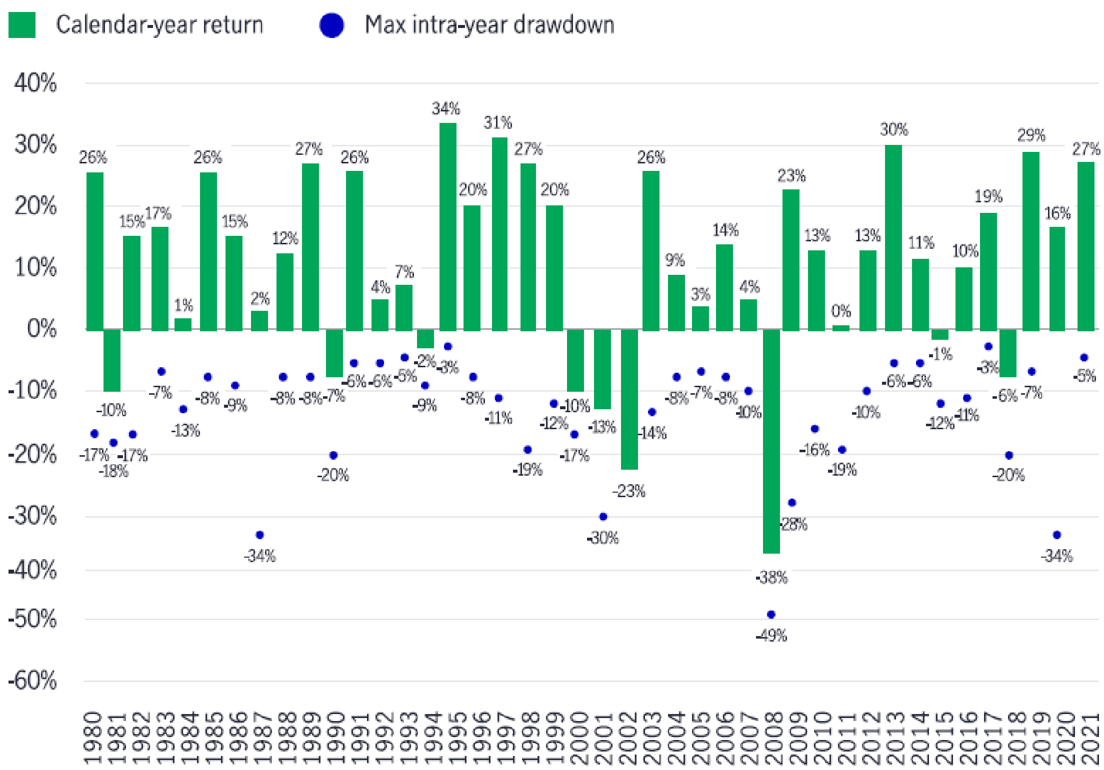
We have four simple rules that we like to use as a framework during these periods of heightened volatility. They are loosely based on advice in the event one comes face to face with a bear in the wild.

Rule #1 – Vanquish fear and panic

When it comes to the stock market, there'll always be a reason to sell. Negative headlines stoke fear in the minds of investors and that's a natural reaction from a human behavioral perspective. Loss aversion is a cognitive bias, which explains why individuals feel the pain of a loss twice as much as the equivalent pleasure of gain. As a result of this, individuals tend to try to avoid losses in whatever way possible.

Similar to a bear attack in the wild, corrections can happen at any time. Stock market corrections (a drop of 10% or more) are common and very difficult to predict. Since1980, the S&P 500 Index has fallen an average of 14.3% in any given calendar year but is positive 78% of the time with an average return of 10.3%! The key is to position an investment portfolio defensively prior to recessions that correspond to large equity drawdowns.

S&P Index – calendar-year and max intra-year returns (1980 – current)



Source: Capital Markets Strategy, Bloomberg, as of December 31, 2021

Another cognitive bias when it comes to humans and investing is availability bias, where we tend to listen the most to the information that's most readily available—like why we tend to read headlines and not the entire news article. It's important that investors take in all available information and make a sound, informed decision rather than one based on the most sensational headline.

Rule #2 – Know your environment

Our work would suggest that the U.S. economy has begun to slow down and will continue to do so throughout the year. But let's be clear: despite the slowdown, the probability of a traditional U.S. recession over the next 12 months remains low. When we say traditional, we mean one that lasts 10 months, on average, and often coincides with elevated unemployment. A technical recession, where GDP is negative over two consecutive quarters, is possible, but we believe a sustained bear market is unlikely.

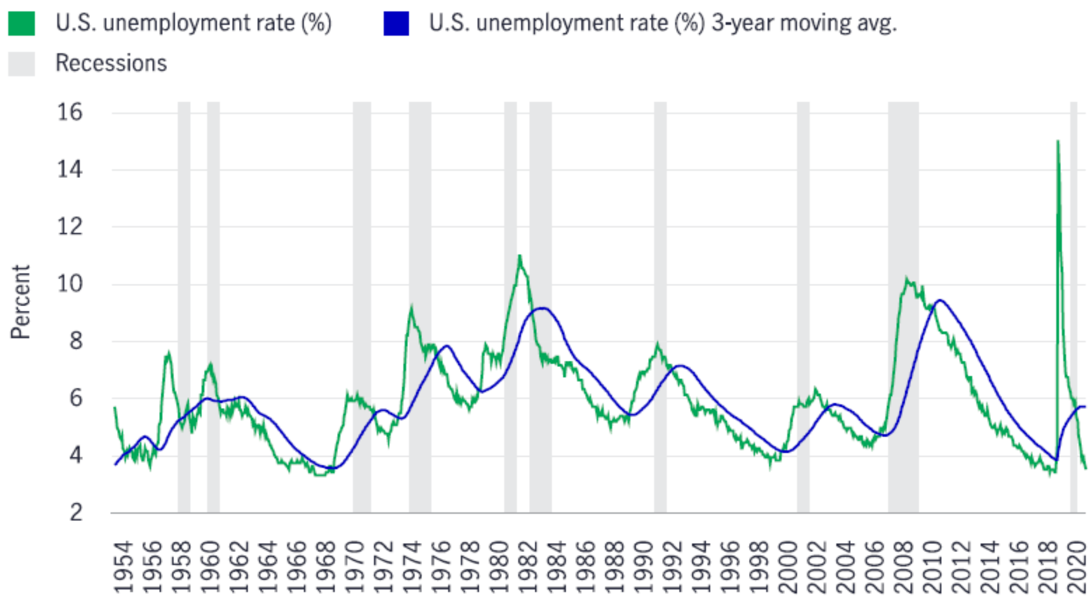
Historically, there are warning signals prior to falling into a traditional economic recession. Some of the signals that we look at are highlighted in the table below. Other than inflationary pressures, which was already signaling a higher risk of recession, we've now seen two other indicators: the yield curve, measured by the difference between the 10-2 year U.S. government bond yields, and financial conditions that have started to signal an economic slowdown. However, the other signs of a recession aren't present today, which supports our narrative of a slowing economy.

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

Source: Capital Markets Strategy, Bloomberg, as of March 31, 2022

Although the economic data is slowing, there's evidence that corporate earnings remain quite resilient. We're almost halfway through Q1 2022 earnings for the S&P500, and 76% of companies have exceeded expectations. Given the negative sentiment today, they're not being rewarded in the form of a higher share price. In their earnings calls, many CEOs are talking about their continued hiring intentions and the tight labour market. Unemployment in the U.S. is very low at 3.6%, and arguably a level that's synonymous with full employment. It's very rare to see recessions when unemployment is this low.

**Recession indicator – U.S. unemployment (%)
1954 – current**



Source: Capital Markets Strategy, Bloomberg, as of March 31, 2022

Rule #3 – Take advantage of opportunities

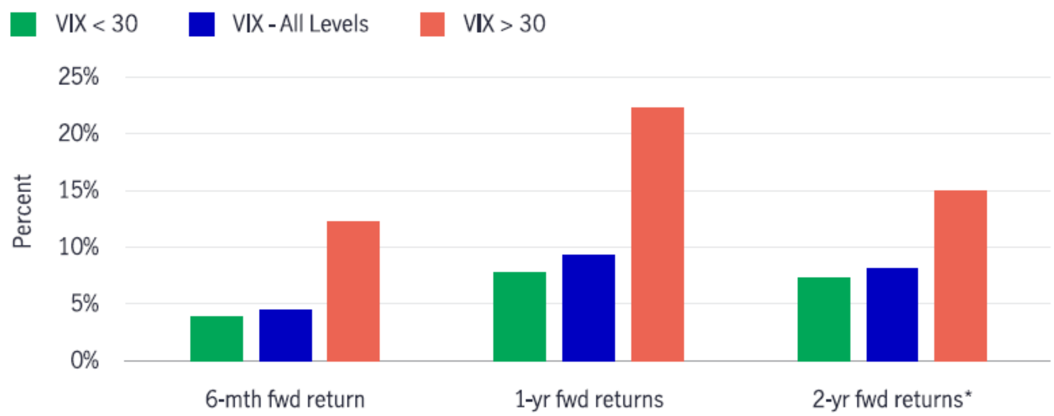
For the long-term investor, it's important to remain focused on the fundamentals. Warren Buffet attributes some of his success to being a contrarian investor. He famously said, "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." Investors know this investment truism to be accurate but it's often hard to execute.

The VIX Index is a great measure of the amount of fear in the markets. When the VIX index is high, there's more fear amongst investors. Since 1990, the VIX has averaged approximately 19, and a measure above 30 is an important level that signifies extreme aversion to equities.

The VIX is once again above 30. Historically, when the VIX has breached 30, the S&P500 Price Index return has been positive more than 80% of the time one year later.

The table below contrasts six-month, one-year, and two-year annualized returns for the S&P 500 Index since 1990 in periods when the VIX is greater than 30, in periods when the VIX is less than 30, and in all periods combined. History suggests that investors can improve their returns by becoming greedy and embracing risk when others are fearful and selling. However, in this environment, it's also important to take advantage of the right opportunities. This isn't a time to add to the higher risk areas of the market but rather to be selective.

S&P 500 Index – six-month, one-year, and two-year* (CAGR) forward returns (1990 – current)



Source: Capital Market Strategy, as of February 28, 2022

When it comes to predicting the number of U.S. Federal Reserve rate hikes, the market is notoriously bad at it. During most rate-hike cycles, the market tends to be overly aggressive in their expectations for the number of rate hikes by the Fed at the beginning of the cycle. Market expectations are for the Fed to raise the overnight interest rate a total of ten times over the next seven meetings leaving the Federal Funds Rate near 3% after the February 1, 2023 meeting. Should we see weaker economic data, it could give enough reason for them to pivot from their ultra-hawkish tone. Any shift in that tone to a less hawkish stance would likely be positive for both equities and fixed income.

Rule #4 – Don't be afraid of what goes bump in the night. If something is meant to harm you, it'll stalk you silently

There's another behavioral bias called confirmation bias. This is where investors seek out information to prove their beliefs. If they're worried about the economy or markets, they'll look for articles or comments on the internet, social media, TV, or elsewhere that helps support their fears. They won't look for information that'll help calm their fears. While it's important to not dismiss the fears, it's important to gather all information to come to an informed decision. It's likely that what they believe will cause the next recession and/or bear market won't be the main catalyst; it's likely to be something completely different.

Our final thoughts—don't run

The data is showing a slowdown in the U.S. economy and abroad, which will also likely impact the Canadian economy. However, it's important not to panic and have a knee-jerk reaction. One of the other key rules when coming across a bear in the wilderness, is not to run away, and that applies to investments. Take a step back, survey the environment, remember or revisit the plan, and stay on course.

Important disclosure

A rise in interest rates typically causes bond prices to fall. The longer the average maturity of the bonds held by a fund, the more sensitive a fund is likely to be to interest-rate changes. The yield earned by a fund will vary with changes in interest rates.

Currency risk is the risk that fluctuations in exchange rates may adversely affect the value of a fund's investments.

The opinions expressed are those of Manulife Investment Management, as of the date of this publication, and are subject to change based on market and other conditions. The information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable, but Manulife Investment Management does not make any representation as to their accuracy, correctness, usefulness, or completeness and does not accept liability for any loss arising from the use hereof or the information and/or analysis contained herein. Manulife Investment Management disclaims any responsibility to update such information. Neither Manulife Investment Management or its affiliates, nor any of their directors, officers, or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained herein.

All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment, or legal advice. Clients should seek professional advice for their situation. Neither Manulife, Manulife Investment Management Limited, Manulife Investment Management, nor any of their affiliates or representatives is providing tax, investment, or legal advice. Past performance does not guarantee future results. This material was prepared solely for informational purposes, does not constitute an offeror an invitation by or on behalf of Manulife Investment Management to any person to buy or sell any security, and is no indication of trading intent in any fund or account managed by Manulife Investment Management. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Unless otherwise specified, all data is sourced from Manulife Investment Management.