Manulife Investment Management

Asset Allocation Insights

Investing after COVID-19: finding lasting opportunities in the new normal

April 2021

Introduction

To call 2020 “unprecedented” wouldn’t begin to do justice to the depth of challenges individuals and organizations around the world found themselves unexpectedly confronting over the past year—nor the speed with which those challenges arrived.

It was early January 2020 when news broke of a pneumonia-like virus circulating in Wuhan, China; before the end of the month, the World Health Organization had declared COVID-19 a global public health emergency and less than six weeks later, many developed nations around the world had implemented broad-based lockdowns in an unproven attempt to contain a virus the medical community knew alarmingly little about. Businesses and schools were quickly shuttered. Those who could work from home did; those who couldn’t found themselves facing a precarious and uncertain financial future almost literally overnight.

While the cost in lives and livelihoods the virus has extracted over the past year is enormous, there is good news at hand and more on the horizon: The lethality of the virus is decidedly not as bad as some had originally feared, doctors and medical professionals have become much better at treating it, and multiple vaccines are already being administered. And while a surge in variants and a third wave of the virus are still weighing heavily on many parts of the world, there are many reasons to be optimistic that 2021 will improve upon 2020.

But despite the near-universal desire to turn the page on 2020 and return to some version of the “old normal,” the pandemic and the changes it has brought with it will almost certainly transform societies in some lasting ways, both big and small. This paper takes a closer look at those changes, the economic and market implications they suggest, and how investors might position their portfolios to benefit from them. We break down both the short-term tactical opportunities we see unfolding as well as some of the longer-term, more permanent shifts likely to transform the economy and the way investors think about the markets.

Part 1: Technological disruptions

The great office exodus

Naturally, not all jobs can be done from home, but one of the more immediate effects of the pandemic was to launch a massive social experiment to discover exactly how many could.

Before COVID-19, estimates suggested that no more than a quarter of all full-time employees worked from home, but since March that number has climbed to at least 37%; some estimates suggest the actual figure is closer to 50%. In certain industries and locales, the current number is significantly higher than that: Computing, legal, business, education, and finance occupations all reported at least 88% of their employees working from home.[1]

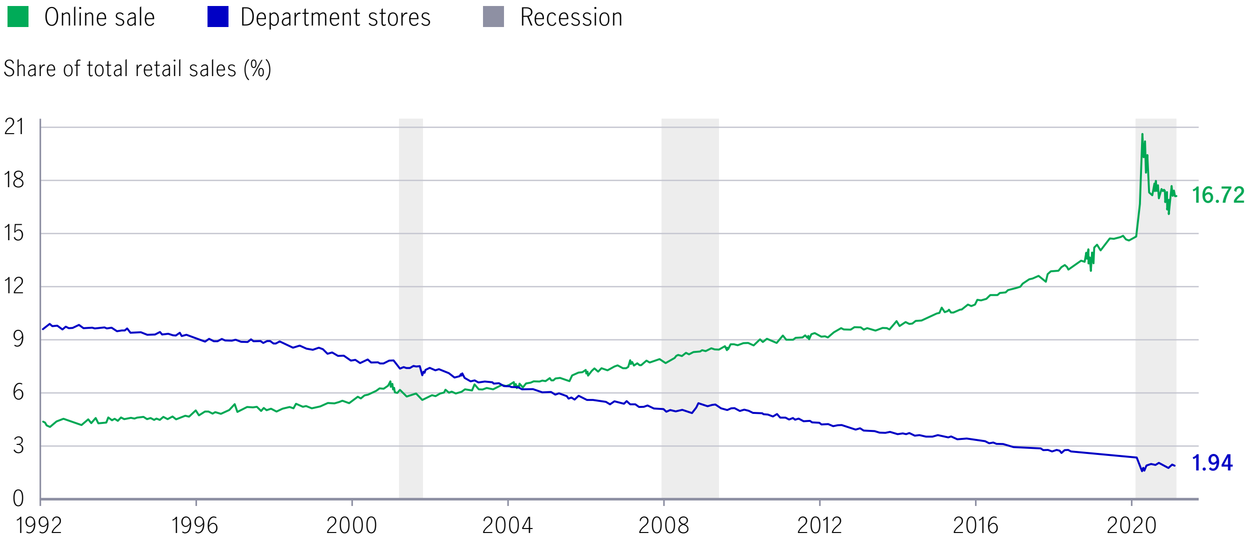
While unexpectedly changing the daily work habits of large swaths of the population may seem like a mostly personal disruption, it has had significant knock-off effects on the economy in some profound ways.

More money spent in and on the home

The dramatic shift in the demands placed on the home—from serving primarily as family sanctuaries to becoming much more multifunctional and versatile spaces—has brought with it a number of changes in patterns of consumption. E-commerce and streaming services, for example, have experienced huge increases in demand as more and more consumption has occurred within the home; that single shift in where buying decisions are made has produced some clear beneficiaries. Brick-and-mortar local businesses, already under decades-old pressure from the shift to online buying habits, will likely continue to lose market share to their digital multinational competitors.

[1] "How Many Jobs Can be Done at Home?" Jonathan I. Dingel and Brent Neiman, Becker Friedman Institute, June 2020.

U.S. consumer: online retail has stabilized at higher levels



Source: U.S. Census Bureau, Macrobond, Manulife Investment Management, as of 15 April 2021. The gray areas represent recession. All economic and/or market performance data is historical and does not guarantee future outcomes.

Increased demand for data

The demand for data itself will likely see a sharp increase. Companies that have successfully weathered the relocation of entire workforces—from out of the office building and into the home office—will find their need for physical space shifting to a need for more digital space. Supporting remote workers through file storage, videoconferencing, and collaborative platforms requires significant investment in cloud-based infrastructure.

Beyond the field of business, the healthcare and education fields also both experienced dramatic rises in demand for data as telemedicine and remote learning both leapt into the limelight this year (with decidedly mixed initial results). Governments, too, may discover an increased appetite for data at multiple levels. Contact tracing, early-warning systems designed to spot flare-ups, and healthcare databases all require significant digital footprints. A great deal of disparity exists between those governments that were early adopters on this front (e.g., South Korea) and those that may feel compelled to catch up (the United States, Canada, and much of Europe).

The bottom line is that those segments of the economy levered to rising demand in digital consumption channels look well positioned for the years to come; those that cannot adapt (i.e., shopping malls) will likely be left behind.

- Positively affected sectors: e-commerce, education, technology, media, telecom
- Negatively affected sectors: general retail, real estate, autos

Lean workforces meet machine workforces

The pandemic clearly highlighted the vulnerabilities in global manufacturers' supply chains this year, and there are a number of changes already emerging in response. Automation, we believe, is an area that will likely see accelerating demand in a postpandemic world. The competitive advantage in being able to perform vital production line functions with minimal staff is, by this point, self-evident, and we believe that trend is only beginning to gather momentum. Artificial intelligence and robots will permeate general-purpose machinery in areas such as food, healthcare, consumer goods, and e-commerce, we believe, helping to better insulate supply chains from exogenous shocks.

The risks exposed by the pandemic aren't the only factors driving this trend. Aging workforces in many parts of the world combined with falling prices as automation technology becomes both more accessible and more efficient should speed the rate of adoption. Both providers of automation technology and those sectors that implement it most effectively stand to benefit, we believe.

- Positively affected sectors: capital goods, e-commerce, technology software

- Negatively affected sectors: travel and leisure

Part 2: Deglobalization

Home field advantage for travel

The reports of business and personal travel's demise in a post-COVID-19 economy are greatly exaggerated. But we do see evidence that travel will be more regional than the trends of previous years indicate. Long multinational business junkets are likely to be curtailed, while international vacations and cross-country trips are likely to transition to outings closer to home.

Migrant workforces may also play a smaller role in the overall global economy in a postpandemic world. The desire and ability of individuals, skilled or not, to cross international borders for work is likely to take several years to return to 2019 levels; some regions and industries where automation and remote work arrangements accelerate may not return to those levels at all.

The West and China: a conscious uncoupling?

It's hard to overstate the significance of China in global trade. One study estimates that roughly 12% of all imports globally originate in China, with levels closer to 20% in the European Union, United States, and Japan.[2] For companies that rely on overseas supply chains, that kind of concentration of risk in a single geography represents a risk that today looks increasingly imprudent. For that reason, we envision a deliberate deemphasis and diversification away from China for developed-market supply chains—and we see a corresponding move by China to deemphasize its reliance on Western markets, accelerating the expansion of its internal value chains and nurturing the growth of a consumer-driven economy.

- Positively affected sectors: media, pharma, food retail
- Negatively affected sectors: transport and logistics, tech hardware and telecom, aerospace, travel and leisure

[2] "The Post-Covid Economy," OECD, Barclays Research, August 2020.

Part 3: Policy and priorities revisited

The baton passes from monetary to fiscal policy

There have been numerous comparisons between the global financial crisis and the lockdown-driven economic collapse of 2020; one comparison worth a closer look is the government fiscal and monetary response.

In 2008, when the global financial crisis loomed, central banks unleashed unprecedented levels of stimulus, including the United States' first foray into quantitative easing. Government spending programs generally played a smaller role to monetary policy, with some regions toeing a budget austerity hardline.

At the beginning of the COVID-19 recession, central banks around the world once again intervened, this time expanding their toolbox even further than in 2008 to include, importantly, direct support of credit markets. However, as winter set in on the northern hemisphere in Q4 2020 and cases spiked again, the recovery's momentum stalled. Subsequent social distancing measures have kept a lid on businesses' operating capacity and job losses began to affect aggregate demand. Problematically, while central banks have been able to provide support to the economy and to financial markets, the crux of the economic headwinds has remained the virus and the pace of vaccinations. As such, monetary policy appears to have reached its limits in the fight against a global pandemic.

Fortunately, governments, particularly in the United States, seem poised to fill the gap and enter a phase of higher baseline structural levels of support. The rollout of vaccines around the world will eventually diminish the urgency of new spending initiatives, but today there remains an opportunity for direct investment in government-favored projects, including infrastructure, education, and greater incentives for investment in low-carbon technologies. We see the emphasis on fiscal spending as the appropriate ongoing tool for economic support to persist, contributing to a larger role for government and, importantly, more sovereign bond issuance.

- Positively affected sectors: infrastructure, education, real estate
- Negatively affected sectors: banks, travel and leisure, general retail

Reevaluating investor priorities amid growing demand for ESG

The pandemic has reminded us how important it is to select companies that can adapt to new ways of consumption and maintain existing levels of service—or even add value—in the absence of fewer physical touchpoints. We've also seen a shift away from profit maximization toward corporate social responsibility that considers the interests of all stakeholders, including clients, employees, shareholders, the community, and the environment.

As a result, we're seeing investors increasingly turn to sustainable investments that track environmental, social, and governance (ESG) factors. According to Morningstar, active funds that invest according to ESG principles have attracted net inflows of more than $70 billion globally in the second quarter of 2020, pushing assets under management in the products to a new high of just over $1 trillion.[3]

This significant global inflow into ESG products may foretell shifting priorities for other forms of capital allocation. Poverty and disease have long traveled hand in hand, and as income disparities continue to be exacerbated by the pandemic, so too will health outcomes, both between and within nations. Even among OECD member countries, we've seen a plateauing of the ultimate health metric—life expectancy—in the 21st century.[4]

But there is reason for optimism. There is today clear evidence of greater consumer engagement in health, and significant advances being made literally every day in the creation of better treatments and therapies and the adoption of new and significant health technologies. After all, in a world concerned about pandemics, health considerations will remain top of mind as governments and corporations formulate their post-COVID-19 planning to address the well-being of citizens, employees, and stakeholders.

Health

- Positively affected sectors: real estate, e-commerce, medtech
- Negatively affected sectors: beverages, luxury, aerospace

Sustainability

- Positively affected sectors: education, real estate
- Negatively affected sectors: banks, travel and leisure, general retail

[3] "ESG funds attract record inflows during crisis," Financial Times, August 10, 2020.

[4] "Health Equity in England: The Marmot Review 10 Years On," The Health Foundation, February 2020.

Part 4: Putting it all together: views from multi-asset solutions team

Economies around the world have slowly started to reopen, albeit unevenly and subject to their vaccination rollouts. In terms of macro data, we've seen encouraging improvement in unemployment figures, with the pace of job creation now sharply accelerating in the United States. Manufacturing data in the United States has surged to its highest level in decades, suggesting positive prospects for the manufacturing side of the global economy, particularly relative to the consumer. More recently, the latest U.S. Purchasing Managers' Index data in 2021 is showing not only a stronger recovery in manufacturing, but also a sizeable improvement in services activity.

Looking at the opportunity set in 2021, we see the merit in taking a balanced approach, tilting toward sectors that are poised to benefit from a continued economic recovery, while also incorporating some more cyclical areas that look undervalued.

We still see upside potential in 2020's market leaders, including tech, communications, consumer discretionary, and growth stocks in general, but we're balancing those areas with targeted positions on the value side, such as industrials, materials, metals and mining, and selectively with financials.

Macroeconomic themes for 2021

- **Inflation returns**

  We expect headline inflation in the United States to rise significantly in Q2 to highs rarely seen in the past decade. Where the financial markets are concerned, what matters is whether inflationary pressure will persist into Q3 and Q4. We don't expect it to, but it's worth noting that any evidence of sustained inflationary pressures above 2.5% on a year-over-year basis is the largest—and most important—risk to our outlook (and the markets).

- **Central bank speak**

  Central bank communication can represent a risk in the coming quarter as policymakers begin to look for ways to normalize monetary policy without exacerbating the sell-off in the bond market. Reaching a happy medium isn't likely to be a smooth process—expect bouts of volatility in fixed-income markets as the yield curve continues to steepen gradually and interest rates climb.

- **Catching up: global services sector**

  We expect the global services sector to catch up fairly aggressively with global manufacturing activity in Q2. That said, it's worth questioning if the global industrial complex (including commodities) can maintain the current level of strong performance throughout the entire quarter—it's one of the few downside risks to our outlook.

- **Emerging markets**

  We remain long-term, strategic believers of emerging-market (EM) assets—both equities and debt. However, peak liquidity, the expected appreciation of the U.S. dollar (however brief), and the slowing growth momentum in China suggest that EM assets could experience mounting headwinds in the coming months. We view any periods of underperformance as an opportunity to reengage.

- **Domestic economic structure**

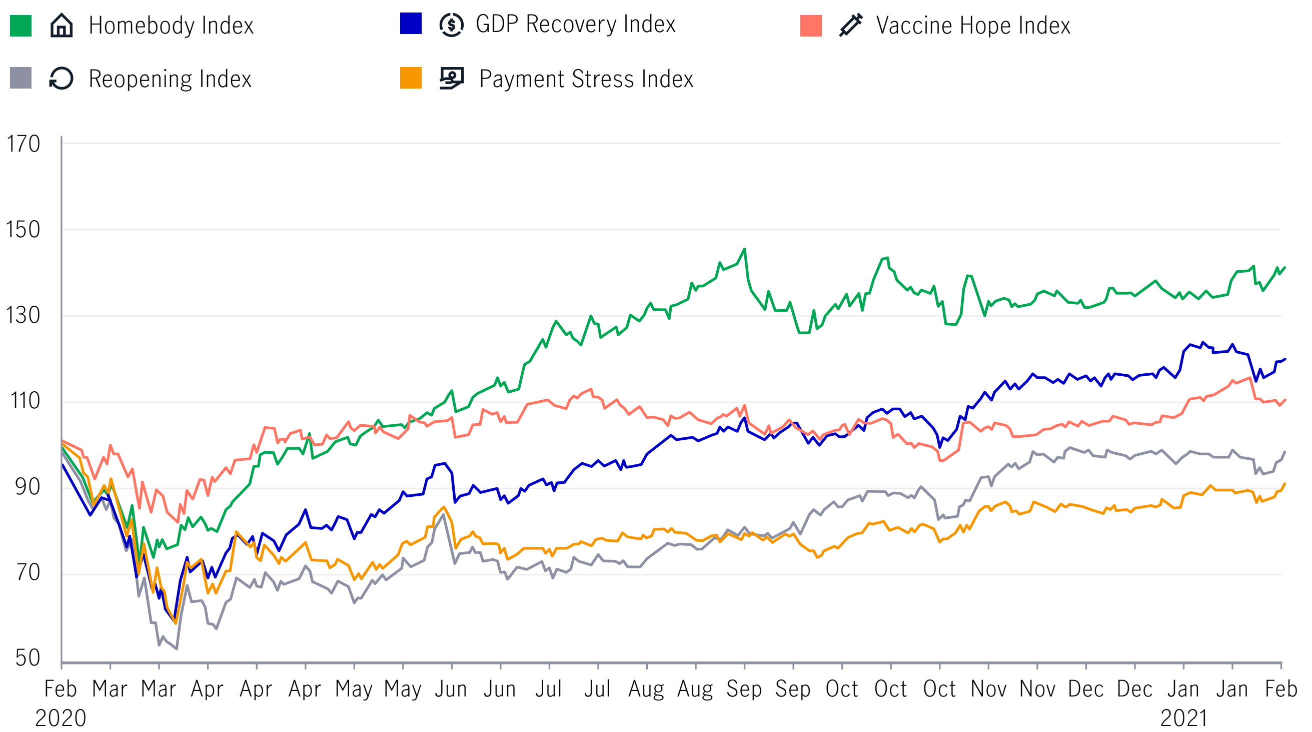
  While investor focus will no doubt be on the great reopening of the global economy, much of the growth outlook for many economies continues to be defined by domestic structural challenges—from persistently low inflation (Japan) to systemically low levels of fiscal support (Europe) to potential housing bubbles (Canada).

Portfolio construction considerations

While we believe there are a number of meaningful short- and long-term opportunities emerging as the world finds a new kind of post-COVID-19 equilibrium, not all of them are easily accessible for investors—not even global institutional asset managers. Some may be too nascent to reliably take advantage of, while others may not offer the necessary scale to add meaningful value to a portfolio.

Nonetheless, these underlying trends can still be monitored and can certainly shape the way we think about the macro environment—a shift away from traditional premises toward emerging, unconventional macro trends. Since the outbreak of the COVID-19 pandemic, we've been tracking a number of alternative data sets, such as the Vaccine Hope Index, Reopening Index, Homebody Index, GDP Recovery Index, and Payment Stress Index. While indexes like these represent just one way we're able to glean insight about the way these investment themes are manifesting themselves in the markets, we believe adding this kind of hard data to our thematic observations is crucial to formulating actionable investment ideas.

Unconventional indexes offer a unique window on today's economy—and today's opportunities. S&P subindex performance, indexed to 100, as of Feb. 20, 2020



Source: Macrobond, Standard & Poor's, Manulife Investment Management, as of February 25, 2021.The indexes above consist of various subsectors of the S&P 500 Index as compiled by Macrobond. It is not possible to invest directly in an index. For more details on the subsectors in each index, see the disclosures below.

Global sector roundup: our 2021 outlook[5]

- **Growth equities: positive**

  Our expectation is for a shift in style leadership as recovery from the recent downturn continues, although it's unclear when that will happen. Over the near term, low interest rates should be supportive of stocks with higher growth rates.

- **Value equities: slightly positive**

  We continue to expect sector and style rotations into 2021, out of growth and into cyclicals/value, as yield curves steepen on the back of reflation. We expect tech to continue to perform well, but will likely lag cyclicals going forward.

- **Quality equities: neutral**

  Quality tends to be more defensive, which could offer support if there is volatility near term. As defined by those companies with strong balance sheet liquidity by comparing current assets to current liabilities, quality has been a top decile factor over the past 10 years.

- **Financials: positive**

  Financials should benefit from fiscal stimulus longer term and valuations remain attractive.

- **Industrials: positive**

  Relative valuations are neither a headwind nor a tailwind. A large-scale infrastructure bill in the United States would be bullish, however, and boost sentiment in the short term. The sector and associated subindustries have historically outperformed over the medium term when government infrastructure spending is greater than 2% of GDP.[5]

- **Information technology: positive**

  Tech has been a consistent outperformer as companies across industries seek more productivity and efficiency. The sector is likely to be positioned well for continued market leadership moving forward

- **Global healthcare: neutral**

  Though relative valuations remain attractive, we maintain our neutral for the short term until there is more certainty around future policy.

- **Global consumer discretionary: positive**

  Consumer discretionary is more cyclical and is expected to outperform in a reflationary environment. Consumer credit and capacity utilization data suggests slight improvements with more room for cyclical outperformance.

- **Global consumer staples: neutral**

  We're currently neutral on this sector, but believe there are some individual names worth a closer look.

- **Global energy: positive**

  Energy is expected to perform well under a reflationary environment with the expectation of firming oil prices. An increased demand for oil helps drain excess inventories, drive normalization, and increase cash flows. The sector remains underowned and has attractive valuations across multiple dimensions (price-to-earnings ratio, price-to-book ratio, and price/earnings-to-growth ratio).

[5] Manulife Investment Management's multi-asset solutions team, as of March 16, 2021. Projections or other forward-looking statements regarding future events, targets, management discipline or other expectations are only current as of the date indicated. There is no assurance that such events will occur, and if there were to occur, the result may be significantly different than shown here. Individual portfolio management teams may have different views and opinions subject to change without notice

- **Global materials: positive**

  Materials have been setting new relative highs on an equal weighted basis versus the broader S&P 500 Index, exhibiting both positive momentum and trend behavior. The materials sector is also currently displaying one of the strongest combinations of earnings and price momentum of any sector in the S&P 500.

- **Global utilities: neutral**

  We're currently neutral on this sector.

- **Global telecoms: neutral**

  We're currently neutral on this sector.

- **Equity market overall: slightly positive**

  We ultimately hold only a cautiously optimistic view at the overall market level. We see relative value in high ROE companies that can sustain positive earnings growth over the foreseeable future.

Asset allocation considerations: balancing equities with fixed income

When thinking about fixed income from a multi-asset perspective, in a world where investors are feeling increasingly compelled to reach for yield, the most attractive opportunities lie outside of the sovereign debt space. But that also suggests to us that the overall valuation for equities should be thought of in a new light.

It's conceivable that equities trade at slightly higher multiples over the foreseeable future in large part because the comparison to fixed income isn't the same as it was over the past 30 years; while bond yields have ticked up modestly, they are still exceptionally low by historical standards.

In such an environment, investors may continue to reward companies that have growing earnings stream, regardless of sector, and those companies may very well trade at higher multiples than they have in the past. We believe that possibility makes it somewhat more challenging—and important—to identify which sectors and securities truly present the opportunity for growth at a reasonable price.

Macrobond's COVID-19 S&P 500 subindexes are composed of the following subsectors, whose inclusion in indexes may not be mutually exclusive:

GDP Recovery Index: chemicals, energy, copper and steel, building products, construction, electrical equipment, machinery, roads and rail, commercial and professional services, consumer discretionary, movies and entertainment;

Homebody Index: food retail, hypermarkets, home improvement, internet retail, home appliances, computers and electronics retail, wireless telecom, interactive media;

Payment Stress Index: REITS, utilities, banks;

Reopening Index: airlines, apparel, hotels, leisure, restaurants, department stores, aerospace/defense, REITs (office, hotel, retail);

Vaccine Hope Index: biotech, health care tech, life sciences tools and services.

Important Information

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 pre-existing 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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