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Mid-year outlook: what investors need to know

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Good afternoon, everyone! On behalf of Manulife Private Wealth, I'd like to welcome you to our Wealth Insights webinar.

I'm Macan Nia, Co-Chief Investment Strategist here at Manulife Investment Management. And joining me today is my partner in crime, Kevin Headland. He is also Co-Chief Investment Strategist at Manulife Investment Management. We're happy to be with you today, and we're happy you could take a few moments out of your busy summer day to listen to us.

We're now at the halfway point of 2025, and as the saying goes, it's been quite a volatile roller coaster ride. It might feel like ages ago, but Liberation Day was actually just a little over three months back. Though if you ask Kevin, he'll probably say it feels like three years ago!

The past six months have been quite volatile. But when we look at capital market returns today, it might surprise many that, despite the ongoing headlines and uncertainty, most developed markets around the world are seeing positive equity returns. In fact, we're seeing mid-to-high single digits gains in many regions, and European equity markets are even posting low double-digit returns.

Bond markets have also performed well, Delivering low to mid-single digit returns. But that's all in the past. This business is always forward looking. So, over the next half hour, we'd like to share our outlook on where we see the world heading from an economic standpoint, as well from the perspectives of both equity and bond markets.

The title of today's presentation is Fast and Furious 25.

Many of you are probably with the Fast and Furious franchise. To my surprise, it turns out it's actually one of the top-performing movie franchises in history, ranking in the global top ten. And we've talked about tiers and over the last three to four months, it's felt like a whirlwind of volatility, and uncertainty. Day-to-day changes, especially around tariff announcements, have left investors feeling whipsawed, constantly shifting their focus left, right, and center. But as investment advisors or specialists, our job is to make sense of the noise and regardless of the market environment, there's always an opportunity to make money.

As we move through today's session, we'll highlight some key takeaways from the presentation, focusing on the global economy, and the current balance of risks. You'll never hear Kevin or I provide specific targets.

Accurately and consistently forecasting targets are extremely challenging, and in my experience, I have yet to meet anyone who can do it reliably. However, we believe our strength lies in identifying the direction of the trend rather than attempting to pinpoint exact targets. We believe the balance of risks to the global economy remains relatively low as we move through the second half of the year.

Turning to equities, I'd like to highlight an important point. When US equities experienced a sharp selloff three months ago, we were among the first to suggest that the prevailing pessimism was excessive. Since then, we've seen a strong rally in the market. While occasional bumps or headlines-driven risks continue to emerge, we believe those concerns are largely overstated.

When we assess the equity landscape, we continue to see corporate profitability as the primary driver of stock performance moving forward. From a bond market perspective, both the Bank of Canada and the Federal Reserve are expected to implement rate cuts in the second half of the year.

However, the magnitude of these cuts is likely to be significantly lower than what investors had anticipated at the start of the year. Both central banks are currently navigating complex and challenging environments, which makes it difficult to implement interest rate cuts.

Despite these challenges, bonds income remain highly attractive in today's market landscape. That said, we continue to emphasize the importance of active security management whether You're investing in equities or fixed income.

Let's now shift our focus to the broader global economic backdrop. There are several lenses through which we can analyze the global economy, and today, we'll walk you through a few of them.

The First Lens is manufacturing. You might wonder why we're highlighting manufacturing in developed markets, were nearly three-quarters of GDP is driven by consumption. The reason we're focusing on manufacturing is because it offers valuable insights into profitability trends across various market indices. When assessing the health of global manufacturing, we turn to a key financial indicator widely recognized in investment circles called Purchasing Managers' Index or PMI.

So, what exactly is in the PMI? It's a survey conducted across thousands of managers in each of the countries listed on the left hand side. These managers are asked a series of questions about the health of their business. The PMI survey asks managers practical questions like Kevin, are you planning to hire soon? Or how are your input costs changing?

We won't get into the math because it's a bit technical, but here's the key: a score above 50 means companies are generally growing, while a score below 50 indicates contradiction.

Kevin and I like to keep things simple.Green is good, yellow is neutral, and red is bad. This color-coded view shows how global manufacturing has changed over the past two years. On the far left, you'll see data from June two years ago and on the far right, from this past June. A lot of yellows, a lot of reds, a few greens. And when you look at the survey questions that hint at where things might be headed, the balance of risks is currently tilted to the downside.

We've highlighted two key areas to see. At the top, you'll notice we've highlighted Canada and Mexico in red. Unsurprisingly, these economies are highly vulnerable to tariff uncertainty. And that impact has been visible in their manufacturing sectors from March all the way through last month.

If tariff uncertainty continues, we expect this weakness to persist. About three quarters down the chart, we've also highlighted several export driven Asian countries, which very similarly vulnerable to tariffs. These economies we're referring to include China, South Korea, Taiwan and Indonesia. While the impact isn't as severe as what we're seeing in Canada, which comes as no surprise, there is clear weakening in this market.

So, as we move through the second half of this year, if uncertainty around tariffs continues, we believe the path of least resistance is likely downward. And this is the challenge: uncertainty around tariffs.

This chart shows measures of tariff uncertainty. Since the Trump administration up to 2025, it has skyrocketed, and recently, it has increased again. One positive development has been recent announcements between the US and other countries. Japan is a good example. There are also rumors that the Europeans and Americans may be close to reaching a resolution. We'll see what happens with Canada.

But if tariff uncertainty remains elevated, it will continue to pose challenges for profitability. Because frankly, one thing humans value is certainty. From a government perspective, even in your own lives, you prefer certainty over uncertainty.

Companies feel the same, and this affects spending and profits. So, if tariff uncertainty increases over the next couple of months and continues to rise, it will likely lead to weaker risk sentiment.

As previously mentioned, developed market such as Canada, the U.S., and Europe is primarily service based and driven by consumer activity. In these economies, consumption plays a central role in fueling growth.

What you're seeing here is a snapshot of Consumer dynamics across these regions. On the left side of the chart, we see the strength of the service Sector. And as we move, toward the far right, it's evident that services continue to fall within the yellow to red zones, Indicating area of concern.

If the cost of living remains elevated, and interest rates do not decline as quickly as investors anticipate, this could present significant headwinds for consumer spending moving forward.

Earlier this morning, we received the latest Canadian retail sales figures, and as expected, the data continues to reflect weakness in the sector. This isn't just a one-off when we look at the average over the past three months, the trend suggests ongoing softness in consumer activity.

This likely to persist, especially in the light of a recent Bank of Canada report indicating that approximately 60% of Canadian mortgages will be up for renewal in the next couple of years. For those with variable rate mortgages, myself included. We've seen a decrease in payments. However, 40% of homeowners with fixed mortgages, depending on the terms of their original agreements, could face payment increases ranging from 10% to 40%.

This kind of increase is likely to have noticeable impact on household consumption. Kevin will speak more about the broader implications and the challenges this presents for both the Bank of Canada and Federal Reserve, particularly in the context of interest rates decisions.

These challenges are compounded by the resilience of the American economy, which continues to defy expectations. Inflation continues to rise, but unlike the U.S., the Canadian economy is not showing the same level of resilience. At the margin, inflation has remained relatively sticky, settling into this new range and showing limited signs of easing. Now, let's turn to the chart.

The green line represents hard data, while the blue line reflects soft data. This chart goes back to 2015, giving us a view of the last ten years.

So, what do we mean by hard data and soft data? Hard data refers to objective facts, things like job losses in the Canadian economy or inflation figures. Measurable realities that help shape our understanding of economic conditions.

On the other hand, soft data is based on sentiment and perception. For example, surveys that ask individuals, like Kevin, how they feel about their financial situation. These responses are influenced by expectations and emotions about the future. Up until the most recent data point, hard data had been the primary driver of economic insights.

While the hard data remained resilient, soft data continued to weaken. In other words, when enough people feel uncertain or pessimistic about the economy, those sentiments can influence real world outcomes. And we've started to see this reflected in the most recent data prints.

So, this is something we're monitoring closely, particularly the point at which consumer sentiment begins to solidify. When feelings become entrenched, they can start influencing actual economic behavior, turning perception into reality. Probably to no one's surprise on this call, when we look at the soft data in the U.S., we see a clear divide along political lines.

The Democrats tend to feel more optimistic about future, while the Republicans generally, view the economy as moving ahead strongly, reflecting a more optimistic sentiment about current conditions and future growth.

This is where the challenge lies. When analyzing data, it's essential to consider the source behind it. And while we're closely monitoring global economic indicators, it's important to note that we're not forecasting a recession far from it. Is it possible? Perhaps, but it's not probable.

While It's a low probability event, the path of least resistance at this stage appears to be toward a weaker outlook as we move through the second half of the year. So, let's shift our focus to equities. As I mentioned earlier, if we listed everything that's happened in the first six months of the year, many would be surprised by how strong equity performance has been.

Despite the backdrop, markets have held up remarkably well in the first half. Now, one challenge we continue to highlight is uncertainty. We've touched on this before and it's important to understand why it matters.

There are two key reasons we point to in our analysis. Blue line represents a measure of economic uncertainty, and the green line shows the VIX. What is VIX? The VIX is a widely used gauge of volatility for the S&P 500, which reflects broader movements in the US stock market.

And it's no surprise that uncertainty remains elevated whether about personal situation or the broader environment, market volatility tends to rise.

This is a natural response, as uncertainty often drives more reactive behavior in financial markets. Right now, we see a rise in uncertainty and with that, the potential for increased volatility over the coming months.

One important relationship we haven't shown here is between uncertainty and savings rates. Historically, when uncertainty increases, households tend to respond by saving more and spending less. This behavioral shift can have meaningful implications for overall economic activity so let's take a closer look at spending behavior. When uncertainty arises, many households reassess their budgets. Looking at disposable income and identifying areas to cut back, what does that mean for the broader economy? It means fewer dollars circulating, which can pose challenges for businesses and profitability.
This ties directly into market dynamics.

While I won't go too deep into the weeds here, it's helpful to remember that there are three primary drivers of market returns in any given year: Number one is the dividends; Number two is the profits; Number three is valuations. Valuations can be tricky to interpret, as they're influenced by sentiment, interest rates, and broader macroeconomic conditions. In a nutshell it's all about sentiment. It is what people are feeling. Over the past few of years, sentiment has been a major driver of markets across the globe.

But it's important to recognize that sentiment alone can't sustain market movements indefinitely. We may initially give a company the benefit of the doubt, but eventually, We expect it to demonstrate why it deserved that trust.

In other words, sentiment must translate into profitability. As we move into the second half of the year, companies that are delivering strong earnings and meeting investor expectations are the ones most likely to continue performing well. Right now, we're in the middle of earnings season, and we're already seeing this dynamic play out. With that, I'll pass it over to you to take us through the second half.

Kevin Headland, CIM
Co-Chief Investment Strategist, Manulife Investment Management

Thanks Macan.

As you mentioned, valuation has played a major role in driving markets. But now, the focus is shifting back to earnings growth essentially, a 'show me the money' moment.

Investors are asking companies to prove their worth today based on expectations of future earnings.

There's a growing narrative that the U.S. market is expensive. On this chart, the gray bars represent the 20-year historical valuation ranges across various global indices. These bars reflect what investors have typically paid for earnings over time. The red diamond shows the current valuation, while the blue circle represents the five-year average.

The key takeaway here is that while the S&P 500 may appear expensive, context matters and comparing current valuations to historical norms helps us better understand where we stand. And here, we highlight the red-yellow square excuse me, the ten-year average. When we look at the S&P 500 index, it does appear somewhat expensive. The red diamond, which marks the current valuation, sits above the average and near the top end of the historical range represented by the gray bar. But what's more important to us is the next bucket: the S&P 500 Equal Weight Index. What does the S&P 500 Equal Weight Index tell us? It equalizes all components of the S&P 500, giving each company the same weight regardless of size. This helps us see that much of the valuation extremes discussed in the media are largely driven by the biggest companies, particularly the tech giants, often referred to as the 'Magnificent Seven' or the top ten.

What that tells us is there's still a lot of opportunity to pick. This insight highlights that there's still meaningful opportunity in individual stock selection. As mentioned earlier in the presentation, we're focusing on security selection identifying quality companies that are well-positioned to drive returns going forward.

This doesn't mean stepping away from markets. In fact, we recently ran an exercise and shared it on LinkedIn: even when investing at record highs, historical data shows that one-year forward returns remain attractive.

Looking back over the past 30 years, investing only on record-high days still yielded an average one-year return of around 10%. So don't be discouraged by hearing that markets are at record highs. This isn't something to shy away from, in fact, it can present a compelling opportunity to invest.

Looking at this chart, we also examined valuations across global markets from Canada to the Russell Midcap, emerging markets, European equities, and international equities. What stands out is that the red diamond, which marks current valuations, is generally not above the long-term average. That tells us there's no obvious place to invest right now borrowing a comment from one of our colleagues in the U.S.

Our focus is on acquiring companies not countries. We're aiming to build a diversified portfolio of equities, with a strong emphasis on high-quality companies. Active management will be critical to driving performance over the next 12 to 18 months. As mentioned, earnings growth is expected to be uneven.

It's not a straightforward opportunity. If we look at the Purchasing Managers' Index (PMI). That's a neutral zone: not great, not terrible. This suggests that earnings growth, represented by the green line, will likely remain choppy and directionless.

In this environment, identifying companies that can outperform the broader market becomes essential. We're looking for businesses with strong fundamentals, those with sustainable earnings growth, lower debt profiles, and competitive advantages or 'moats' within their industries. These are the types of companies that we believe will lead in the months ahead.

Unless we see a significant uptick in the PMI, equity returns will be harder to come by. That's why our focus is on quality companies with predictable performance and resilience.

Switching to fixed income: bonds have been overlooked by many investors, especially after the challenges of 2022. But nearly four years on, it's time to move past that. Fixed income has proven to be a strong asset class, delivering solid returns over 5% net of fees and offering downside protection.

This is a very attractive environment for fixed income, as Marco mentioned. Central banks like the Bank of Canada and the Federal Reserve have set expectations, and the market has priced in potential rate cuts. This creates opportunities for investors to re-engage with bonds as part of a balanced strategy.

This outlook is grounded in mathematics, specifically, data from the options market. It's something we monitor regularly to gauge market expectations. Let's start with the Bank of Canada. The blue line here shows that the market is currently pricing in approximately 0.88 rate cuts. In simpler terms, there's an 88% chance of a single 25 basis point cut by the end of this year. Now, we often get asked: 'What's priced in by year-end?' But the real question is: 'What happens beyond that?' The end-of-year forecast matters less than the broader trajectory of rate policy.

What we're seeing is that the Bank of Canada is nearing the start of its rate-cutting cycle, which we view as a positive development. Depending on how the data unfolds, particularly around inflation and economic growth, we could see one or two additional cuts next year.

The central bank's role here is to support economic growth, and rate cuts are one of the tools they can use to do that.

Turning to the U.S. Federal Reserve: they've been on pause for some time, but the market is now pricing in about 1.89 rate cuts by year-end. That's nearly two 25 basis point cuts, with the first likely coming around September again, highly dependent on incoming data.

There's also political pressure, particularly from the Trump administration, urging the Fed to ease rates. This adds another layer of complexity to the decision-making process.

In summary, while the timing and magnitude of rate cuts remain uncertain, the direction is becoming clearer. Both central banks are approaching a more accommodative stance, which could have meaningful implications for fixed income and equity markets alike.

Ultimately, central banks will remain data dependent. It will be interesting to see what unfolds next year as Jerome Powell's term as Chair of the Federal Reserve comes to an end or enters a new phase, depending on reappointment.

However, it's important to remember that rate decisions are made by committee. The Chair plays a key role but does not single-handedly determine the path of rate cuts. That's a crucial point for markets to keep in mind.

Earlier, I mentioned the mortgage situation in Canada, which continues to be a significant factor in the broader economic picture. As rates shift, the impact on household debt, refinancing activity, and consumer spending will be closely watched. These dynamics will also influence how aggressively central banks move forward with rate adjustments.

Over 60% of Canadian mortgages are set to renew between now and the end of 2027. The key point here is that current interest rates are actually lower than the stress-tested rates many borrowers qualified under five years ago. So, from a risk perspective, we're not overly concerned about the mortgage market itself.

What we are watching closely is the impact on consumer behavior, specifically, disposable income. Even if rates are lower, monthly payments could still rise by a couple hundred dollars, and that extra cost has to come from somewhere. Reduced spending in other areas could slow down economic growth.

On the manufacturing side, input costs have been rising, largely due to tariffs and ongoing uncertainty. While we don't expect inflation to spike like it did from 2020 to 2023, we do anticipate 'sticky' inflation meaning it will be harder to bring it down to the 2% target.

This stickiness in inflation could affect consumption habits. CPI in the U.S., shown by the blue line, is likely to remain elevated due to these pressures, with upside risks in several components.

One challenge for fixed income investors has been the unusual volatility in the bond market. Bonds are typically more stable, but uncertainty around central bank rate cuts has created turbulence. The MOVE Index, which tracks volatility in the U.S. Treasury curve, reflects this. It's like the VIX Index for equities but focused on bonds.

While short-term readings may seem elevated, a longer-term view provides better context. This highlights the importance of staying focused on fundamentals and understanding the broader market cycle.

Bond market volatility remains elevated over the long term, even though it has come down slightly in recent months. This is why active duration management is so important in fixed income investing. It's no longer as simple as buying long-duration bonds and waiting for yields to drop, that strategy hasn't played out well recently.

Active duration management allows us to navigate these shifts more effectively. Another key factor in fixed income is patience. Unlike stocks, bonds don't pay out daily. When you see a quoted yield for a bond portfolio, that's the expected return over 12 months not three or six. So, patience is essential.

What excites us about bonds right now is that yields are above historical averages. The chart shows the last 14 years of average yields, with the red diamond representing current levels, the blue triangle showing the five-year average, and the yellow square indicating the ten-year average. Across the board, yields today are higher than historical benchmarks.

This means investors are getting paid more now than they typically have over the past decade. One area that's a bit tighter is high-yield credit, so we're cautious about taking on too much risk there. However, investment-grade credit especially that fourth bar from the left, is offering extremely attractive yields.

The final key point is the price you pay for those yields. Valuation matters and being selective helps ensure we're capturing value without overreaching risk.

Unlike equities, where yields are currently priced a bit above average, fixed income offers a compelling opportunity. Prices are below historical averages, and yields are above them. That means not only are we earning more income, but there's also potential for capital gains.

This combination makes fixed income a strong component of a well-diversified, balanced portfolio.

To wrap up, let's revisit the key themes Macan and I discussed: Global economy, equities, valuations, fixed income.

That's all the time we have today. Thank you all for joining us. We hope you found the discussion informative and useful. If you have any questions or feedback, please reach out to your investment counselor.

On behalf of Macan and myself, we wish you a pleasant summer. Enjoy the sunshine, stay cool, and we look forward to connecting with you again soon. Thanks, everyone, and have a great day!
