BALANCING ACT

Nikko AM Multi-Asset's global research views to assist clients in balancing their portfolios to produce superior returns.

Snapshot

We have previously written about our concern that monetary policy is reaching the limits of its effectiveness, particularly when considering zero and negative interest rate policies (ZIRP & NIRP) and quantitative easing (QE). However, we believe that the latest experimental monetary policy to do the rounds of central banking rhetoric—'helicopter money'—may actually prove effective. But it comes with significant risks.

'Helicopter money' is essentially a cash transfer from central banks to the general population. The central bank creates new money and deposits it in people's bank accounts, either through direct transfers or tax rebates. The hope is that this will encourage the population to spend, thereby increasing aggregate demand and spurring growth in the economy.

Central banks hope the direct route of 'helicopter money' will prove more effective than the more circuitous route of QE, which requires the added liquidity to be recycled through banks in order to reach the population. This seems like a reasonable assumption to us. If you suddenly received a few thousand dollars in your bank account, there is a good chance you might spend it.

However, there is also a risk you might just save it. If your government is in austerity mode, cutting spending and raising taxes, then the chances of you saving it increase considerably. So to be truly effective, there has to be a sensible coordination between fiscal policy and monetary policy to maximise the chances that the 'helicopter money' does not simply disappear under the mattress. If a country can manage this type of coordination, then in theory 'helicopter money' has a reasonable chance of working.

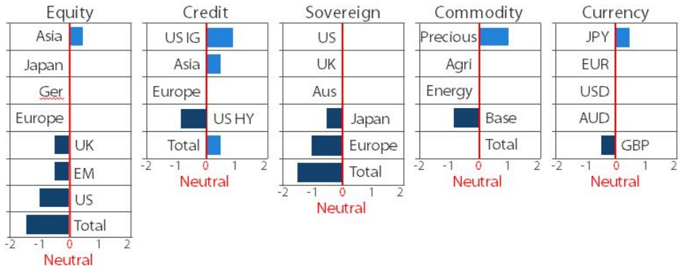
Does this sound a bit too good to be true? Critics of 'helicopter money' say it will end badly as the permanent increase in the money supply will result in runaway inflation. Supporters suggest that this is already happening anyway because QE is presented as a temporary increase in the money supply, but in reality can sit on the central bank balance sheet for years.

In the Multi-Asset team, we can see the benefit to consumers of taking this next step. But we have a nagging doubt that once central banks 'cross the Rubicon' of temporary to permanent, the risk of a hit to confidence rises considerably.

The financial system is founded on confidence. Fiat money, fractional-reserve banking and central bank experiments are all based on the premise that the people believe the dollar they earn is worth more than the paper it is printed on. If central banks suddenly start creating these dollars out of thin air in massive quantities, there is a chance that people will start questioning what that dollar is really worth. If this happens, the foundations start to shake and gold becomes the asset of choice. It is not possible to assess the odds of this happening, but our guess is it is much greater than zero.

In theory, 'helicopter money' stands a real chance of being effective in boosting consumption. That said, there are considerable risks to people's belief in the value of money. We hope that central banks are considering all the potential ramifications before embarking on this new experiment.

Asset Class Hierarchy



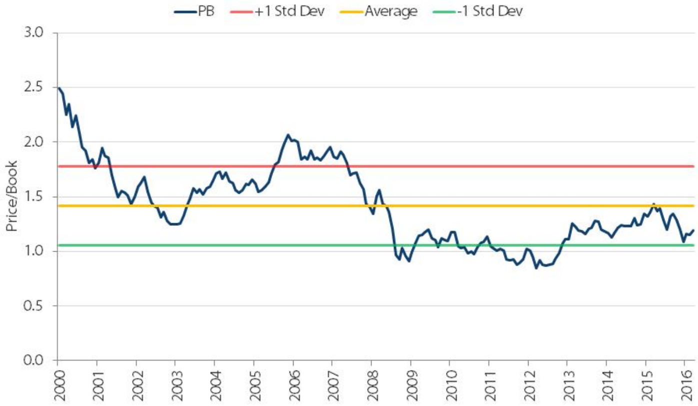
Note: Sum of the above positions does not equate to 0 in aggregate – cash is the balancing item.

Equities

Japan equities are still neutral

Japanese equities have been the worst performing developed market year to date, with losses over 10% in local currency terms. As a result, momentum remains poor. However, the sell-off has made them cheaper, with our valuation models suggesting Japanese equities are cheap across the board. Chart 1 shows the price-to-book (PB) ratio is at levels similar to 2008. Government initiatives like the Corporate Governance Code also appear to be bearing fruit as return on equity (ROE) and margins are both improving from the depressed levels of the lost decades.

Chart 1: Japanese price-to-book ratio

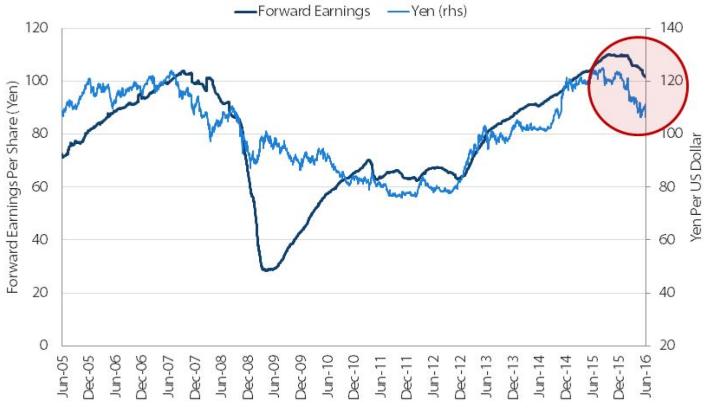


Source: Bloomberg 2016

Recent fiscal developments are also potentially supportive, with the government delaying the consumption tax hike to 2018 and increasing the supplementary budget to cater for victims of the Kumamoto earthquake. Generally, this would all result in a more positive score in our research process given the cheap valuations and potential catalysts for earnings growth.

So what is pulling our score back to neutral? There are two factors – earnings and the potential for policy error. Despite having delivered for multiple consecutive quarters, more recently Japanese companies have struggled to deliver earnings in the face of a stronger Yen and an overall weaker trade backdrop. Chart 2 shows how earnings momentum has deteriorated as the Yen has strengthened. With the US formally designating Japan on the 'monitoring list' for currency manipulation, the Bank of Japan's ability to intervene and arrest the Yen appreciation has been curtailed. Japanese companies look to be facing a Yen headwind.

Chart 2: Japanese earnings and the Yen



Source: Bloomberg 2016

Our second concern is the potential for policy error. We wrote in January that we felt the Bank of Japan's move to negative interest rates was a policy error. Japan had accommodated zero interest rates for over a decade, so the sudden move to negative risked spooking the population and undoing any optimism that 'Abenomics' had been able to create to date. The subsequent poor consumption numbers suggest this may have been the case.

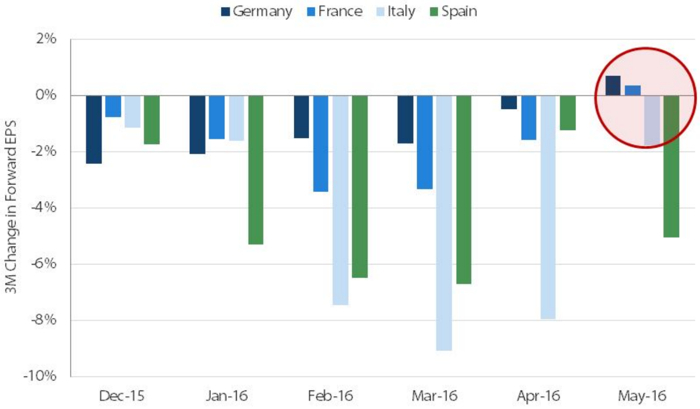
Japanese policymakers are now in a tricky position. The latest move to negative rates has produced some poor outcomes, with the Yen 10% stronger and the stock market 10% weaker, and has been widely criticised as a policy error. Currency intervention is off the table for fear of accusations of being a currency manipulator and so the Bank of Japan is being backed into a corner. In this environment, the chance of further monetary policy experimentation becomes heightened and the risk of an error grows.

Until we see greater clarity on the direction of Japanese fiscal and monetary policy, we remain cautious on the macro outlook for Japan. Granted, the equity market is cheap, but the potential impact of a policy error is profound and so we remain neutrally positioned in Japanese equities.

Germany is our preferred European allocation

Compared with the rest of Europe, German equities are not cheap. Our valuation models suggest PB ratios are more expensive in Germany than anywhere else in Europe. But it is in the earnings outlook that Germany becomes more attractive. Momentum for earnings growth has recently turned positive for German equities (see Chart 3), whereas the rest of Europe is still struggling. Italy in particular has disappointed as the banking sector continues to weigh on earnings.

Chart 3: European earnings momentum

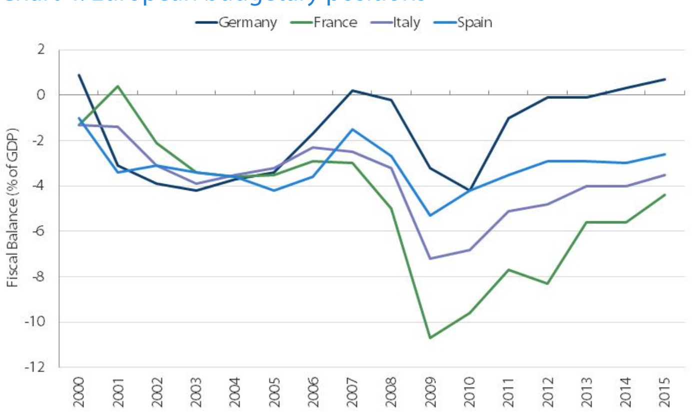


Source: Bloomberg 2016

German companies' ability to lead the rest of Europe makes sense given the comparative health of the relative economies. The European Central Bank needs to set policy for all of Europe and so has to consider the needs of all economies in the union. Negative interest rates may be necessary for Italian banks trying to recapitalise, but it is hard to suggest it is necessary for the vast majority of German companies. The current exceptionally easy monetary policy settings are a boon for Germany.

Relative fiscal health also favours Germany. The government is the only European country in surplus, as can be seen in Chart 4. Where German policymakers can afford to implement expansionary policy, the rest of Europe is struggling to keep fiscal deficits under control, although it should be noted that at least the trajectory is in the right direction. Brussels has been more forgiving of late when holding governments accountable to the 3% deficit rules, but the idea of expansionary policy from many European countries is currently just not affordable.

Chart 4: European budgetary positions



Source: Bloomberg 2016

The area where Germany is facing similar struggles to the rest of Europe is in domestic politics. The refugee crisis has heightened sensitivity around immigration across the whole of Europe and any party espousing tighter laws for foreigners is seeing a boost in the polls. This can be seen in Germany with the rise of the Alternative for Germany Party (AfG) whose anti-immigration stance is directly at odds with Chancellor Merkel's open borders policy. Germany does not face a national election until late 2017, but further weakening of the government's popularity is an added risk that needs to be monitored.

Mexico is our preferred holding in Latin America

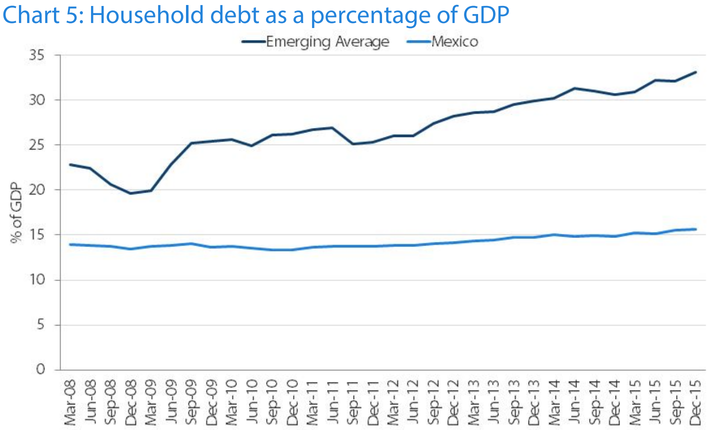
Mexico has been deemed a safe-haven since global trade began to slow in 2011, significantly outperforming its neighbours in Latin America, such as Brazil. Mexico was early to begin structural reforms and has benefited from its newfound competitive advantage. Labour is now cheaper than both China and Brazil helping to lift foreign direct investment (FDI), including USD 23 billion from global auto makers since 2010 alone.

In late January, Chinese stimulus and a more dovish US Federal Reserve marked a turning point in sentiment, helping to lift commodity prices and leading to significant repositioning in favour of riskier locations. Some refer to it as the 'dash for trash', but in the case of Latin America, this characterisation is not completely fair as macro fundamentals have indeed improved.

Part of the euphoria in Latin America is also driven by an improving political outlook. Argentina is deep in the midst of structural reforms and recent momentum toward the impeachment of President Rousseff in Brazil has brought hopes for the same there. Structural reforms are always positive for long-term growth prospects, but they do not necessarily bode well for near-term earnings, as fiscal reform typically weighs on demand and therefore revenues.

We still prefer Mexico where reforms are beginning to pay growth dividends, including a healthier consumer that is helping to fill the growth gap from still weak trade. Importantly, as shown in Chart 5, the Mexican consumer carries significantly less debt than in broader emerging markets, so the recent pick-up in consumer credit is more sustainable than elsewhere.

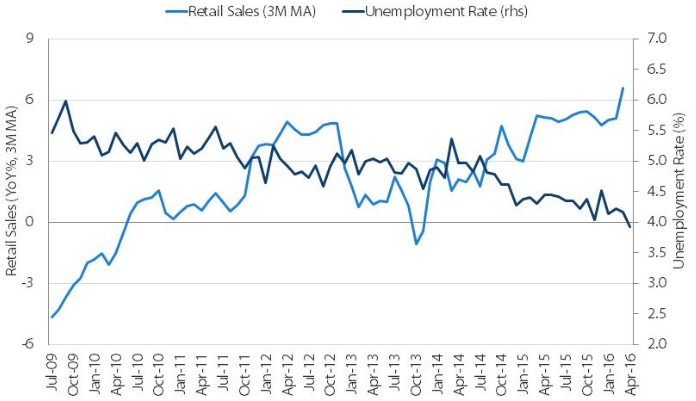
Chart 5: Household debt as a percentage of GDP



Source: BIS

Higher market share for exports and strong FDI have also led to a steady decline in the unemployment rate, which is mirrored by steady increases in retail sales, as shown in Chart 6.

Chart 6: Mexican unemployment vs. retail sales



Source: Bloomberg 2016

The challenge for Mexican equities is that they are expensive and while the earnings outlook has improved, exposure to weak demand in the rest of Latin America remains a headwind. Momentum turned positive for equities this month and with a steadily improving macro backdrop, we upgraded Mexico to neutral.

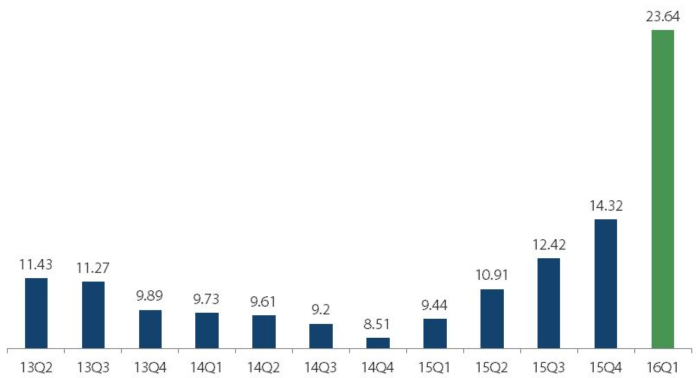
Credit

We are still underweight low quality credit

The stability and improvement in energy prices in May helped low quality (high yield) outperform high quality (investment-grade) credit, most notably in Asia. Over the past year, being overweight high quality credit has been the right call in the US. However, low quality credit has outperformed in Asia. Our research still favours high quality over low quality credit and we favour the US over Asia.

Markets were concerned earlier in the year when US bank commercial & industrial (C&I) non-performing loans (NPLs) spiked 65% from USD 14.32 billion to USD 23.64 billion (see Chart 7). The main culprit appears to be increased stress within the energy sector after the commodity sell-off in the first quarter. While initially alarming, this translates to a more benign NPL ratio of 1.24%, well below the world average and more importantly below the coverage ratio for most US financial institutions. While the NPL rise is no immediate threat, it could provide US banks with more reasons to start tightening lending standards.

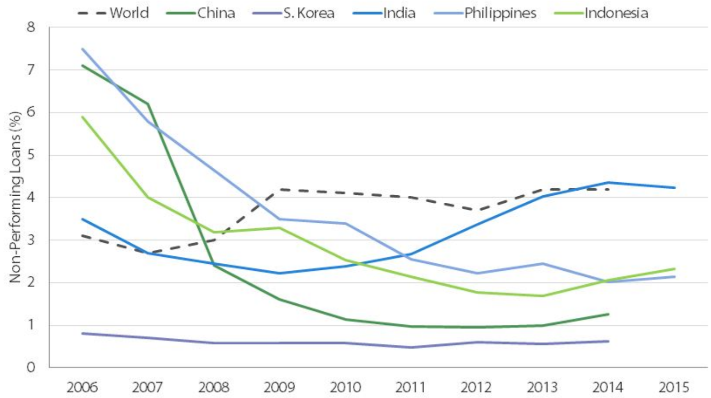
Chart 7: US bank C&I NPLs (USD Billions)



Source: Bank Reg Data 2016

Asian NPLs have fallen since the crisis and remain low compared with the rest of the world (see Chart 8). India's NPL rate has been growing as domestic growth slows and exports and agriculture decline. The country is likely to see a further increase in NPLs as its methodology changes from 150-day recognition to the world standard of 90 days. This difference in NPL methodology can muddy the waters when assessing emerging markets (EMs). Chinese NPLs are very low compared with the rest of the world, but similar to India, China uses a different methodology.

Chart 8: Asian NPLs (%)



Source: World Bank

If China were to apply the 'western banking norm', its NPLs could be closer to 15-20%, according to some analysts, far higher than current estimates. Banks in China are fairly well capitalised, but if 10% NPLs materialised all at once, this would signal crisis proportions and probably trigger bail-outs. Combined with worries over wealth management products' off-balance sheet liabilities, the credit situation in China is less than ideal. However, given the high level of saving and ammunition at the government's disposal, the country has the ability to restructure its debt issues before the situation becomes dire.

It is for these reasons that we favour high quality credit. Low quality credit has a greater reliance on bank funding, which is set to tighten in both the US and Asia. As NPLs increase, the ability to refinance will become even more restricted for low quality borrowers. Conversely, high quality credit is undergoing a tailwind thanks to monetary policy, with a liquidity glut trying to find a low risk home in a zero rate world. This has pushed investors further out the risk curve, rewarding visible cash flow from high quality companies. As a result, we remain overweight investment-grade credit.

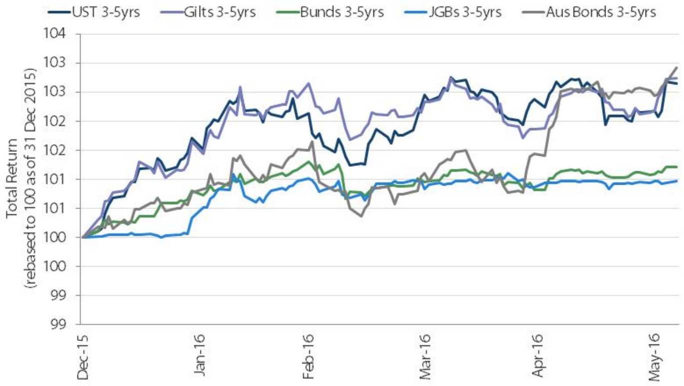
The US appears to be showing symptoms of nearing the end of its cycle. Lending standards are tightening and leverage is high, with earnings before interest, tax, depreciation and amortisation (EBITDA) deteriorating. Asia is trying to deleverage—there are credit stresses throughout the region, but there is also capacity and willingness to reform. Both appear to be fair value, but from a macro perspective, we prefer the US to Asia within investment grade. We continue to trade defensively in both regions, owning high quality, low duration names.

Sovereign

We remain underweight sovereign bonds

Our underweight position in sovereign bonds has not been profitable year-to-date. Slowing global growth and concerns over deflation have combined with QE in Europe and Japan to drive sovereign bond yields to historically low levels. We do take small solace from the fact our preferred duration in the US, UK and Australia has performed well.

Chart 9: Sovereign bond performance



Source: Bloomberg 2016

As with any research view that is potentially growing stale, we carefully review the drivers of our position to ensure they are still relevant:

- Valuation – when assessed either on inflation expectations or real yields, our models show all sovereign bonds as expensive;
- Momentum – our models are generally positive with the trend for improving momentum; and
- Macro – the outlook is very mixed, with QE supportive in contrast to the push for greater fiscal easing and inflation showing signs of turning around.

Despite the more recent positive momentum, an expensive asset with a deteriorating macro outlook still warrants a negative score. The inflation picture, although priced for deflation, is showing signs of increasing in the short term as the energy shock of 2015 unwinds and wage pressures continue to build in certain sectors. We remain concerned that this deterioration in underlying fundamentals is being masked by central banks' persistent buying of duration.

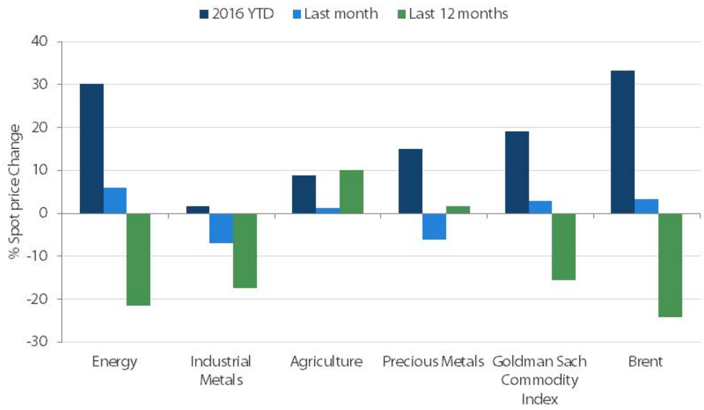
Cash is still our preferred defensive asset. We believe sovereign bonds are at risk of a dramatic and sudden repricing and so prefer to stay underweight the asset class.

Commodities

We maintain our neutral stance on commodities

Commodity prices extended their 2016 gains by another 3% in May, with almost all of it coming from Energy. Agriculture prices were flat, while prices of Industrial Metals and Precious Metals fell around 7% each.

Chart 10: Commodity sector performance



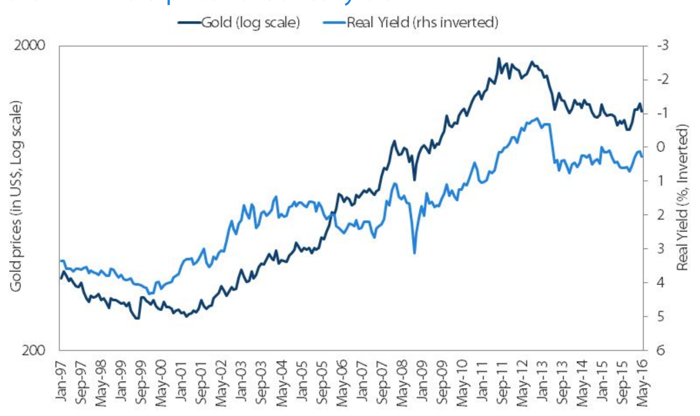
Source: Bloomberg 2016

Industrial Metals are our least preferred exposure across commodities. Momentum is still negative and the macro picture remains bleak due to structural oversupply and growth slowdown in China. Recent price action confirms our bearish view.

However, markets have been less in sync with our constructive view on Gold. After rallying +20% to April this year, prices have fallen significantly over recent weeks. Chart 11 may offer some insights into these moves. The chart plots the gold price in US dollars vs. real yields in the US over the last 20 years. Gold prices are shown in logarithmic scale while real yields are the yield on 10-year Treasury inflation-protected securities (TIPS).

As real yields remove the inflation risk premium embedded within nominal 'risk-free' yields, they can be considered to be the real opportunity cost of holding onto money vs. spending it on consumption or investing in alternative risk-free assets. As such, lower real yields should boost the attractiveness of both consumption and of a safe-haven investment in Gold, and vice versa. In Chart 11, real yields are inverted so a rising line represents falling real yields and a falling line represents rising real yields.

Chart 11: Gold price vs. US real yields



Source: Bloomberg 2016

It is clear that there has been a very strong relationship between gold prices and real yields over the last couple of decades, which includes periods of both excessive bullishness and bearishness on gold, rising and US falling rates, and weakness and strength in the US currency.

Gold rose strongly from below USD 300 per troy ounce at the turn of the millennium to near USD 1,800 at the end of 2012. Over this period, real yields fell from 4% to -0.75%. Gold and real yields both reversed course from there, with gold falling to USD 1,000 while real yields increased to 0.70% by the end of 2015. Judged against this relationship, both the gain in gold from January to April this year, as well as the correction in May begin to make sense. In the first period, real yields fell again from 70 bps to 12 bps, while in the second they increased to 27 bps.

The question is: where to from here? If inflation does pick up later in the year, as we currently expect it to, and the Fed maintains its dovish bias then real yields would resume their decline and support Gold prices. We would be happy to remain long Gold in this scenario. On the other hand, if real yields rise because the economy improves significantly and the Fed tightens to get ahead of rising inflationary expectations, it could mean a weak environment for Gold prices.

However, even the second scenario is not entirely negative for Gold as the margin of error in monetary policy making at the Fed (and at the Bank of Japan, European Central Bank and People's Bank of China) has become extremely slim. As we alluded to in the introduction, any slip here would likely severely shake confidence in fiat currencies and make Gold look all the more alluring as the only safe store of value. We believe this upside tail risk to Gold more than compensates for the cost of maintaining a constructive view in an environment where real rates are no longer falling.

Currency

Our currency hierarchy remains unchanged

We recently downgraded our long-term positive view on the US dollar in favour of the Yen and Euro. Market attention has been focused on the divergence in monetary policy and has been driving expectations. Many market forces drive currencies, not just interest rate differentials. It is worth recognising that both the Yen and Euro are running large trade surpluses and so as the capital accounts stabilise, the pressure for these currencies will be to appreciate.

We do not expect a sudden US dollar bear market and so it remains in the middle of our hierarchy. The Yen and Euro are cheap and both are experiencing positive momentum so still deserve to rank above the US dollar.

Process

In-house research to understand the key drivers of return:

Valuation	Momentum	Macro
Quant models to assess relative value	Quant models to measure asset momentum over the medium term	Analyse macro cycles with tested correlation to asset
Example for equity use 5Y CAPE, P/B & ROE	Used to inform valuation model	Monetary policy, fiscal policy, consumer, earnings & liquidity cycles
Final decision judgemental		
Example		
+	N	N
Final Score +		

Important Information