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October 2018

By Multi-Asset Team

BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

A trade deal was finally struck between the US and Canada that combined with the Mexico deal has been rebranded as "USMCA", though it could aptly be described as the same old NAFTA with a few tweaks. The deal tilts protectionist, but perhaps the most controversial new clause requires notification of any trade talks with a "non-market" economy which some say gives the US effective veto power over Canada and Mexico negotiating trade agreements with China. In any case, having mostly settled its trade skirmishes around the world, the US has clearly narrowed its trade focus on China.

It is still hoped that some sort of trade agreement can be struck between the US and China, beginning with a meeting between Trump and Xi scheduled for late November, but it is increasingly apparent that tensions have risen above simple trade imbalances and are likely to remain protracted. Optically, the relative strength of the US economy and its equity markets might suggest that the US is winning the battle, but the war is far from over.

While the US rides the "sugar high" of a late cycle fiscal boost and China navigates slower growth from its efforts to deleverage, it is not difficult to imagine the tables turning – at least at the margin – as the Federal Reserve (Fed) continuously tightens while China policy is now firmly in easing territory.

The direct economic impact of tariffs is a bit higher for China than the US, but still seems manageable given efforts to use stimulus to help fill the gap. However, it is the indirect impact of trade wars, mainly the disruption of supply chains, that is harder to quantify. No doubt, changes are in motion including pushing lower value manufacturing to places like Vietnam, but it will take time while profit margins will be squeezed on both sides of the Pacific.

President Trump often likes to take credit for US equity gains as a reflection of his policy success, so one can imagine that market losses may encourage him to cut some kind of deal with China before a deeper impact unfolds. Given the Trump administration's track record for backing off from its strongest demands to get a deal done, it is reasonable to assume the same could hold true for China. But given the breadth of the divide, China may be different. US equities still look strong from an earnings and growth perspective, but the evolving impact of trade wars on profit margins is a clear watch point.

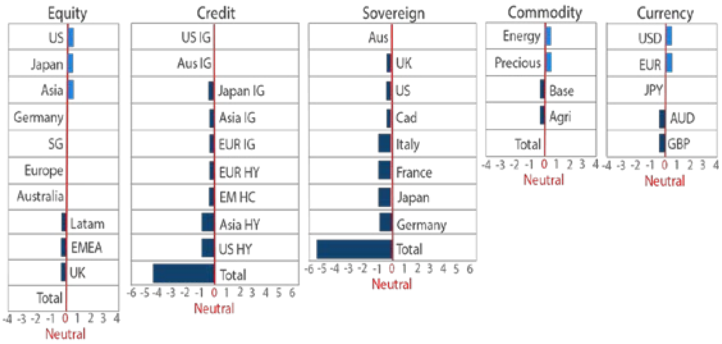
Another watch point is the steady monetary tightening that is spreading across the developed world. For now, it is just the US hiking rates, but between the US reducing its balance sheet while the European Central Bank (ECB) is due to end asset purchases at year-end, central bank balance sheets will be contracting, in the aggregate, for the first time since the global financial crisis – in effect, giving back to markets the full power of price discovery.

Financial conditions are far from tight, but the tide of liquidity in the form of cheap money is clearly receding. The velocity of the crises in Turkey and Argentina are a reflection of the changing tide. For now, a deeper crisis has been averted given bold policy moves by each country to address their external imbalances, but these unfolding events remind us of the importance of distinguishing quality assets.

Imbalances in Turkey and Argentina are more idiosyncratic than symptomatic of broader EM problems. However, while their imbalances may be particularly egregious, they are far from unique, which is why we stay cautious and selective across markets – both in EM and DM. As net savers, Asia remains less vulnerable to tighter liquidity conditions, though there are pockets of issues related to dollar denominated debt.

Dollar strength is another key watch point as it directly impacts risk assets, EM in particular. While the dollar has not moved much relative to G7 currencies since May, EM currencies have struggled, partly for trade wars but mostly for EM stress, emanating out of Turkey and Argentina. Given that a deeper crisis has been averted, we do see scope for the dollar to stabilise which would be a tailwind for EM assets. Of course, the primary risk is further bouts of stress, which would tend to keep the dollar strong – particularly as Fed policy remains tight while the People's Bank of China (PBOC) is easing.

Asset Class Hierarchy (Team view[1])



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

[1]The asset classes or sectors mentioned herein are a reflection of the portfolio manager's current view of the investment strategies taken on behalf of the portfolio managed. These comments should not be constituted as an investment research or recommendation advice. Any prediction, projection or forecast on sectors, the economy and/or the market trends is not necessarily indicative of their future state or likely performances.

Research Views

The hierarchies remain broadly the same with only minor adjustments. There were no changes to the Equity or Sovereign hierarchies. The Credit hierarchy saw several minor adjustments in Investment Grade and High Yield. In FX, the EUR was lifted above JPY.

Global equities

Our equities hierarchy remains unchanged. However we find ourselves becoming incrementally more cautious on risky assets as a whole. Our composite model scores for Germany and Asia ex Japan slip a notch to neutral driven by a fall in momentum scores from neutral to negative. As there are no offsetting upgrades to any other markets this leaves us rating only the US and Japan as better than neutral across the entire developed equities complex.

Valuations are no longer expensive for developed markets outside the US. However they are not attractive enough yet either. At the same time momentum has continued to deteriorate and is now neutral or negative everywhere except Australia. The macro outlook is positive for the US, but is ambiguous enough everywhere else to lead us to no better than a neutral macro view.

This brings us to the idiosyncratic opportunities that EM turbulence has thrown up this year. One we would like to highlight is that there are no sacred cows in an environment of tightening global liquidity – not even erstwhile darlings of global investors such as Indian equities.

Our emerging market research process has accorded an overweight stance on India since February. However we downgraded this two months ago. Relative to history, valuations had moved from neutral to expensive in addition to cross-market valuations already being stretched. Macro concerns had started to build up as well. These included the risks of fiscal deterioration from higher imported energy costs, INR weakness and prospects of further monetary tightening, higher political uncertainty, earnings disappointments particularly for financial and consumer companies and a broad based deterioration in profitability.

Indian equities have since corrected 10% from their late August peak and continue to be pulled down by the financial crisis precipitated by the default of the Infrastructure Leasing and Financial Services (IL&FS) company. According to the Finance Ministry as many as 1,500 smaller non-banking financial companies (NBFCs) may lose their licenses in the fallout. The IL&FS group forms 16% of the total exposure of banks in NBFCs. The increased cost of funding for these NBFCs will likely lead to a challenging liquidity environment for them and others.

What do Argentina, Turkey and now Indian NBFCs have in common? Instead of the obvious answer related to over-reliance on easy liquidity conditions, we would submit that all three have been great opportunities for the skilled active manager to add value over passive benchmarks.

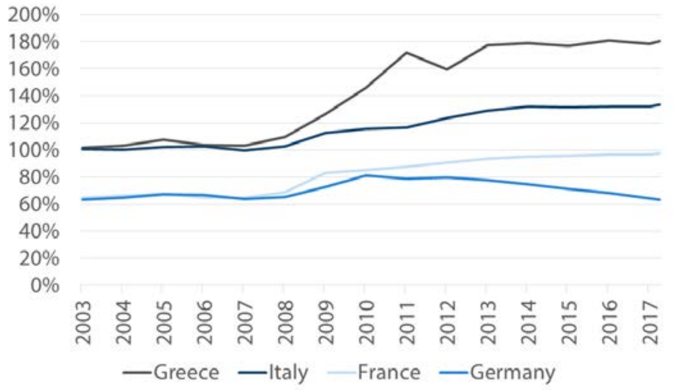
Global bonds

Our bond hierarchy is unchanged from last month although we have expanded our coverage to include Italian government bonds. Italy comes in under the US and Canada as part of a small group we consider for a neutral allocation.

Italian bonds have of course been "in the news" recently as its government works to fashion a budget plan that will be acceptable to the European Commission (EC). The unlikely coalition partners of the populist Five Star Movement and the right wing Northern League have sought to expand the budget deficit in order to fund election promises that include a basic income for the poor, tax cuts and lowering the retirement age.

Under EC rules, member countries are expected to respect maximum thresholds of 60% debt to GDP and fiscal budget deficits of 3% of GDP. In Italy's case, the government is proposing a deficit of 2.4%, well below the EC threshold but more than double prior deficits. With a large debt to GDP ratio of 133%, second only to Greece in the EU, Italy is expected to make greater efforts to reduce debt levels.

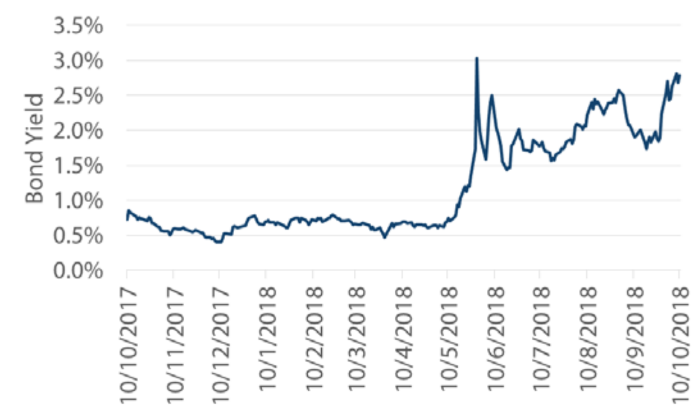
Chart 1: Gross government debt to GDP ratios



Source: Bloomberg, March 2018

This generally translates to further demands for austerity in Italy, undoubtedly a controversial remedy. This is certainly a sensitive subject in Italy and a strong protest vote against austerity likely helped the current coalition to power. It is therefore not surprising that this government is requesting a modest fiscal expansion in its first budget. Although the current budget proposal may not be to the market's or the EC's liking, it is a far cry from the doomsday projections of budget deficits of 5-6% of GDP shortly after the election.

Chart 2: Italian 5-year government bond yield



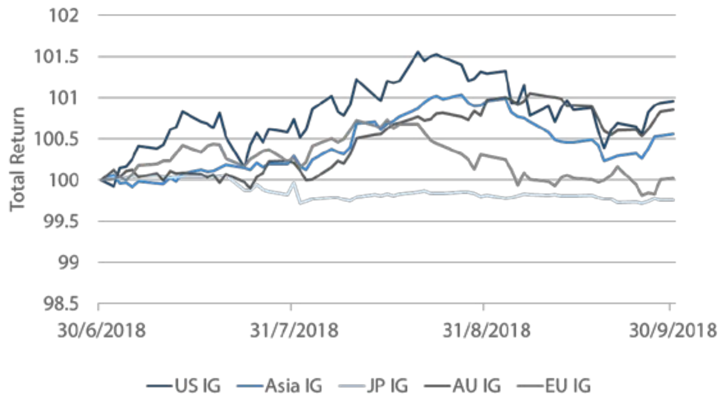
Source: Bloomberg, October 2018

Trading in Italian bonds has unsurprisingly been volatile, with 5-year bond yields moving in a very wide range of 1.5% to 3%. And perhaps counterintuitively, it is these spikes in borrowing costs that provides an effective curb on the government's worst impulses and instant feedback to budget negotiators from both sides. Our expectation is that Italy and the EC will ultimately come to an agreement that markets can live with, making current bond yields an attractive opportunity.

Global credit

The credit hierarchy saw minor shifts in macro lead to upgrades to both Australian investment grade (IG) and European high yield (HY), but a downgrade to Asian IG. US IG remains at the top, for now, as underlying sovereign yields above 3.2% and slightly wider spreads from the beginning of the year make the asset class relatively better value.

Chart 3: 3-month hedged total return

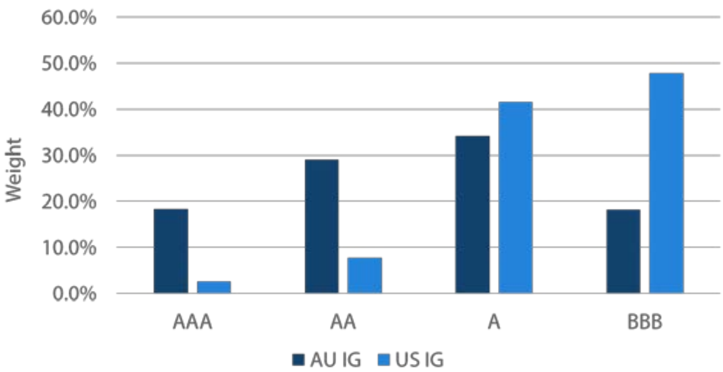


Source: ICE BofAML, Bloomberg, September 2018

We have favoured Australian fixed income for some time given our view that the Reserve Bank of Australia (RBA) will be on hold for the foreseeable future, limiting the downside from the underlying sovereign yield. While we have owned Australian IG, we refrained from upgrading it in the hierarchy due to expensive valuations. However, from a macro perspective, it remains one of our favourites.

Australian corporates have reasonable leverage when compared to their overseas counterparts. They have not increased leverage to fund share buybacks or increase dividends. In fact it has been more usual for corporates to use earnings to pay down debt. As such, the Australian corporate index has an average rating of A+, with less than 20% of the index lower than A-, compared to the US with almost 50% below A-. The index yields about 50 basis points (bps) less than US IG on a hedged basis, but with a duration almost half that of the US and an average credit rating two notches above, perhaps this is justified.

Chart 4: Credit rating cohorts



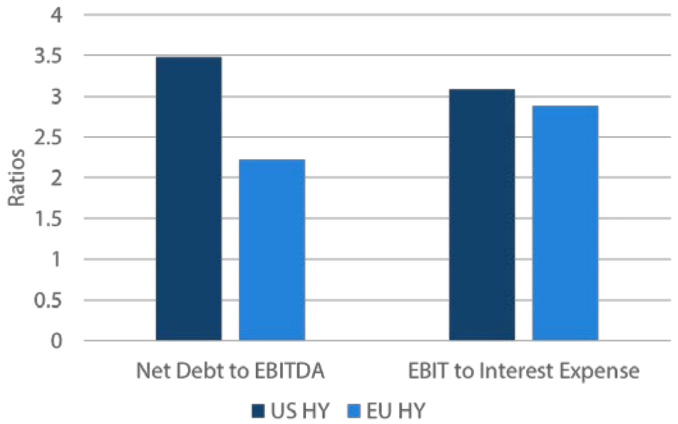
Source: Bloomberg AusBond, iBoxx, September 2018

While issuance has picked up quite strongly, particularly in August, it was met with strong demand, keeping spreads tight. Compared to European and US markets, spread volatility has remained low. Likely downgrades for the sovereign and big four banks is diminishing as the federal budget position improves and concerns about the overheating of the housing market abate. These positives in leverage, ratings and flows led us to upgrade macro, lifting Australian IG further up the hierarchy.

EU HY yields around 30bps more than US HY on a USD hedged basis, with similar duration. However, the fundamentals have diverged. As shown in chart 5, US HY corporates have continued to increase leverage over the past few years, where the net debt to EBITDA ratio is now significantly higher than their EU counterparts. Meanwhile, flows are picking up in EU HY funds, whereas US HY funds continue to see outflows with cash declining to uncomfortably low levels. We prefer EU HY over US HY for better leverage and flow dynamics.

Nevertheless, we continue to be cautiously positioned, favouring higher quality and lower duration credits over high yield for now, especially at this late stage in the cycle.

Chart 5: Q2 leverage and coverage ratios



Source: ICE BofAML, eVestment, Worldscope, S&P LCD, UBS, September 2018

FX

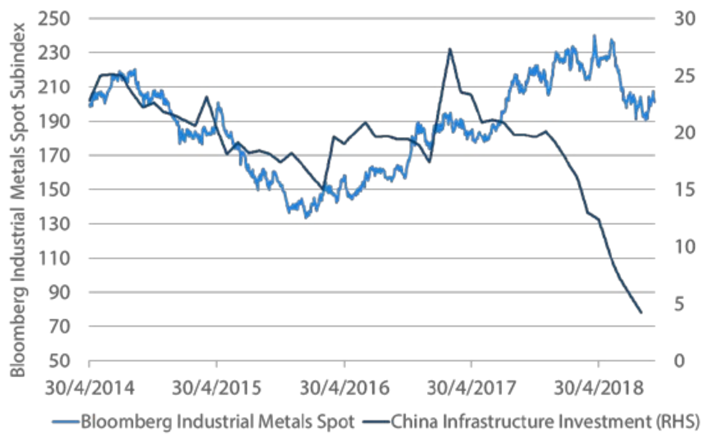
We lifted the EUR above JPY for impending shifts in monetary policy and the shift in capital flows. The ECB has confirmed that asset purchases will conclude at year-end with the first rates hikes expected in late 2019. While the Bank of Japan has reduced purchases and is allowing long-term rates to moderately rise, this is mainly aimed at taking the pressure off regional banks rather than tightening policy. Thus, the EUR looks to strengthen relative to JPY as its policy gradually shifts to tightening.

JPY had strengthened into the EM crisis over the summer, which is mainly a function of capital withdrawal by Japanese investors. As external pressures have eased, JPY weakness has resumed. Of course, this dynamic can change quickly should stress return.

Commodities

Over the last six months, industrial metals have been the worst performing commodity, slumping almost 20% from early June to mid-August – at least partly a function of slowing infrastructure investment in China as shown in Chart 6. After having ramped infrastructure investment above 20% through early 2017, a commitment to financial deleveraging has seen infrastructure investment fall to just 4.25% in August 2018.

Chart 6: Slowing Chinese infrastructure investment



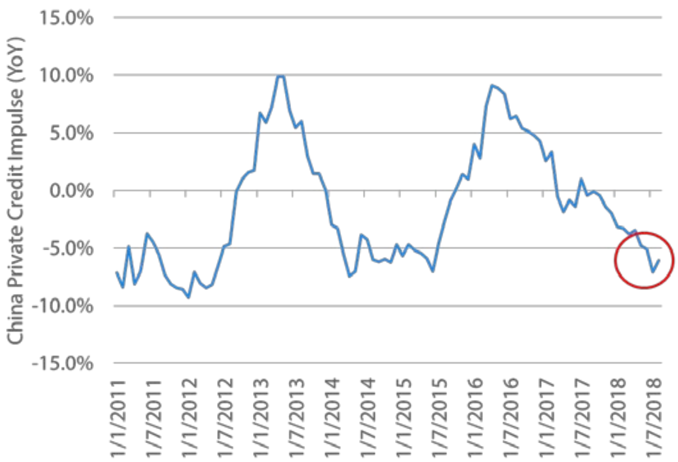
Source: Bloomberg, October 2018

Worries over slowing growth were undoubtedly exacerbated by trade war concerns, deepening the correction. In the ongoing challenge of balancing reforms against required growth, the government has once again shifted toward easing – partly to bring relief from the current pains of deleveraging and also to mitigate the impending pain of an escalating trade war.

The PBOC is injecting liquidity, cutting the reserve requirement ratio (RRR) by 250bps over 6 months, with latest 100bps cut implemented on Sunday, 7 October. In addition to encouraging bank lending to small and medium enterprises, the Ministry of Finance has given the green light for local governments to speed up bond issuance to finance infrastructure investment.

As shown in Chart 7, the credit impulse has bottomed, which is helping to lift industrial metal prices on the prospect of accelerating infrastructure investment.

Chart 7: China credit impulse



Source: Bloomberg, Nikko AM, September 2018

The near-term outlook has improved, but we still remain cautious on industrials over the medium to long term. The current stimulus is designed to remove the "sting" from the recent bout of deleveraging and likely trade war impact, but it is not nearly of the scale seen in 2015 when growth was much weaker. China's economy is rebalancing away from investment toward consumption while it remains committed to deleveraging. These reform efforts are certainly positive for long-term sustainable growth, but less supportive for commodity demand on the scale history would otherwise suggest.

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
Example		
+	N	N
Final Score +		

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