March 2016

By Multi-Asset Team

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Nikko Asset Management

# BALANCING ACT

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

## Snapshot

In Japan, the changing of the seasons in March means it is time to celebrate 'Hanami'—a 1,000-year old custom where young and old flock to parks and fields to appreciate the beauty of the blooming cherry blossoms. The experience is fleeting, however, since the blossoms generally only last for a week.

Success in investing can sometimes be equally as fleeting—the despair of January was quickly replaced by the euphoria of February and March. However, last year's winners have become this year's laggards, and vice versa. Japan equities have been struggling in 2016, but Brazilian equities are up 20% already in common currency terms. The almighty US dollar has taken a back seat to the Yen and Euro, and oil is up nearly 50% from its February lows.

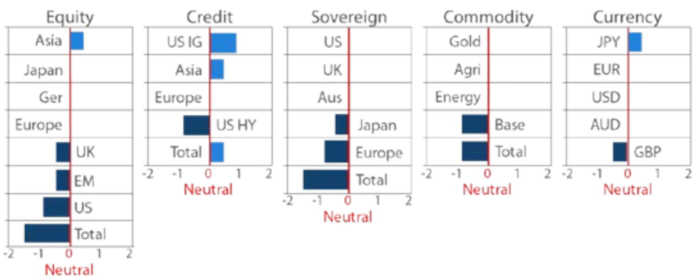
Are we seeing a genuine change in market leadership or is the price action of the first quarter a simple adjustment of overcrowded trades? We think it is a little bit of both.

Earlier this year, we moved Japan one notch down from the top of our equity hierarchy and emerging markets (EMs) one notch up from the bottom. This was not due to a wholesale change in views. It was more in recognition that some of the underlying fundamentals had deteriorated in Japan (earnings and the impact of negative rates) and improved in EMs (valuations and currency adjustment). For equities, we think the recent volatile price action is more a function of position covering in overcrowded trades, rather than an emergence of new market leadership from EMs.

The situation is similar for oil. Based on our research, we expect oil to oscillate around current levels rather than embark on a meaningful rally. The 50% rise from February appears to be the result of an extremely oversold market rebounding to more realistic levels.

Where we have changed our views on market leadership is in the currency markets. Our long-standing expectation for the US dollar to be the dominant currency has been softening over recent months. We have now moved it from the top of the currency hierarchy, replaced by the Yen and Euro. Momentum has recently turned negative on the US dollar and, with valuations expensive, it more than warranted a downgrade.

### Asset Class Hierarchy



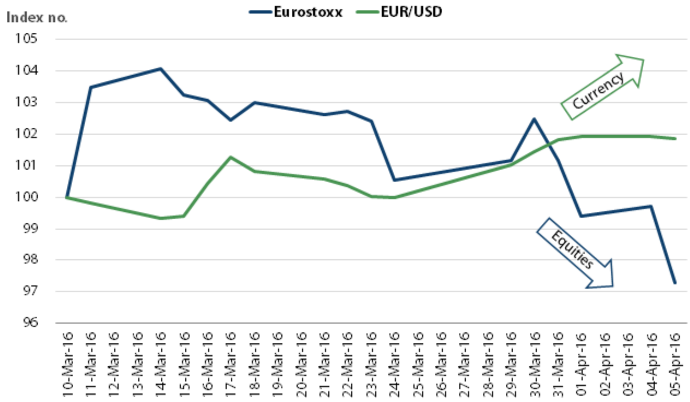

**Note: Sum of the above positions does not equate to 0 in aggregate – cash is the balancing item.**

## Equities

### German equities have moved above Europe in the equity hierarchy

On March 10, the European Central Bank (ECB) delivered what is commonly referred to in market parlance as the 'bazooka' – a stimulus programme well beyond market expectations. The ECB cut the refinancing rate to 0%; cut the deposit rate to -0.4%; increased its quantitative easing (QE) programme to EUR 80 billion per month and expanded the list of approved assets to include corporate bonds; as well as introducing four new targeted long-term refinancing operation (TLTRO) programmes to provide favourable funding for banks. Previous 'bazookas' have led to stronger equity markets (mainly through multiple expansion) and weaker currencies. Chart 1 shows that the actual performance of European assets since the announcement – not exactly what was expected.

Chart 1: European assets since ECB announcement




Source: Bloomberg 2016

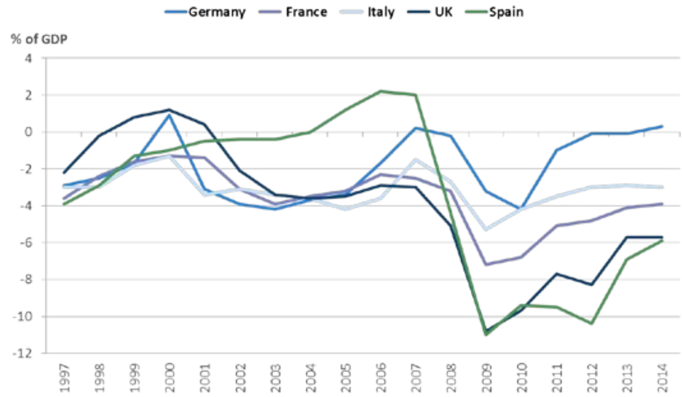
We have been suggesting for a while that monetary policy may be reaching its effective limits in most developed economies. The negative market reaction (equity sell-off, currency rally) to both the recent ECB 'bazooka' and Japan's move to negative rates in January would suggest many investors are coming to a similar conclusion. This is potentially problematic for Europe.

Extremely easy monetary policy has helped drive European equities higher over the last three years. The weaker currency has improved companies' competitive position and expectations for greater market share. In addition, a multiple expansion has occurred on the expectation that lower rates would lead to increased demand for credit and a resultant boost to growth. Unfortunately, growth across Europe has been anaemic.

If monetary policy is reaching its effective limits and investors are no longer willing to take ECB rhetoric at face value, then there is an increased chance of a further re-rating lower for European equities as markets unwind the optimistic expectations. One way to avoid this outcome would be to complement the monetary stimulus with fiscal spending.

This is where Europe faces a problem. Chart 2 shows the fiscal positions for the major economies in Europe. Outside Germany, the majority of Europe is running a large fiscal deficit. The guidance for the Growth & Stability Pact for EU members states the fiscal deficit should not exceed 3% of GDP – only Germany currently conforms. The capacity to meaningfully increase fiscal spending is severely hampered both by the poor starting point and the lack of appetite in EU decision-making to dig a deeper fiscal hole. This is weighed down further by the constant threat posed by the refugee crisis and the possibility of another terrorist attack.

Chart 2: European fiscal balance




Source: Bloomberg 2016

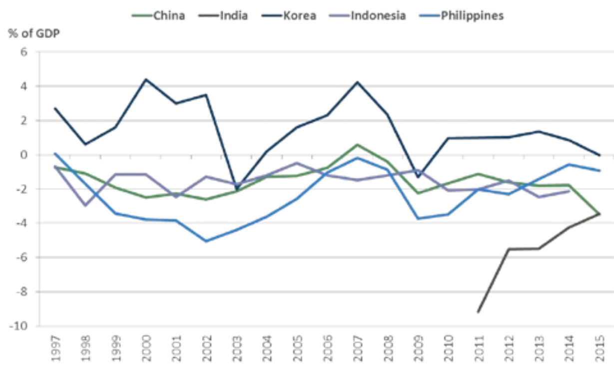
Germany is much better placed to face these challenges. The government's fiscal position is strong, company earnings are stabilising following the Volkswagen and Deutsche Bank issues of last year, and debt levels across most sectors are at manageable levels with the potential to increase leverage and drive growth.

We have long seen European equities as providing unrewarded volatility, but have been willing to overlook some of the shortcomings given the cheap valuations and extremely easy monetary policy. Valuations are no longer as attractive and with the limits of monetary policy potentially being reached, we have decided to move European equities below Germany on the hierarchy.

## Asia is developing a fiscal tailwind

Compared with the fiscal positions in Europe, government balance sheets in Asia are in a significantly healthier position. As shown in Chart 3, all the economies are in a manageable deficit (India is the outlier, but the fiscal position is rapidly improving). This is allowing Asian countries to ramp up fiscal spending in an environment where global trade is slowing, putting a greater emphasis on domestic growth.

Chart 3: Asian fiscal balance




Source: Bloomberg 2016

India's recent budget is a case in point. By targeting continued fiscal consolidation (FY16 budget deficit target maintained at 3.5%) while also increasing spending on rural development programmes, where growth has lagged, India was regarded as having struck just the right balance to enable monetary and fiscal policy to work together in supporting growth. A fiscally less prudent budget would have made it harder for the Reserve Bank of India (RBI) to cut rates further, while a budget that failed to stimulate rural expansion would have missed out on an opportunity to boost growth, as well as votes in the upcoming state elections with a large rural electoral base.

China is also increasing fiscal stimulus. Chart 4 compares China's debt and deficit targets for 2016 as announced at the annual session of the National People's Congress (NPC) last month. It shows an even greater willingness on the part of Chinese policymakers to embark on fiscal spending to support growth. The total deficit across central and local governments is projected to rise from RMB 1.62 trillion in 2015 to RMB 2.18 trillion in 2016.

Furthermore, the draft 13th Five Year Plan (FYP) earmarks higher spending focused on 'pro-reform' items like green technology, advanced manufacturing and the internet. It sets an ambitious target of increasing the value added to GDP from such strategic emerging industries from 8% in 2015 to 15% in 2020.

Chart 4: China debt and deficit targets

| | 2015 | 2016 |
|---|---|---|
| Central deficit | 1.12 trillion | 1.4 trillion |
| Local government deficit | 500 billion | 780 billion |
| Total deficit | 1.62 trillion | 2.18 trillion |
| Local government debt swap program bonds | 3.2 trillion | 5 trillion* |
| Special purpose local government bond issuance | 100 billion | 400 billion |
| Local government bond issuance to finance deficit | 500 billion | 780 billion |
| Total local bond issuance (sum of above) | 600 billion | 1.18 trillion |
| Total local government debt cap | 16 trillion | 17.18 trillion |

*Eurasia Group estimate based on finance minister statements
Note: All amounts listed in RMB
Source: Ministry of Finance 2016 work report, public statements by finance officials, Eurasia Group

The effects can already be seen in industrial profits, which expanded in February after seven months of declines, according to data released by the National Bureau of Statistics. The slowdown in fixed asset investment (FAI) appears to have bottomed, while new project planned FAI has strongly accelerated since late last year. At the same time, other indicators of economic activity like credit growth and Tier 1 property prices are all suggestive of a recent pick-up.

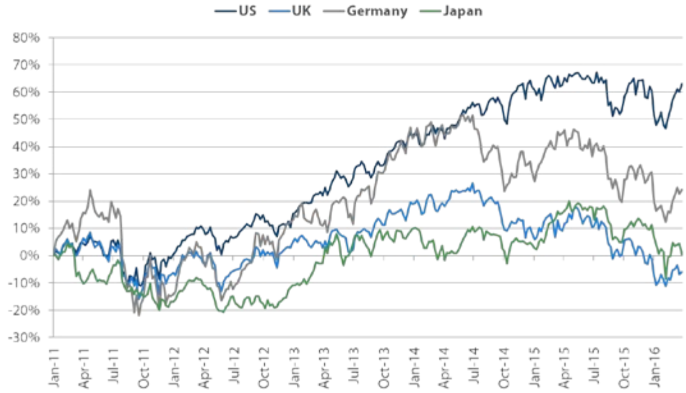
Another source of fiscal boost is Indonesia, although it is focused more narrowly on infrastructure spending alone and is not without its challenges. Effective implementation of the USD 23 billion infrastructure budget for the current fiscal year is central to the government achieving its policy objective of lifting growth from 4.8% in 2015 to 5.3% in 2016. Stability in oil and commodity prices have greatly reduced the risk of fiscal slippage, while key administration appointments have significantly improved the probability that the budget will actually be spent after years of under-investment.

Asian equities remain at the top of our equity hierarchy. Valuations are cheap, monetary policy is easing and given the strong government balance sheets, the capacity and will to increase fiscal spending is high. There is evidence the momentum in Asian earnings is turning more positive and we expect this to continue as the fiscal boost drives growth.

## UK equities continue to face headwinds

UK equities have been a poor performer compared with other major developed markets, as shown in Chart 5. All key markets have delivered a positive return since 2011 except the UK, which has fallen around 10% when measured in USD terms. Due to its close ties with Europe, UK equities were hit hard during the 2012 Euro crisis, and the subsequent recovery was short-circuited in 2014 as the Energy sector imploded (13% of the FTSE 100 UK Index). The Financial sector (20% of the FTSE 100) has been responsible for most of the poor performance so far in 2016.

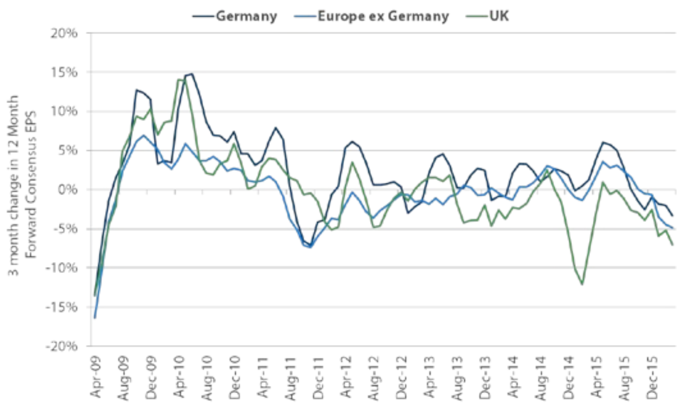
Chart 5: Developed market equity performance




Source: Bloomberg 2016

Unfortunately for the UK, the headwinds to equity performance still exist. Valuations don't look particularly attractive given the collapse in earnings. Chart 6 shows the severe deterioration in earnings momentum and given the two larger sectors of Energy and Financials are still struggling, this does not appear likely to reverse any time soon.

Chart 6: UK & European equity earnings momentum




Source: Bloomberg 2016

With average valuations and poor momentum, the last pillar of support could come from the macro side. Unfortunately, the headwinds here look to be building as well. Monetary policy has been at full tilt but has provided little stimulus for growth. UK Chancellor George Osborne is intent on delivering a budget surplus by 2020, but this entails investment and public spending cuts that will provide a fiscal drag to growth.

These macro headwinds are overshadowed by the greatest potential risk to UK equities this year, which is 'Brexit'. Polls have the two sides neck and neck but the accuracy is being widely questioned. A look at the odds-makers shows a chance of around 35% that the UK leaves the EU. This is an uncomfortably high number and it increased after the recent Brussels bombing. As the June referendum draws closer, it is highly likely the chance of Brexit will increase.

An exit from the EU would be a problem for many equity sectors that currently experience preferential treatment from being an EU member. The greatest impact would be felt through trade and investment where new arrangements would need to be made with the EU as a non-member. It is likely that these would be less favourable than current terms lest it encourage other EU members to consider following the UK's example.

UK equities are currently not attractive from either a valuation, momentum or macro perspective. With the risks around Brexit growing, we are inclined to maintain our view and keep the UK in the lower half of our equity hierarchy.

## Credit

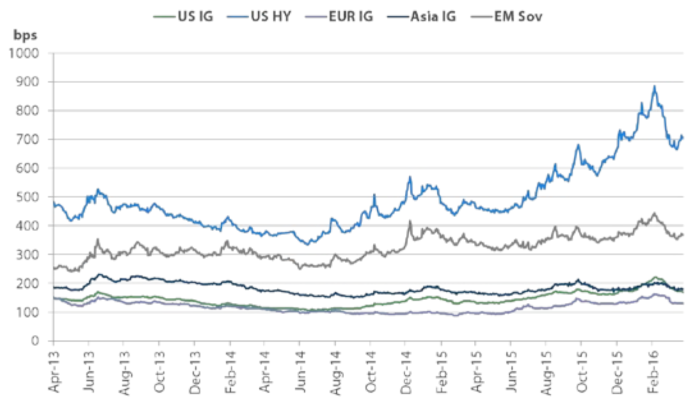
### We remain invested in high quality, low duration credit

The strong performance of high yield debt since the January sell-off (see Chart 7) raises the question of whether it is time to start increasing our allocation to low quality debt. We still believe it is too early for the following reasons:

1. Our research indicates that increased borrowing costs have the most profound effect on the weakest balance sheets, typically in high yield debt;
2. The poor performance of the Financials equity sector signals a tightening of lending standards; and
3. The rationalisation of misallocated capital in the energy/commodity sector appears to be ongoing.

Until such time as any or all of these factors stop acting as headwinds, we will maintain our long-standing credit view of preferring high quality over low quality issuers.

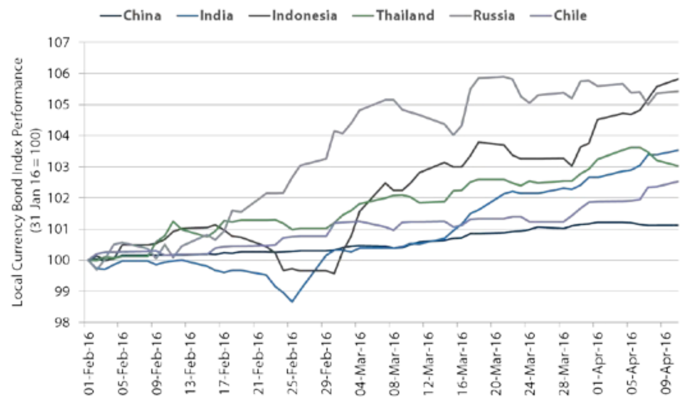
Chart 7: Credit spreads




Source: Bloomberg 2016. IG–Investment grade. HY–High yield. Sov–Sovereign.

We have adjusted our position in credit in the EM local currency bond space. The respite in the US dollar rally has allowed many EM currencies to stabilise. This has reduced the pressure on inflation from weaker currencies and allowed the central banks to ease monetary policy. Subsequently, local currency bonds have performed well as shown in Chart 8. We have been selectively increasing exposure to countries like Mexico and India where government balance sheets are strong and issuance is high quality.

Chart 8: Local currency bond performance



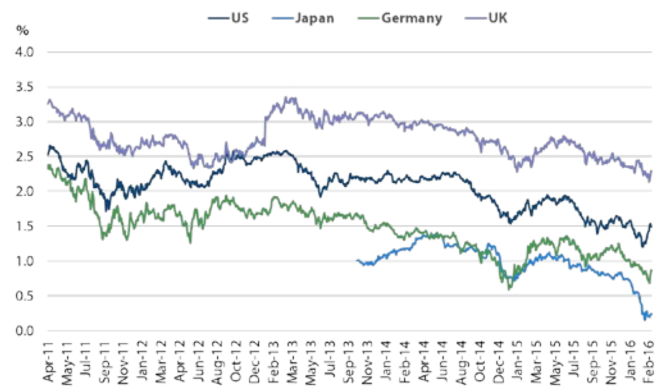

Source: Bloomberg 2016

## Sovereign

### We remain underweight sovereign bonds

We remain underweight sovereign bonds despite the strong rally so far in 2016. Our preferred defensive asset in our portfolios is still cash. Where we do allocate duration it is to bonds where the cost of that defensive insurance is not prohibitive like US Treasuries, UK Gilts and Australian bonds.

Chart 9: Long-term inflation expectations




Source: Bloomberg 2016

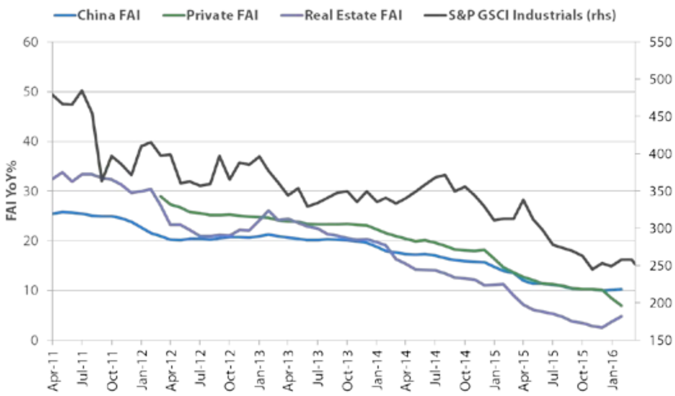
Long-term inflation expectations remain severely depressed and yet core inflation in certain economies is ticking up. The importance of this is being masked in bond markets by central banks' persistent monthly buying. We believe sovereign bonds are at risk of a dramatic and sudden repricing and so prefer to stay underweight the asset class.

## Commodities

### We maintain our underweight allocation to commodities

Within commodities, we retain base metals at the bottom of our hierarchy this month. However, we are cognisant of the significant upside risk to base metals from a sustained pick-up in Chinese economic activity. Chart 10 shows the strong relationship that has existed between commodity prices as measured by the Goldman Sachs Commodity Index and Chinese FAI. The key here is that the relationship is strongest when FAI is isolated to the property sector. This is not a surprise as construction has a much higher intensity of base metals than infrastructure. Given policy continues to be directed chiefly at stimulating non-property FAI, we believe our bearish positioning on base metals is still appropriate.

Chart 10: Commodity prices and China FAI




Source: Bloomberg 2016

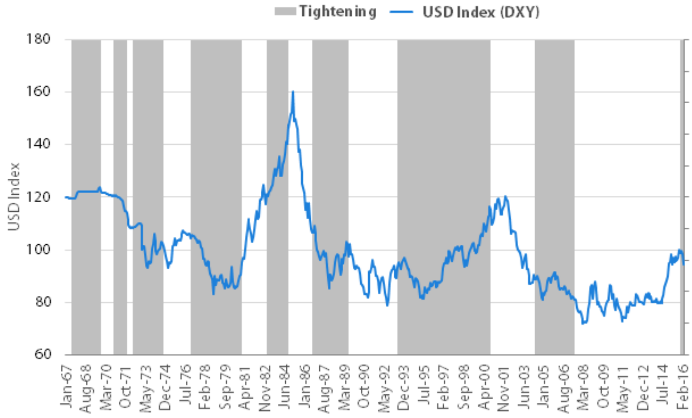
## Currency

### US dollar is no longer at the top of our currency hierarchy

After a few months of reducing our positive view on the US dollar, it has now been replaced at the top of the hierarchy by the Yen and Euro. The US dollar has been expensive for a while but we had been willing to persist with our view as long as momentum remained positive. This month, our models show momentum in the US dollar has rolled over, particularly against the Yen and Euro.

Market attention has also been focused on the divergence in monetary policy and this has been driving expectations. It is worth noting that a tightening in US interest rates is not a guaranteed sign that the US dollar will rally. As can be seen in Chart 11, the correlation between US dollar strength and US rate increases is inconclusive. Sometimes the US dollar rallies as rates rise (1982) and at other times it sells off (2004).

Chart 11: US Federal Fund rate increases and the US dollar




Source: Bloomberg 2016

Many market forces drive currencies, not just interest rate differentials. Below the surface, 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 not expensive and both are experiencing positive momentum so deserve to be elevated 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