BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

Equity pessimism took a breather in July as investors shifted focus from trade wars to the start of this quarter's highly anticipated earnings season. With 53% of the companies in the S&P 500 reporting, over 80% had positive earnings-per-share surprises and almost 80% reported a positive sales surprise. The good news from the US continued, with the economy growing over 4%, the fastest since 2014, including a better-than-expected 4% rise in consumer spending. Outside the US, Chinese equities enjoyed much needed relief as policy makers signalled modest easing, and European equities were boosted by a seemingly successful Trump-Juncker trade meeting.

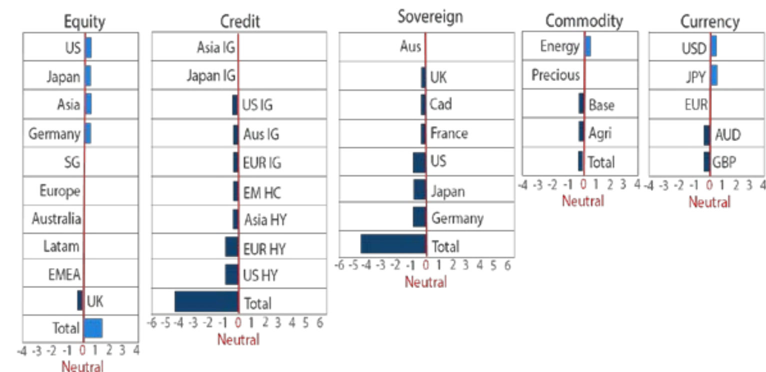
Despite increasing optimism, the threat of renewed trade tensions remains in the background. The deal with Europe to avert auto tariffs has been viewed both in the positive – this signals Trump's willingness to strike deals before the mid-terms; to more negative – Trump is making peace with his traditional allies to help facilitate an even more aggressive stance towards China. Regardless, it poses an opportunity to bring negotiations with China back to the fore, with unofficial reports that US Treasury Secretary Steven Mnuchin and Chinese Vice Premier Liu He are looking for ways to reengage in negotiations.

The US may have the upper hand over China not just for the latter's greater dependence on exports in their trade relationship, but also for its firmer economic health. Trump may be ratcheting up pressure while the US' stronger position lasts, ideally to strike a deal sooner rather than later to firm up support for the GOP in the upcoming mid-term elections in November. In any case, neither can afford a trade war – the US would be at high risk of falling into recession and dashing Trump's hopes for a second term, and China could risk losing control of its delicate deleveraging balancing act.

The primary impasse is China's "Made in China 2025" initiative. Through subsidies and incentives, the initiative is designed to push China's technology industry up the value chain while aiming for Chinese suppliers to significantly increase market share by 2025. China has long steered capital to industries of interest, but high tech is increasingly intertwined with national security, effectively challenging the balance of power, which raises the stakes.

As it stands, China has downplayed the initiative and avoided referring to its name in the press, but there is so far no concrete commitment to rolling it back. For now, the standoff continues, but as other countries cut deals with the US, China may soon feel it needs to do the same.

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. Equity and Sovereign changes were mainly driven by changes in momentum, whereas valuation changes drove changes in Credit.

Global equities

US equities remain at the top of the hierarchy, along with Japan and Asia ex-Japan. Singapore drops below Germany as momentum slips and new property curbs weigh on the property and banking sectors. EMEA drops as its trajectory turns more negative as external imbalances are increasingly vulnerable against tighter global financial conditions. LATAM falls as a result of headwinds from commodity weakness, a strong dollar and continued trade war fears.

While we continue to discuss the implications of trade wars in our opening snapshot, we remain positive on China over the medium term. Despite slowing growth, tighter liquidity and rising defaults, earnings estimates have continued to be adjusted to the upside. Potential trade wars are still a clear tail risk, but it is really credit conditions and the government's response that determines the earnings trajectory.

According to data compiled by Bloomberg, defaults currently stand at about USD 5bn so far in 2018, including nine private and 25 public offerings. These are big numbers that are set to worsen, and the main risk is tighter credit with the potential to damage the real economy.

The shift to easier policy including bank injections to support credit should ease concerns. Coupled with fiscal stimulus including infrastructure investment and tax cuts, the growth outlook is increasingly positive.

China's pivot toward easing weakened the currency, but the speed of the adjustment drew concerns that China could continue to devalue as a trade war response and risk having another bout of capital flight as experienced in the summer of 2015. We are less concerned for three reasons:

1. The currency was overvalued, especially relative to major trade partners including Europe and Japan, but is now approaching fair value to complete the adjustment.
2. The speed of the drawdown may have partly been a response to the fast escalation of threatened tariffs, but ultimately, China is still highly motivated to support a stable currency.
3. The capital account is more closed and growth is far healthier than in 2015, limiting both the ability and incentive for capital to flow out of the country.

Despite the 18% decline in equity prices from January highs, earnings estimates continue to rise, reflecting a far healthier growth environment than in 2015.

Chart 1: Chinese equities price versus earnings

Source: Bloomberg, July 2018

In 2015, earnings plunged on weak demand and falling purchasing prices (Producer Price Index (PPI): -6% in December 2015) subtracting directly from industrial profits. Through supply side reforms, PPI stands at +4.7% in June 2018. This, coupled with new infrastructure investment, should only improve top line growth.

While industrial profits remain important drivers of the index, "new China" continues to thrive. New China companies, and companies in the region that feed into its supply chain, have replaced cost leadership with technological expertise to increasingly take market share from global multinationals. The indiscriminate sell-off therefore presents opportunity.

Global bonds

Our Sovereign bond hierarchy has been relatively stable in recent months as Australian Government bonds and UK Gilts remain our favoured global bond exposures. One market that has remained near the bottom of our rankings is Japanese Government Bonds (JGBs).

It would be an understatement to suggest that Bank of Japan (BOJ) Monetary Policy Meetings have not been garnering much attention for some time. At the beginning of July, there did not seem to be any reason to believe that the next meeting would be any different. However, after a few well-placed stories in the Japanese press, market participants began to wonder if the BOJ was considering tweaks to its long held Yield Curve Control (YCC) policy that aims to keep 10-year JGB yields at around 0%. In the end, the BOJ retained its negative interest rate and YCC policies but introduced forward guidance and more "flexibility" in implementing its YCC policy. It is this flexibility that has injected dormant volatility into JGB trading.

Although never stated anywhere in official BOJ communication, the unofficial range for 10-year JGBs had been +/- 0.10% up until the latest meeting. Governor Kuroda used his press conference following the 31st July meeting to indicate that more flexibility suggested that 10-year JGB yields may be allowed to trade in a range of +/- 0.20%. As can be seen in Chart 2, the market immediately began testing this new range by pushing 10-year yields above 0.10%. The tacit confirmation seemed to come with no new buying operations by the BOJ, which had previously kept yields from moving above 0.10%.

Chart 2: 10-year JGB yields

Source: Bloomberg, July 2018

We have generally not held JGBs due to their very low yields. However, the temptation has been there under YCC to play the range of 0%-0.10% for 10-year JGBs. Even though this has provided a few opportunities in the past year, we have considered this strategy akin to picking up pennies in front of a steamroller. The risk/reward profile is simply not very attractive, with the prospect of a number of small gains at the risk of a large loss should BOJ raise the YCC target or abandon the policy altogether. If and when Japanese bond yields rise in the future, we will continue to assess the risk/reward of owning JGBs.

Global credit

The credit hierarchy saw a few changes as spreads tightened again, leading to valuation downgrades across US investment grade (IG), EM hard currency (HC) and EUR high yield (HY). Asian IG bucked the trend with further spread widening, offering some valuation support. However, we remain cautious overall.

Trade war fears managed to push Asian IG credit spreads out 30 basis points (bps) year-to-date. While Asian spreads remained the same over the month of July, US IG tightened 15bps. This was enough to flip US IG spread valuation to negative but improve Asian IG spread valuation to neutral. Despite the rally in the dollar, Asian IG spreads relative to US IG remained fairly constant at around 25bps throughout the first half of the year. Only when Trump announced his first set of tariffs in June did the two markets diverge more noticeably.

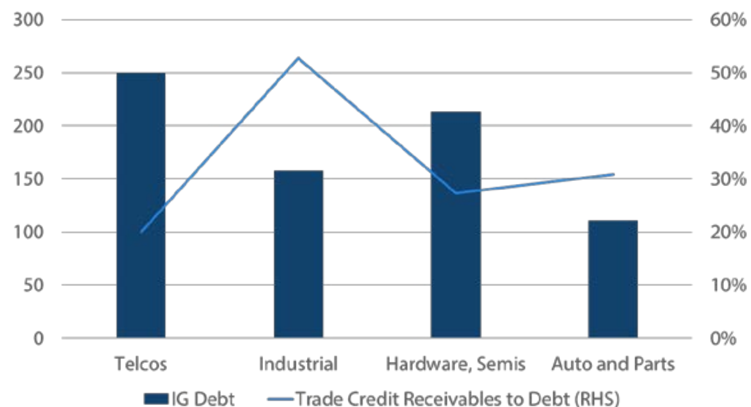
Chart 3: Asian IG option-adjusted spreads (OAS) vs US IG OAS

Source: Bloomberg, July 2018

Earnings in Asia remain strong, but could deteriorate if global trade slows. The widening in spreads helps price in some of the trade war effects, along with slower expected Chinese growth, but whether spreads have widened enough is still an open question. Sovereign balance sheets remain in decent shape with strong reserves, which will help keep corporate credit tethered somewhat. Further easing from China should help improve domestic demand, limit defaults and slow spread widening. However, the extent of the potential trade war is still unknown, so despite improving valuations, we remain cautious, preferring shorter duration and higher quality names for now.

Spreads tightened in the US on the back of strong earnings. However, it appears less likely that spreads have adjusted to price in the potential fallout if US tariffs and China retaliation goes through. Consumer cyclicals such as autos, communication companies, industrials and technology would likely be directly affected. What is less telegraphed is the potential contagion from a reduction in trade finance. These industries have above average trade credit usage. If the financial shocks from tariffs result in a reduction in their upfront payments to suppliers, the financial stress could move along the production chain.

Chart 4: US IG Industries impacted by trade wars



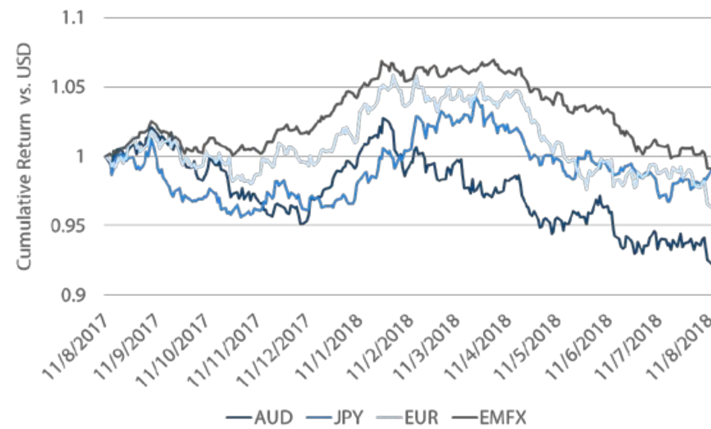
Source: Bloomberg, FDIC, UBS, July 2018

However the impact would likely be more acute in the US HY space, where almost no stress appears to be priced in. In a trade war scenario, US IG would also suffer, but this could be partially offset with the drop in UST yields. EU credit would likely also suffer given more globally exposed corporates.

FX

Our developed markets FX hierarchy remains unchanged with USD and JPY favoured relative to the EUR, AUD and GBP. While our hierarchy reflects a research view based on the relative valuation, momentum and macro characteristics of each currency market, it also corresponds to a positioning that would benefit from any continued weakness in emerging market currencies, given the higher sensitivity of the AUD and EUR to emerging market currencies relative to the safe havens of USD and JPY.

Chart 5: Sensitivity to EM FX of major DM currencies

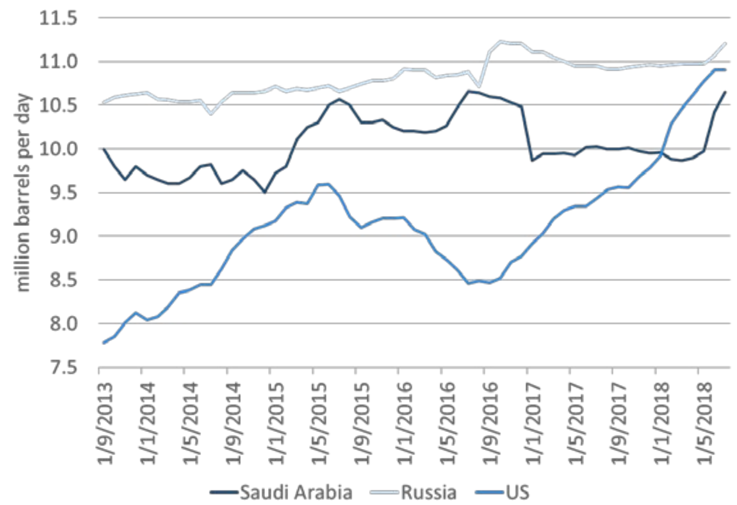


Source: Bloomberg, August 2018

Commodities

Geopolitics dominated headlines for crude oil prices last month. President Trump pushed countries to stop importing from Iran to cut its exports to zero. In return, Iranian President Rouhani threatened to close the Strait of Hormuz, a crucial passage for 35% of global seaborne oil shipments, according to the US Energy Information Administration (EIA). A week later, President Trump took everyone by surprise (again) by offering to meet with Iranian President without preconditions. Meanwhile, Saudi Arabia and Russia ramped up their outputs massively post the June OPEC meeting, as shown in Chart 6. Saudi Arabia was particularly under pressure as President Trump threatened to withdraw military protection should they not increase production. All this contributed to higher volatility in crude oil prices.

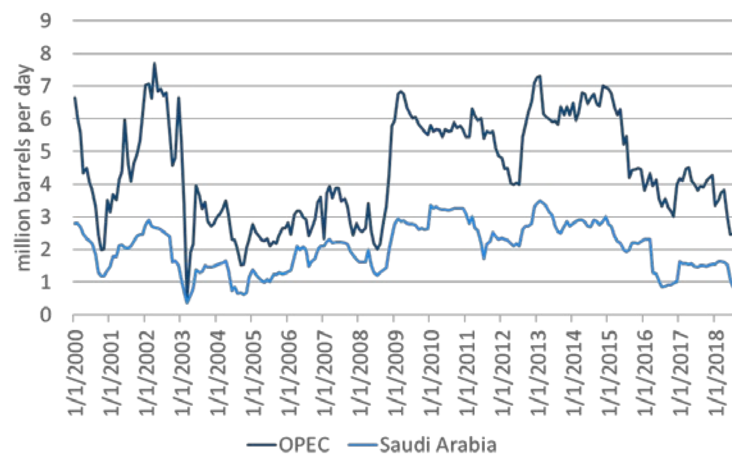
Chart 6: Major crude oil supplier outputs



Source: Bloomberg, July 2018

While it is difficult to gauge the direction of geopolitics, our assessment of fundamentals shows that oil supply is currently very tight. Chart 7 shows that total OPEC spare capacity is about 2.5 million barrels per day, and Saudi Arabia's spare capacity is in the range of 850,000. The last time the market was this tight was in 2008, when oil prices rallied to all-time highs.

Chart 7: OPEC spare capacity



Source: Bloomberg, July 2018

Naturally, one wonders who would be able to fill in the void if Iran is sanctioned out of market. Iran is currently producing at its maximum capacity, 3.7 million barrels per day, according to OPEC, which is more than the total spare capacity of all OPEC countries for now. Saudi Arabia is unlikely to come to the rescue this time with less than a million barrels of spare capacity left. Russia is also producing at its maximum output over the last five years. US shale producers are probably the most likely candidate, having added back 2.5 million barrels of output within the last two years. Even so, it is impossible to sanction Iranian exports to zero without putting upward pressure on oil prices in the short term.

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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