FOR INSTITUTIONAL/ PROFESSIONAL / SOPHISTICATED INVESTORS ONLY

April 2018

Multi-Asset Team

Nikko Asset Management

BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

As much as we would prefer to discuss market fundamentals over the trials and tribulations of the current US Administration, it has been largely unavoidable in this first quarter of 2018. For many US equities investors, the nadir of their relationship with President Trump came at the end of 2017. For us, this marked the end of a primarily inward looking Trump administration that had tried its hand at domestic policy issues such as immigration and healthcare (mostly unsuccessful) and a substantial loosening of fiscal policy through business and personal tax cuts (most successfully).

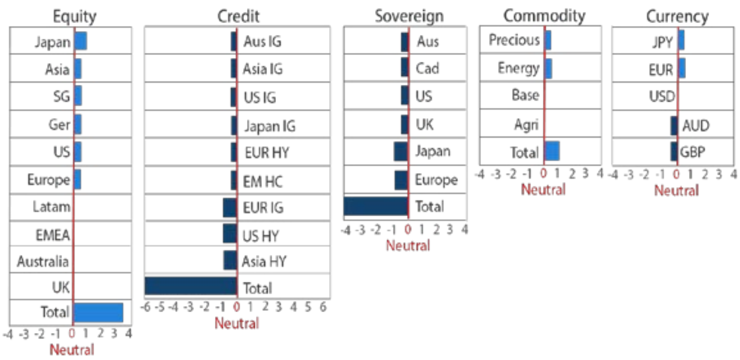
To the extent that underwhelming forays into immigration and healthcare policy suggested a new President having difficulty finding his feet, markets correctly surmised that a better chance of consensus on tax cuts would ultimately deliver this policy change where others had so far failed. It also certainly helped that the successful policy win was squarely aimed at encouraging economic growth and so markets continued to celebrate into the new year.

The upsurge in global equities has now lost momentum and markets have been in a holding pattern through the first quarter, albeit a highly volatile one. This uncertainty has been fuelled by a US administration that has become more outward looking in policy areas such as foreign policy and trade. It is on the world stage where President Trump's words and actions are scrutinised by a much wider audience than his domestic constituency. His unconventional style and propensity to change policy direction with little warning have often left investors scrambling to understand the policy aims of the US. Although it would appear that President Trump considers this a virtue of his administration, investors would likely disagree as the risk on/off switch is becoming well worn.

So at this juncture, we believe it is a good time to once again point out the strong fundamentals in place for equities markets, if not only to remind ourselves, but to provide some true notes amongst all of this recent noise. The economic backdrop is undoubtedly supportive. Real GDP growth in the G20 is forecast to be 3.4% in 2018 and 3.2% in 2019, appreciably better than the long term (20 years) average growth rate of 2.9%.

Forecast earnings growth is even more impressive. In the US, tax cuts have turbo-boosted expected earnings growth in 2018 to 16.6%, with another 10% increase expected in 2019. Across the Pacific in Japan, an even greater increase is expected with annual earnings growth of 28% in 2018. And the positive outlook for earnings doesn't end there with China A-Shares expecting 11.8% growth and Europe 8.6%. The combination of strong global economic growth and impressive expected earnings growth should provide powerful noise-cancelling headphones for investors to reach for in the coming quarter.

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.

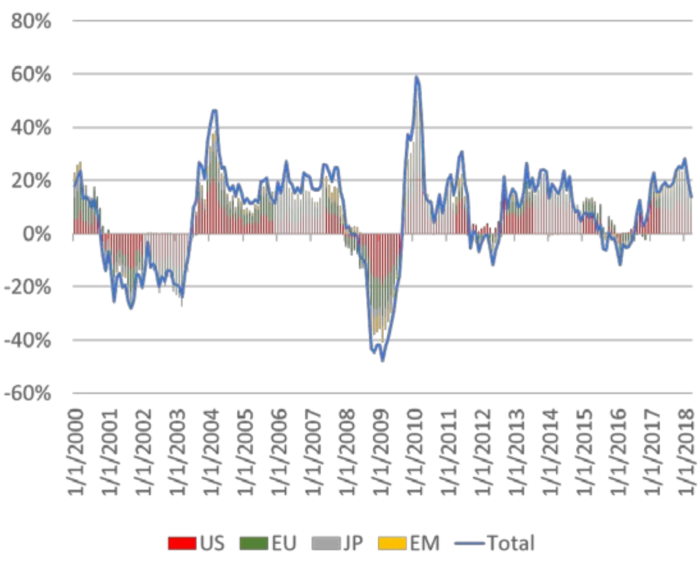
Research Views

Global equities

Trade war concerns continue to be a thorn in the side of our constructive equities view. Despite the headline grabbing threats, nothing has actually happened yet. The US-China tariffs are still only proposals. At this point it is near impossible to even begin to draw out representative scenarios of how the negotiations will play out, let alone ascribe any probabilities to individual scenarios or model likely asset class impact from each. However, despite strong fundamentals, equities could well end up on the back foot from this increased uncertainty given the role they play as a bellwether of risk appetite.

Why this is a concern can be seen from Chart 1. The chart shows a rolling 12 month return attribution of global equity markets over the last couple of decades into major regions. This shows little evidence of decoupling across equity market performance globally. This makes it less likely that we will see a smooth change of market leadership from US (and developed markets) to emerging market (EM) equities for example, or from technology companies to non-technology companies. Indeed if the US equity market was to decisively roll over under the weight of its stretched valuation and trade war uncertainty, there may be nowhere to hide.

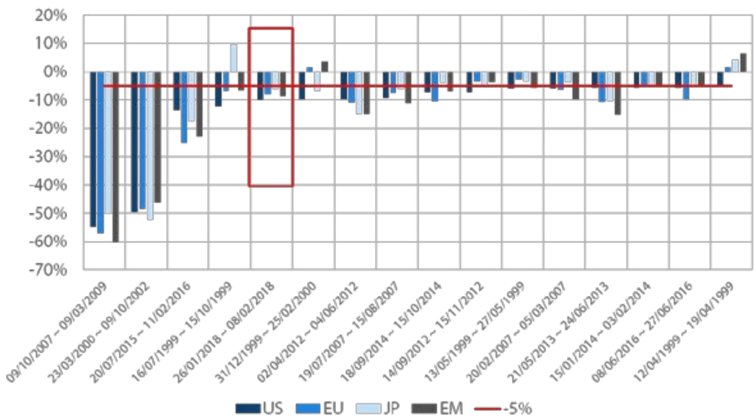
Chart 1: 12-month rolling global equity performance



Source: Nikko Asset Management, 2018

Historically, EM has provided some diversification at least, particularly in 1999/2000. Chart 2 shows the worst peak to trough drawdowns on US equities in the last 20 years, together with performance through each of these drawdowns in other markets. Even though correlations increase under stress, the value of diversifying from US (or global developed) equities into Japan and EM was clear during the 1999/2000 period.

Chart 2: Regional equity performance – worst 10 drawdowns



Source: Nikko Asset Management, 2018

As both Japan and EM Asia are our most preferred equity market exposures at present, it mitigates some of our concern around retaining a constructive view on "global equities". At the other end of the hierarchy, we lift the Emerging Europe, Middle East and Africa (EMEA) region two notches higher and above Australia and the UK equity markets.

The upgrade is predicated mainly on an improvement of valuations of EMEA equities from expensive to neutral on our proprietary valuation models. Our research view on the macro backdrop is also now more constructive based on the state of the consumer in Russia and South Africa. Private consumption has been a primary driver of growth in Russia on the back of steady real wage growth and declining inflation. However even in South Africa we now expect stronger consumer driven growth given reduction in political risk post the leadership transition of the African National Congress from Jacob Zuma to Cyril Ramaphosa.

Global bonds

Our sovereign bond hierarchy was unchanged following a relatively quiet month for global bonds as the gradual recovery from the highs in bond yields earlier this year continued. Both US Treasuries and European bonds performed well as US and China trade tariffs unsettled equities markets.

While most are familiar with the VIX measure of volatility for US equities, the US Treasury market also has a measure of volatility. The MOVE index measures the implied volatility on 1-month Treasury options across the US yield curve.

Chart 3 shows the path for both of these indices over the last year. Following the spike in volatility in early February, the VIX has remained elevated while the MOVE index retreated back to the range that held for much of 2017. Until greater stability returns to global equities markets, investors will likely continue to safe harbour their capital in sovereign bonds and inhibit bearish bond fundamentals from translating into higher bond yields.

Chart 3: Bond and Equities Volatility

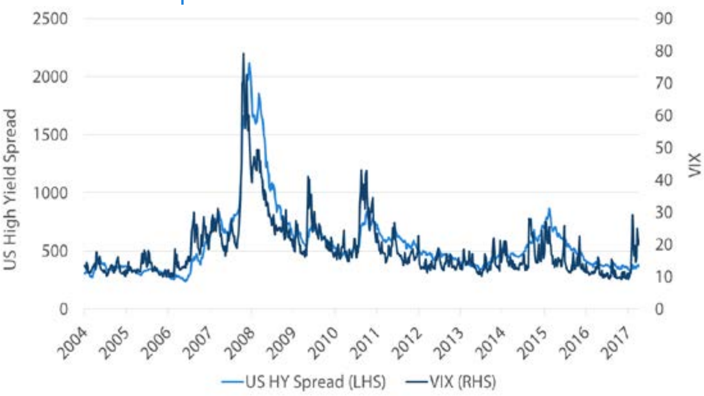
Source: Merrill Lynch, CBOE, Bloomberg, 2018

Global credit

Our credit hierarchy was unchanged for the month. Australian investment grade (IG) retains the top spot due to stable expectations on spreads and our view on the stability of the underlying sovereign. Asian IG retains its spot above US IG primarily due to the yield pickup and lower duration risk, given our more negative stance on US Treasuries.

Due to the historically tight spreads across most credit markets, we have spent time considering the implications of rising sovereign rates on the asset class. After the recent bout of equity volatility, it is sensible to start questioning when spreads may start to widen. Typically, high yield spreads tend to widen when equity volatility increases, which has yet to materialise.

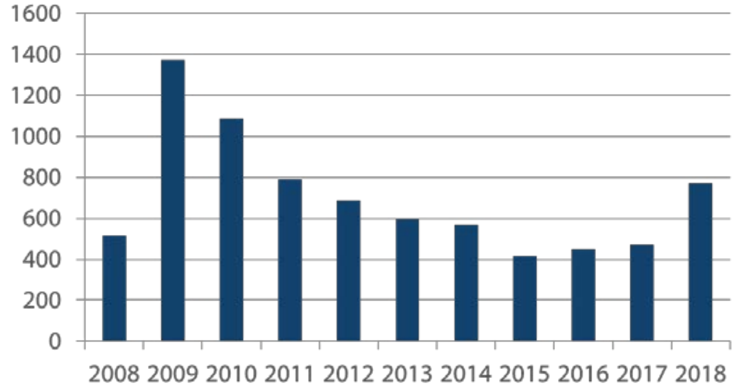
Chart 4: US HY Spreads vs VIX



Source: ICE BofAML, Bloomberg

US High Yield continues to have a very low default rate, at 1.8% for 2017. However, new Chapter 11 filings for March were up 64% from 2017, to the highest level since 2011. December 2017 saw a spike of bankruptcies, but this can be attributed to corporates writing off losses at the higher tax rate. However, a spike in 2018 comes at a surprise given the much lower tax rate. This could be an indication that the credit cycle is growing long in the tooth.

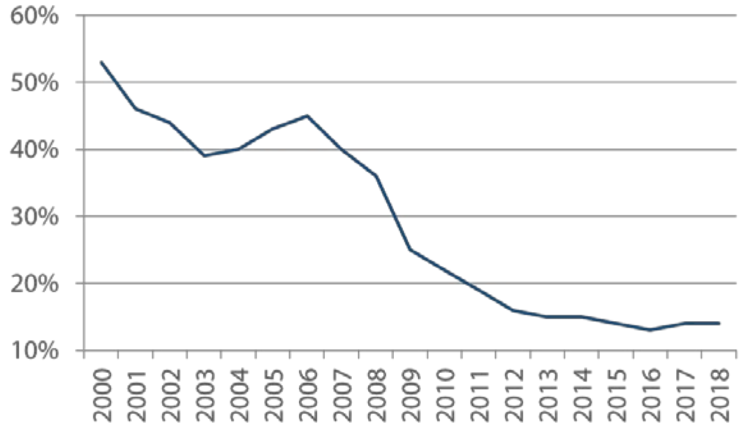
Chart 5: March US Commercial Chapter 11 Filings



Source: ABI.org

US 3 Month Libor has risen from around 1.7% to over 2.3% this year alone, which could be the culprit for some of these bankruptcies. Many corporates relied on cheap credit and now have to refinance at higher rates. Rising rates in a highly leveraged system does worry us, but this is likely to impact high yield more than their investment grade counterparts. US large cap companies have been using the low interest rate environment to extend out their maturities through bond issuances, limiting their reliance on short term financing. Short term financing only represents 14% of total credit outstanding, down significantly from the early to mid-2000s.

Chart 6: Short-Term Credit as a % of Total Credit



Source: FRB, Merrill Lynch

We continue to favour investment grade over high yield as we believe late credit cycle dynamics will start to erode high yield fundamentals, but given our positive outlook on corporate earnings, we believe increased cash flow should continue to support investment grade spreads for now.

Currencies

As concerns for trade wars mount, the currency implications simplistically seem obvious, but are not necessarily so in the case of the dollar. A trade war in motion implies a simultaneous reduction of the US trade deficit and decrease in China's trade surplus that would seem to favour USD over CNY in terms of net change in trade flows.

However, as the world's reserve currency, the dollar can behave differently where capital flows and central bank operations can overwhelm the effect of changes in the trade account. The US needs foreign banks to continue buying its overwhelming supply of treasuries, which reserve currency status generally affords. Foreign central banks have always abided by holding excess dollars, due to trade surpluses, in FX reserves most often in the form of US debt instruments. But what if these purchases slow, stop or even reverse?

Nothing requires central banks to hold dollars, but they generally choose to in order to keep currencies stable relative to the dollar. If the People's Bank of China (PBOC) slows purchases, the dollar could remain weak while making it more difficult for the US to finance its gaping fiscal deficits with likely higher yield requirements. This could be a powerful tool on the part of China in the event of a trade war, the so-called "nuclear option". We don't pretend to know how these developments will unfold, but it does present a potentially daunting conundrum for the US which historically had little concern for finding sources to fund its fiscal deficits.

It also presents difficulty in managing currency risk in a portfolio context vis-a-vis risk appetite. Typically, a weak dollar is associated with "risk on" as central banks around the world monetise the weak dollar, boosting local bank liquidity to lift growth, while a strong dollar is associated with "risk off", doing just the opposite. Typically, risk off is also associated with compression in UST yields in a "flight to safety". But as we have pointed out previously, this relationship has been breaking down since late 2017 where the dollar has continued to weaken while yields are on the rise.

Chart 7: US Dollar Index and Treasuries

Source: Citi, Bloomberg, 2018

Fundamentally, we have been negative on the dollar owing to rich valuations, negative momentum and weak macro fundamentals despite the fact that the Fed is hiking rates. From a portfolio construction perspective, measuring exposures becomes a more delicate process in light of historical correlations that are lately not holding with a geopolitical backdrop that has the potential to sustain this divergence. Our base case remains that trade wars will not break out, but these dynamics bear a close watch to ensure risk is properly managed.

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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