

EMERGING DIVERGENCE AS UNWINDING OF QE GATHERS PACE

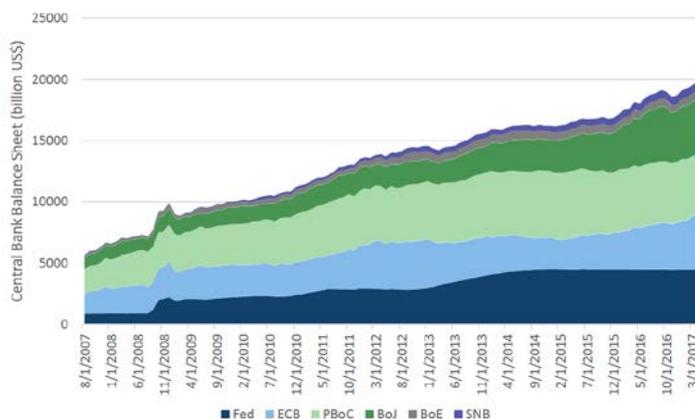
Emerging markets (EM) have been on a tear, originally lifted from the doldrums in early 2016 by China stimulus, but now self-sustaining with a synchronized economic recovery across emerging markets and Europe. Yes, the US has been hiking rates, but so far the EM recovery has remained durable despite bouts of dollar strength and rising treasury yields.

However in late June, central banks (CB) across developed markets changed their tune towards sounding broadly hawkish, signalling various progressions towards unwinding quantitative easing (QE).

In this piece, we consider the potential impact on EM assets of the slowing expansion and eventual contraction in central bank balance sheets. In preparing to contract its own balance sheet, the Fed has assured markets “it will be like watching paint dry”, but our team is not sure of market stability as collective efforts to wind down global QE gathers pace.

CB balance sheets have been expanding continuously since the financial crisis, from US \$5 trillion to nearly \$20 trillion, shown in Chart 1, as CBs have been using asset purchases (QE) to ease policy beyond the capacity of cutting rates. Former Fed Chairman Ben Bernanke once stated that \$600B in QE was equivalent to 75 basis points (bps) in rate cuts. If so, US QE since 2008 was equivalent to 4.5% in rate cuts beyond taking rates to nearly zero. Not surprisingly, on the prospect of reducing the balance sheet, policymakers estimate the rate hike equivalent to be much smaller, but the fact is no one really knows the degree of tightening impact.

Chart 1: Central bank balance sheets (Billion USD)

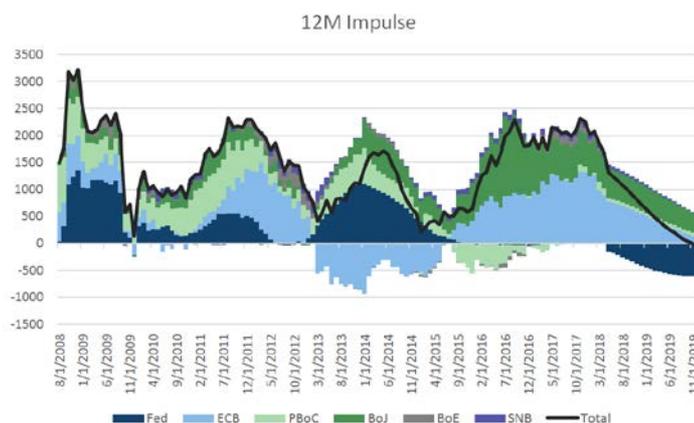


Source: Bloomberg 2017

To date, the Fed has hiked rates by 100 bps and is currently aiming to start running off a small portion of the balance sheet later this year – starting at \$10 billion a month, lifting the amount by \$10 billion each quarter to a cap of \$50 billion over 12 months. Markets didn’t seem to notice the ECB’s reducing its own QE by EUR 20 billion (from 80b to 60b, although such also entailed extending the QE program) back in April, so it is fair to assume that the process can start without much market fanfare. However, as the roll-off deepens with the ECB likely to start reducing its own QE in 2018, the cumulative effect starts to become meaningful.

The cumulative degree of QE easing (or tightening) can be measured as the 12-month change in aggregate central bank balance sheets – call it the QE impulse – shown in Chart 2. We also include in this chart a two year projection, based on the Fed’s balance sheet roll-off and gradual tapering by the ECB (assuming a 10 billion euro reduction each quarter starting in 2018). The projection is only an illustration as the specifics of ECB tapering are still unknown, but it makes the point that the QE impulse will decline considerably over the next two years.

Chart 2: QE Impulse: the change in central bank balance sheets (rolling 12M, Billion USD)



Source: Bloomberg 2017

To lend perspective on the potential EM impact, we compare the QE impulse to global FX reserves in Chart 3, the changes of which tend to be dominated by EM, as reserves are used to manage currencies against capital flows. FX reserves and the QE impulse tend to move together where predictably accelerating QE adds to EM inflows whereas deceleration reduces inflows or can cause outflows. A declining QE impulse should eventually begin reducing flows to EM, probably starting next year.

Chart 3: QE impulse versus 12-month change in global FX Reserves

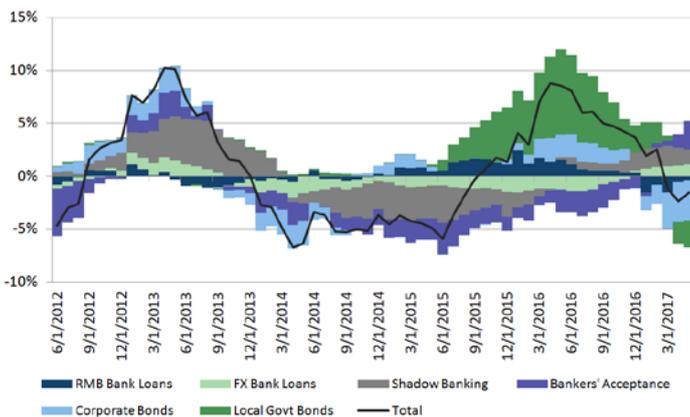


Source: Bloomberg 2017

The QE impulse is just one driver that tends to magnify flows based on changing liquidity, but fundamentals including global demand are the chief driver of growth prospects and, therefore, capital flows. The impulse decline in 2014 happened to coincide with sharp tightening in China initiated by its crackdown on shadow banking and corruption that led to a sharp decline in global demand.

Given the size and importance of China to global demand, China's credit impulse, shown in Chart 4, is a useful barometer for measuring the prospective direction of global demand. The massive injection that began in mid-2015 transmitted to a lift in global demand by early 2016, which has since spread to a more synchronized global recovery that now includes most of EM and also Europe with many countries being lifted out of downturns that began five or more years ago.

Chart 4: China credit impulse (12-month change in credit injections)



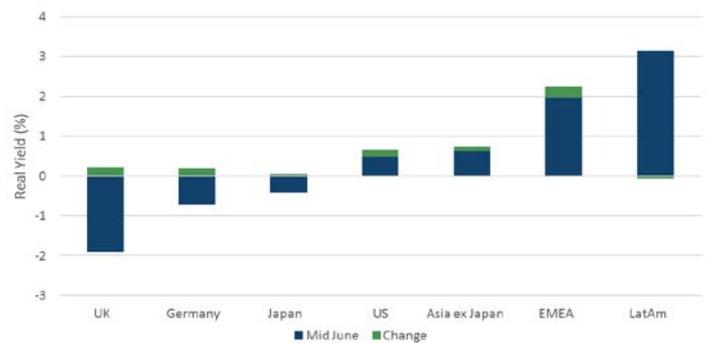
Source: Bloomberg 2017

This year, China has once again shifted to tightening, mainly to curb speculative leverage through shadow banking which had the knock-on effect of slowing bond issuance. The tightening seemed to reflect across the commodity complex, where prices declined since January. There has been some debate as to whether the decline is purely financial in terms of reducing speculative leverage, or whether real demand has in fact slowed. It is difficult to say, but as the credit impulse has begun to lift more recently, commodity prices have found support and global growth still appears healthy. We attribute the resilience, in part, to the extent of the economic adjustment

that completed in early 2016, with further tailwinds lent by varying degrees of reform, mostly in Asia.

Given the relative health of global demand, the recent sell-off in bonds is unlikely to turn into a broad risk off event that weighs on EM assets. We would remain cautious on duration, but selectively less so for EM bonds, which are far less expensive than DM. As shown in Chart 5, real yields are positive in EM, lending a buffer to the rise in real yields across developed markets where most real yields still remain negative. The green portion of the bar shows the change in real yield since the sell-off began in mid-June, indicating that LatAm and Asia remained stable while pockets of stress emerged in EMEA, including South Africa and Turkey.

Chart 5: Real yields

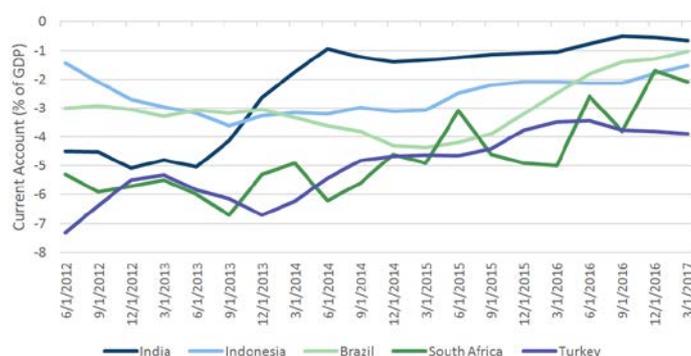


Source: Bloomberg 2017

As tighter policy advances into 2018 and the QE impulse begins to decline more precipitously over the next two years, we believe pockets of EM will be increasingly risky – something like the “Fragile 5” during the taper tantrum back in mid-2013 when Fed Chairman Ben Bernanke announced plans to begin winding down QE. However, we might now call it the “Fragile 2”, or possibly the “Fragile 3”.

The Fragile 5 included Turkey, South Africa, Brazil, Indonesia and India, all of which depended heavily on QE impulse flows to help fund their large current account deficits. As shown in Chart 6, current account deficits have improved across all five countries, making them less vulnerable, but while India, Indonesia and Brazil have managed to push reforms to rebalance their economies, improvements in Turkey and South Africa came mainly from weak growth therefore depressed imports. Political risk is on the rise in both countries with current policies aiming for more imbalanced growth, and, therefore, again wider current account deficits. As liquidity begins to tighten, it is reasonable to assume these two countries are at risk of deeper outflows. Brazil has pushed reforms, but also remains in a precarious position, as fiscal deficits remain wide and reforms slow with still weak political leadership. Further slippage could add it to the fragile lot.

Chart 6: "Fragile 5" Current Account Deficits



Source: Bloomberg 2017

Conclusion

We expect the EM rally will continue on the back of strong growth, but in 2018, performance is likely to diverge, with imbalanced economies that depend on foreign capital flows likely feeling the strain of tighter policy by the Fed and the ECB.

Both CBs intend to shift policy very slowly, and since global growth is broad and policy in China mostly accommodative, the sell-off (mostly confined to EM currencies) caused by CBs suddenly sounding hawkish in late June is unlikely to escalate into a taper tantrum as experienced in 2013. However, the steady removal of balance sheet support will start to become meaningful in 2018, reducing flows to EM with potentially pockets of outflows.

Reforms have reduced the Fragile 5, which were most impacted by the taper tantrum in 2013, to the "Fragile 2" (Turkey and South Africa) or perhaps "Fragile 3" (adding Brazil), for which insufficient reforms leave these economies still highly vulnerable to reductions in foreign flows. It is possible such strains could broaden across the complex if risk appetite turns sufficiently negative but, if this is the case, CBs seem more likely to pull back rather than forge ahead as they will be eager to preserve their policy gains.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a

substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realized. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may

provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.