BALANCING ACT

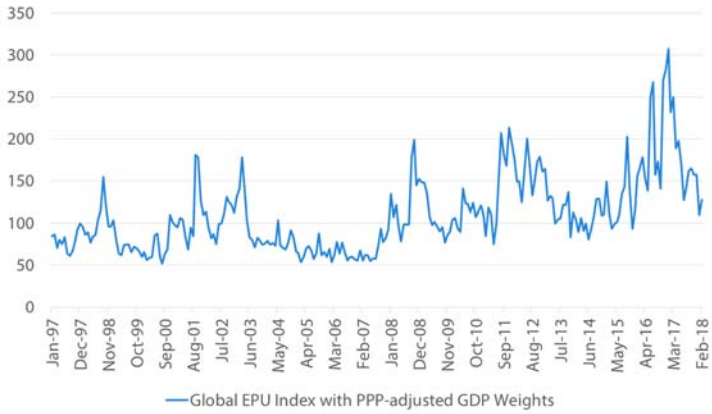
Nikko AM Multi-Asset's global research views

Snapshot

Markets continue to come to terms with the return of higher volatility, triggered ostensibly by fears of inflation and the unwinding of highly leveraged short volatility positions at the beginning of last month. To this list we can now also add the spectre of increasing protectionism and outright Trade Wars.

Volatility will likely remain elevated against the current backdrop of rising economic uncertainty. As shown in Chart 1, global economic policy uncertainty ticked up last month, after several months of decline, post the highs hit in the immediate aftermath of the US presidential election in November 2016.

Chart 1: Global Economic Policy Uncertainty Index



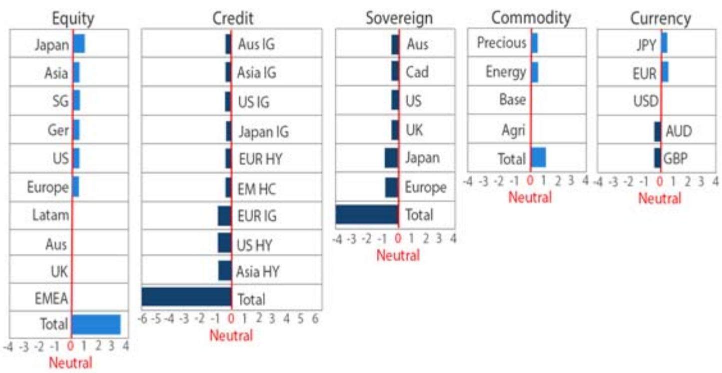
Source: Bloomberg, 2018

However the news is not all bad. Tensions on the Korean peninsula have markedly eased with all concerned parties showing a greater willingness to engage with each other. The protectionist rhetoric coming out of the White House appears to be a case where the bark is proving worse than the bite. Lastly, fears around the possibly indefinite extension of Mr Xi Jinping's presidential tenure in China are now also ebbing on recognition that this was neither completely unexpected nor exceptional.

On inflation, we believe the knee-jerk reaction to a strong jobs report in the February misses the bigger picture. Global inflation bottomed out in late 2015 and has been climbing ever since (see Chart 3). In fact on this measure inflation is already above its twenty year average and close to the 2% official target of several global Central Banks. Given strong deflationary forces of technological disruption and globalisation, this would suggest that risks to inflation are more symmetrical than suggested by recent market fears.

The key opportunity that higher volatility offers investors is the ability to add value through active risk taking. This is just as true for top-down allocation as it is for high conviction bottom-up stock picking. We expect markets to continue to be buffeted by strong crosswinds of reflation, geopolitics and shifting risk appetite. In response, our views and portfolios will remain anchored in effective risk diversification and a systematic research process that carefully calibrates signals from proprietary valuation, momentum and macro models.

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.

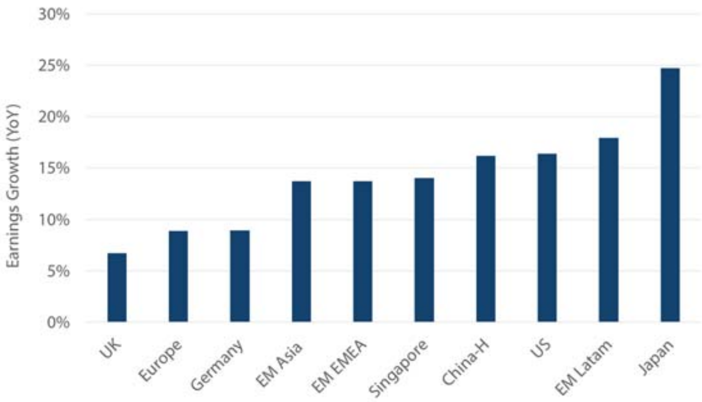
Research Views

Global equities

A strong earnings outlook helps us stay constructive on equities despite the return of market volatility. We also retain the same relative preferences for markets as last month, with Japan on top and emerging markets (EM) ex Asia and the UK at the bottom.

A stronger Japanese yen (JPY) has weighed on Japan equities recently. However, as noted in a recent report by our Chief Strategist Naoki Kamiyama, we believe volume expansion should continue to support corporate earnings despite JPY strength. As shown in Chart 2, corporate Japan earnings outlook remains among the strongest across global markets. This suggests there may be some margin of safety even if earnings expectations were to be trimmed back marginally.

Chart 2: Consensus Forecast for Earnings growth



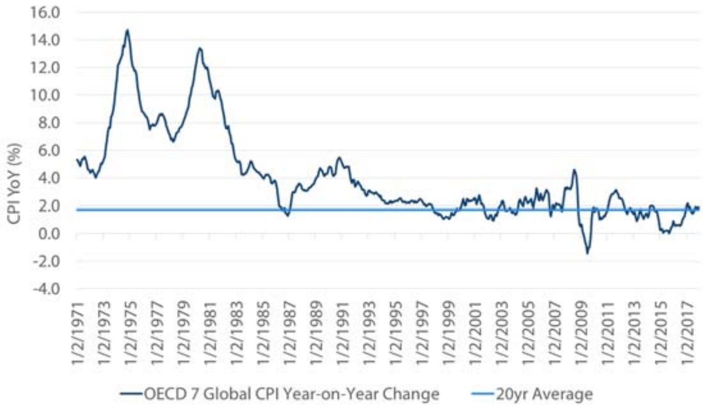
Source: Bloomberg, 2018

At the same time the recent pullback has lifted valuations to positive on our models. The macro outlook is supportive not just for the earnings tailwind but also because monetary policy is still accommodative and fiscal policy remains expansionary. On the former, the reappointment of Mr Haruhiko Kuroda for a second five year term as Bank of Japan (BOJ) governor reinforces continuity in monetary policy. On the latter, the record budget of JPY 97.7 trillion for FY2018 is expected to pass the lower house as scheduled.

Global bonds

We remain cautious on sovereign bonds given expensive valuations, negative momentum and macro headwinds – not least of which is the gradual bottoming of global inflation as discussed in the introduction and shown in Chart 3 below.

Chart 3: Global Inflation - OECD Major 7 Countries

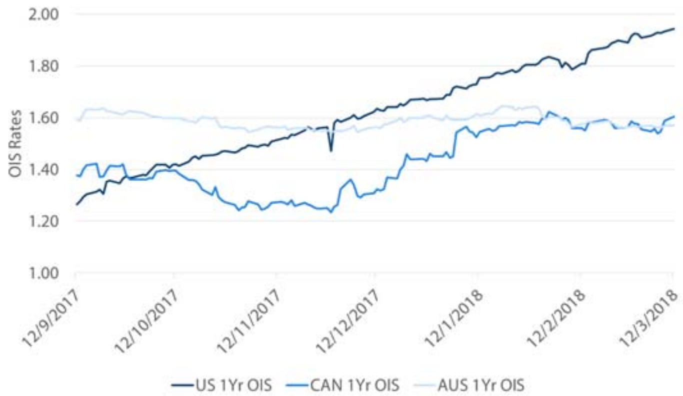


Source: Bloomberg, 2018

We've upgraded Canada above the US and UK on our bonds hierarchy. Australian sovereigns remain on top while JGBs and Bunds remain at the bottom, reflecting our preference for yield and central bank outlooks.

One way to compare the expected path of central bank cash rates is to look at the overnight indexed swap (OIS) markets. The 1-year OIS, which is essentially the expected average cash rate over the next year, is shown in Chart 4 below.

Chart 4: 1-Year OIS Rates



Source: Bloomberg, 2018

The US Federal Reserve (Fed) has been steadfast in its resolve to normalise interest rates and this is reflected in the 1-year OIS rate of 1.94% relative to the upper boundary of 1.5% on US Fed Funds. This would indicate that the market is expecting at least 0.75% of further tightening over the next year. We can also see that these expectations have been steadily rising over the last six months.

Canada's 1-year OIS, however, has been more variable. Expectations for the overnight target rate began to rise from early December last year until last month, mirroring the rise in the US. Canada's OIS rate has since flattened out, reflecting the notes of caution and patience coming through in Bank of Canada communications around the future policy path.

Conversely, the Australian OIS has been fairly constant, if not falling slightly, over the same period. This reflects market expectations that the Reserve Bank of Australia (RBA) could keep its official cash rate unchanged over the next year. It is these divergent monetary policy paths between the US and Canada/Australia that supports our current hierarchy putting both Australia and Canada above US sovereigns.

Our **global credit** hierarchy underwent several changes this month due to changes in valuation and momentum, which saw a net reduction in scores overall. There is no denying that credit is expensive and in certain countries, like the US, quite late in the cycle. Given the tightness of spreads, the underlying sovereign views become more of a determining factor for investment grade (IG) than in the past. Given the stage in the cycle, we are more concerned with high yield (HY), despite default rates and fundamentals remaining fairly stable. The largest change this month was the move down for US and EU IG along with the inclusion of Australian IG.

Australian IG debuts at the top of the hierarchy, although not due to any exciting reason other than its momentum is slightly better than the rest and we are more positive on the underlying sovereign risk. We believe the RBA will be on hold throughout 2018, even though the market continues to price Australian Sovereigns as if they were an extension of US or Canadian monetary policy. The Australian economy remains resilient, with the latest National Australia Bank (NAB) survey showing no signs of concern. Earnings continue to improve, but lack the excitement seen in other parts of the world, such as the US. Australian corporates remain reasonably leveraged when compared to their overseas counterparts and tend to show a perceived resilience when compared to US IG spreads. Local demand remains very strong for AUD paper and supply continues to be limited, especially outside of the financial sector. In short, we see no signs of concern to suggest spread widening any time soon and continue to favour the underlying sovereign risk.

Chart 5: US IG vs Aus IG OAS Spreads

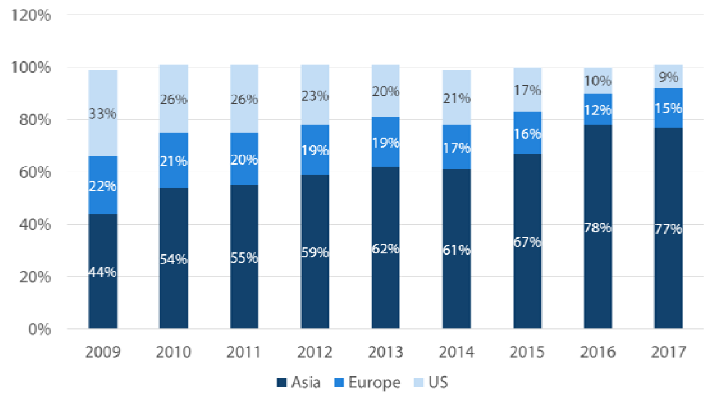
Source: Intercontinental Exchange (ICE) BofAML, Bloomberg, 2018

Unlike Australia, we are quite excited about the earnings story and improving fundamentals in Asia and the US, but similarly question how much further spreads can realistically be expected to tighten. However, our expectation is for continued yield appreciation for US Treasuries (UST), making us more wary on USD linked credit. Asia IG has overtaken US IG given its lower duration and therefore lower risk to further rising yields. The US is also further along in the cycle when credit is at greater risk.

We believe Asia is better positioned to benefit from global growth, providing exposure to high growth countries at the earlier stage in their development. While Asia's credit issuance versus GDP is not too far away from their developed market counterparts, their GDP and therefore their bond market is expected to continue growing. This should lead to deeper and more liquid credit markets within Asia, reducing the need for bank financing, which can be highly cyclical, and further bolstering growth.

Unlike the US, which has seen plenty of demand from 'yield tourists' over the past two years, Asian credit remains under-owned by foreign investors, with is over 70% owned by locals. This strong domestic bid has helped prevent spreads from widening despite record issuance over the past few years. Given the increasing wealth accumulated in Asia, along with the propensity to save and invest with a regional home bias, we believe this local bid could continue to strengthen. While Asian IG looks expensive versus its own history, when adjusted for duration and credit quality, it looks attractive versus the US.

Chart 6: Asia Credit New Issue Allocations



Source: Bond Radar, JP Morgan, 2018

From a pure spread perspective, Japan IG looks attractive. It is the only credit market whose spread appears cheap. However, even after the pickup from hedging the Yen back to dollars, the overall yield is relatively low and offers limited protection from any potential BOJ taper tantrum. Europe IG (EUR IG) fell further down the hierarchy as momentum turned negative. The European Central Bank (ECB) tapering, while not imminent, has the potential to hurt EUR IG on two fronts – spread widening from reduced credit purchases and rising yields as sovereign purchases reduce. This has pushed most investors down the quality spectrum into HY.

EM Hard Currency (EM HC) moved further up the hierarchy as valuations improved in Latin America (Latam) and overall value and momentum overall remains neutral. From a spread perspective, we view EM HC quite favourably, but have similar issues with the underling UST yield risk. However, while not discussed in this section, there is a clear preference for emerging market local currency debt, given the relatively attractive real yields and more supportive point in their monetary cycle.

Commodities

We retain our constructive view on Commodities as valuations and momentum are both attractive. The macro backdrop remains supportive given rising inflation, constrained supply, growing demand and weakness in the USD with which commodities continue to be strongly negatively correlated.

Currencies

Last month we lifted JPY above the USD on the hierarchy as it remains inexpensive and with improving momentum. This month we further lift it to the top while downgrading the AUD two notches down to below the EUR and USD.

The outlook for the AUD has weakened recently through a combination of declining interest rate differentials and global trade concerns. With roughly 40% of Australia's GDP coming from trade, it is not surprising that recent trade skirmishes between the US and others has caused market participants to re-evaluate prospects for the AUD.

Chart 7: Citi Terms of Trade and AUD

Source: Citi, Bloomberg, 2018

In addition, the AUD has a close correlation to the terms of trade (ToT) as shown in Chart 7. An improving ToT in late 2017 provided support to the AUD, which peaked just above 81 cents, but more recently the ToT has fallen, turning from tailwind to headwind.

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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