June 2017

By John Vail,
Chief Global Strategist

nikko am
Nikko Asset Management

EVEN MORE ECONOMIC AND EQUITY REFLATION DESPITE LESS DOVISH CENTRAL BANKS

Global Investment Committee Outlook

Global Growth Should Continue to Match the Positive Consensus Outlook

As a quick review, global GDP estimates for CY17 have not changed much since our March meeting's forecast of moderate growth. Meanwhile, equity markets have in aggregate matched our fairly bullish targets, but bond yields fell compared to our expectation of increases. Looking ahead, despite all the troubles on the world stage, the Global Investment Committee estimates that for the next four quarters, the G-3 and Chinese economies will continue to match the positive consensus outlook and that central banks will only be gradually less dovish, while equity markets will continue their upward path, although in moderate fashion. We continue to think that bond yields will rise, but very slowly. As the Fed will be cutting its balance sheet soon and the ECB starts to taper its purchases soon thereafter, there is, however, significant risk of higher volatility and bond yields rising more than consensus, especially when US economic indicators rebound from their mixed 1Q results.

There is great market uncertainty about Trump's and the Republican Party's legislative success, but we still believe that a good portion of his plans will eventuate in the 2H17 or soon thereafter. Essentially, Republican legislators are in control of the agenda now, and they are desperate to overcome their internal divisions so as to achieve some success before the next legislative elections eighteen months hence.

As for geopolitical issues, we believe, as have markets so far, that such will be handled without crisis due to the strong economic incentives of all major players, although the situations in North Korea and the Middle East are at very dangerous levels. Even the stability of the domestic US political system is under threat now that both sides have been fueled into a frenzy.

As for the major economies, US GDP, at a 2.3% Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR) in the 2H17, should match consensus expectations, with a 2.1% rate in the 1H18, which, although not booming, is quite firm. Growth should come from increased personal consumption, fixed asset investment, government spending and inventories, while net trade will likely be negative.

Meanwhile, the Eurozone's and Japan's GDP will likely grow at 1.7% and 1.4%, respectively on a HoH SAAR basis in the 2H17 and 1.7% and 0.9%, respectively, in the 1H18, approximately equaling consensus. These results should re-assure risk markets and corporate profit estimates should continue to show strong growth for CY17 and CY18. Personal consumption and capex should lead economic growth forward in each region, with trade being slightly positive for Japan, while slightly negative for Europe. BREXIT concerns will be increasingly crystalized in the coming quarters, although the real effect should be delayed to well into 2018. Japan will also continue to benefit from the large fiscal stimulus enacted last year.

Lastly, China's official GDP should be 6.4% HoH SAAR in both periods, which is similar to consensus forecasts. Here too, personal consumption will likely lead the way, while fiscal stimulus will continue to provide some (but fading) support, including to private capex.

Central Banks: Continued Shifts towards Normalization

In March, we were more moderately hawkish than consensus by expecting the Fed to hike twice more in CY17 and to start balance sheet reduction by year-end, and such is now the consensus. We expect the reduction to begin in September and also now forecast 25 bps hikes in the 4Q17 and 2Q18. The ECB and BOJ, however, have stayed more dovish than we thought. In our March meeting, we did not expect many major changes in CY17, but the ECB did not use side-methods to mildly decrease accommodation like we thought it would. It has, however, seemingly indicated to market experts to expect QE tapering of E5BB per month cumulatively starting in January, which would mean no QE purchases at CY18-end. Meanwhile, the BOJ has done nothing to reduce accommodation, although it is buying fewer bonds than expected due to tight market supply and instead is relying on its 10-year bond yield target. Both are more confident about their economies now, but the odds of any major monetary change from the current consensus is unlikely. We also expect the ECB to hint, after it begins its indicated taper, that it will raise interest rates in late 2018. The BOJ in the 2H17 should indicate a less accommodative plan for 2018, but such will be made conditional on improving macro-fundamental factors. As we expect the economy to remain firm, with an increasing CPI, the BOJ should hike its 10-year JGB target to 0.3% in the 2Q18. As for inflation, we expect the US Core CPI to be 1.7% YoY in December, and as we expect the Brent oil price to be $49 then, we expect the headline CPI to be 1.7% YoY, as well.

Rising USD and G-3 Bond Yields

Given our scenario, we expect G-3 bond yields to rise gradually through the 2H17 and 1H18. For US 10Y Treasuries, our target for December-end is 2.4%, while those for 10Y JGBs and German Bunds are 0.1% and 0.45%, respectively. These are not major changes from current levels, and we expect only moderate further increases through June 2018, as well, at 2.6%, 0.3% and 0.65%, respectively.

For Australia, we expect 2.65% in December and 2.85% six months after that. This implies (coupled with our forex targets) that including coupon income, the Citigroup WGBI (index of global bonds) should produce a -1.3% unannualized return from a base date of June 18th through September in USD terms, -2.4% through December and -4.1% through June 2018. Thus, we continue to **maintain an underweight stance on global bonds for USD-based investors.** The WGBI index in Yen terms should be -0.2% through September, +0.6% through December and +0.5% through June 2018. As for JGBs, we target the 10Y to have a -0.4% total unannualized return in Yen terms through September and December, with -2.4% through June 2018, so within bonds, we clearly prefer overseas bonds for Yen-based investors.

Our scenario in March called for a stronger USD, but the opposite has occurred so far, mostly due to lower confidence in US reflation, coupled with greater confidence in Europe's and Japan's future. From the 113 level at our March meeting, the Yen is now 111.5 compared to our June-end forecast of 114, while from the 1,07 base level, the EUR is 1.11 vs. our 1.06 forecast. Clearly, confidence in Europe has improved due to confirmation of the relatively strong macro data and improved political prospects related to recent elections.

Because Fed policy will tighten faster than BOJ policy and we expect some US legislative reflationary success to finally occur, we expect the Yen to weaken to 114:USD at end-December. As for the EUR, we expect it to be 1.09:USD then. We expect 116 and 1.08, respectively, four quarters from now and the AUD to be 0.75 for each period, respectively, vs. the USD, thanks to relatively stable commodity prices and higher local interest rates. As for commodities, they have been quite volatile and driven by non-market events, especially the compliance and durability of the OPEC-Russia agreement, but the result has not been as good as we anticipated, although we did not expect a significant increase, due to stronger US oil production and lower Chinese reflation. Looking ahead, commodity prices should be relatively flat despite continued global economic growth, with our Brent forecast at $49 in December and $50 in June 2018.

Still Overweight Global Equities

Our March meeting's MSCI World Index target for June was slightly exceeded by June 16th, with some countries rising less than expected, but others more so. As mentioned, despite all the political wrangling, we still think a good portion of Trump's agenda will be enacted in the 2H17 or soon thereafter, including moderately-sized corporate tax cuts and some additional infrastructure spending, although it will be important for markets whether this is financed with short term deficits or offset by spending cuts. This success is built into US equity prices, so they will likely decline if the results disappoint some investors, but in the end, the animal spirits that have been released should keep the profit outlook strong and equity prices from falling too much. Other major global equity markets (see text below) should also perform reasonably well, so aggregating our national forecasts from our base date of June 16th, we forecast that the MSCI World Total Return Index will increase 3.0% (unannualized) through September in USD terms (4.2% in Yen terms), 5.6% in December (8.8% in Yen terms) and 10.7% by June 2018 (16.0% in Yen terms). **Clearly, this suggests a continued overweight stance on global equities for USD- based investors (and Yen-based investors, as well).**

Aren't US equities too expensive? The answer is "Yes" if Trump's agenda is not passed, but we think significant portions will be enacted and that the global economic reflation cycle will be hard to stop. Interest rates will rise, in our view, pressuring valuations a bit, but not by very much and Fed policy will remain quite accommodative. US deregulation and accelerated share buybacks are further icing on the cake, and although there are moderate profit headwinds from a mildly stronger USD, CY17 and CY18 earnings should be quite strong. Currently, because the tax cuts are not legislated, analysts are not adjusting their EPS forecasts for such, but this **is likely a major anomaly that makes the market much less expensive than it appears.** Indeed, we estimate that the market is trading on about 16.9 times CY18 EPS (and even less if buybacks due to the repatriation "holiday" are greater than expected). In sum, these factors should send the SPX to 2499 (3.3% total unannualized return from our base date) at end-September and 2687 in June 2018 (12.5% total return), which is higher than its peers and, thus, **justifies an overweight stance.**

European equity prices should perform quite well in local terms, with Euro Stoxx rising to 398 and the FTSE to 7620 at end-September (420 and 7920 in June 2018). This translates to 2.6% and 7.9% unannualized MSCI Europe returns in USD terms for those periods. Fears of a banking crisis have greatly diminished (although the threat remains) and global growth should cause consensus profit estimates to rise. BREXIT rhetoric will likely become harsher, and, thus, we expect UK equities to underperform the rest of the region, but the market will likely ignore the threats of a major disruption of European trade. Valuations in Europe are a bit high, but because of the improving intermediate-term profit outlook, we think they can be sustained despite a less dovish ECB stance ahead. Meanwhile, like our last few quarterly meetings, we still don't see any European election leading to significant problems. Thus, equity prices can come close to rising along with earnings. In sum, **we are positive, but will have a slightly underweight stance on the region.**

In our last reporting period, **Japanese equities performed moderately well in both local currency terms and USD terms, in line with the MSCI World Index.** We expect TOPIX at end-September to hit 1633, with 1717 by June 2018 for a total return of 1.7% and 4.6% in USD terms respectively (2.9% and 9.6% in Yen terms). These are, of course, relatively muted USD-termed gains, as our Japanese equity team is not as confident in market sentiment as before. As for the fundamental drivers, we expect continued corporate governance improvement (including profit orientation and improved returns to shareholders) to be a prime positive factor, but macro factors are likely to play a positive role too. Japan's economy will likely grow well above its trend, driven by improved consumer and corporate sentiment, as well as likely improvements in net trade after the 2Q17, as the global economy, especially in China, continues to grow. Such, combined with a weaker Yen, should be a positive driver for corporate profits, while valuations are reasonable, so the outlook is positive, in our view; however, given that the other regions' USD-termed equity returns are higher, **we maintain our slight underweight stance.**

As for the Developed Pacific-ex Japan region, we expect Hong Kong and Australian equities to perform well, and as we expect their currencies will be stable, this leads to a 3.5% unannualized return in USD terms through September and 12.8% by June 2018. This is greatly due to China's continued economic rise, its capital outflows to HK, and especially for Australia, China's continuing demand for commodities and services. Thus, we **will maintain an overweight stance on the region.**

Investment Strategy Concluding View

After a strong start to the year, there was no value-added to be had, except in a risk-adjusted sense, by asset allocation between global bonds and global equities in the prior quarterly reporting period to June 16th, as both returned slightly above 4% on an unannualized basis in USD terms.

Looking forward, there is no doubt that the Trump agenda carries many uncertainties and that geopolitical tail risks remain quite large, but the Global Investment Committee remains upbeat because the net impulses for global economic growth and corporate profits continue to improve. Similar to our last meeting, this justifies **an overweight stance on global equities, particularly for the US and Pacific ex Japan.** Meanwhile, global bond yields should rise slightly, so we **maintain an underweight stance on global bonds, with a slight overweight stance on USD cash** for USD-based clients. For Yen-based clients, however, cash looks less attractive than global bonds, but more attractive than JGBs.

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 websitewww.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 nether 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 Decree80/98, 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.