BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

After depreciating for over 18 months, the US dollar has managed to make a comeback, recouping its 5% YTD loss in a matter of weeks. Coupled with 10 year US Treasury (UST) yields hovering around 3%, this has put pressure on Emerging Markets (EM). Indonesia local currency bonds have sold off over fears of fragility, the Turkish Lira sell-off accelerated, and Argentina had to raise interest rates to 40% to stem the loss in its currency. While Jerome Powell mentioned recently in Zurich that EM economies are well placed to navigate US tightening, he also hinted that these countries should have seen this coming. In a way, actions by the US Federal Reserve (Fed) may push countries to either join the tightening club voluntarily, or by force to prevent the collapse of their currency. So is it time to turn bearish on EM?

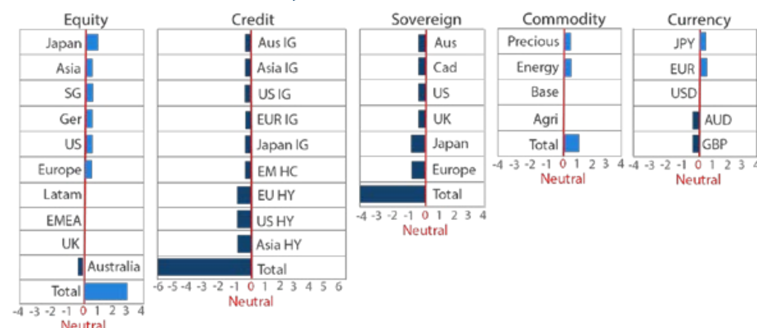
EM fundamentals are in a much better place than they were during the Taper Tantrum in 2013. Trade and capital flows have been bolstered after increased global growth, helping improve current accounts and reserves. Inflation in most emerging economies so far remains contained. The lessons from 2013 have led to a number of fiscal reforms which puts EM on a far stronger footing than they were in the past. However, despite this, there is still a tipping point when rates or the dollar go too far.

While the recent rally in the US dollar could be seen as a short squeeze as investors take off their long Euro positions after Eurozone data disappointed, it is still too early to know if this rally has legs. Thankfully, UST yields managed to bounce off their resistance level of 3.05% and seem to be somewhat contained for now. Of course, inflation surprise to the upside would cause the Fed to shift to more aggressive tightening and change the outlook considerably, but this is not our base case despite record low unemployment. Inflation remains broadly moderate around the world, and it is difficult to imagine US inflation significantly breaking out on its own.

We remain watchful of recent dollar strength, but continue to believe that the dollar remains expensive and structurally weak where recent strength is deemed more of a correction than a switch from its general downtrend. Nevertheless, dollar strength can become self-reinforcing within EM if it triggers deleveraging of dollar debt. It is perhaps normal for the dollar to rise with yields, but this didn't prove to be the case for the first few of months of the year.

Dollar strength is at least a partial reflection of market uncertainty due to potential trade war, US inflation concerns and now a bit of a slowdown in global growth momentum. None of these fears are yet confirmed realities, but higher market volatility, in general, seems to be magnifying the sense of uncertainty. Given the fundamental strength and the relatively early stage of the current upcycle, we believe growth will persist, albeit with more volatility due to various uncertainties.

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

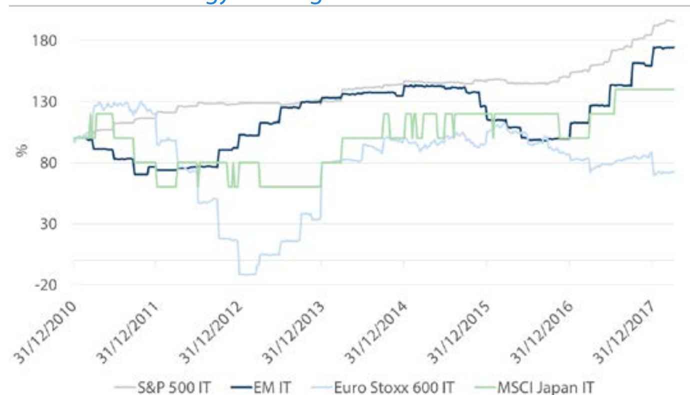
The hierarchies remain broadly the same with only minor adjustments.

Global equities

EM technology shows value relative to global peers

Asia remains second on our hierarchy, just behind Japan, with valuations improving to neutral. While valuations are no longer cheap, this can be somewhat explained by the shifting composition of the index towards tech. While US tech earnings have shown relatively steady growth over the last seven years, EM tech earnings experienced a downdraft in 2015, but have picked up considerably since early 2016, nearly catching up to US levels. In Chart 1, we compare tech earnings within EM (mostly located in Asia) against the US, Europe and Japan.

Chart 1: Technology earnings around the world



Source: Bloomberg, December 2017

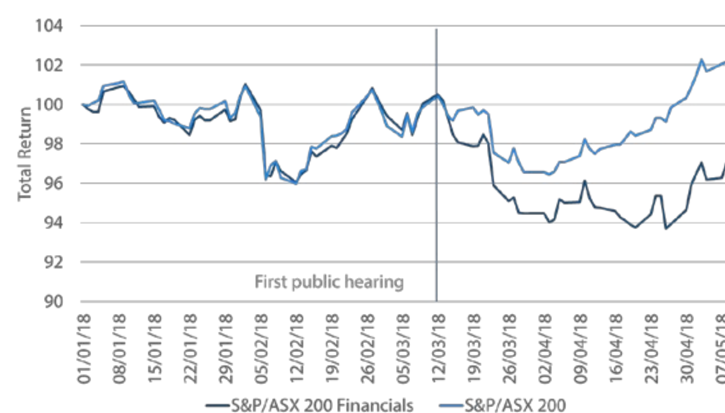
While EM tech earnings growth remains quite robust, valuations are comparatively cheap at 14x forward earnings versus 18x in the US. Given rising regulatory risk in the US due to Facebook's recent accidental leak and misuse of personal data, EM tech could well have an earnings advantage over the US going forward.

Australia slips below the UK

UK valuations remain the second cheapest developed market after Japan, with momentum improving to neutral this month. While we still have our doubts over the shape and impact of Brexit, there are other factors that remain supportive. The strong move in the oil price should act as a tailwind to UK equities, with oil companies accounting for over 16% of the index. The ex-resources component is overweight defensive assets and on average has relatively low operation leverage compared to other major markets. This underweight to cyclicality is useful when non-financial cyclicals are expensive against defensives, which may lead to outperformance if global lead indicators start to roll over. The recent weakness in the pound/strength in the dollar will bode well for overseas revenues. While we remain cautious on the outlook for Brexit, we have moved the UK up slightly in the hierarchy above Australia.

Australia has had a bad run in the press lately – in the past few weeks the country learned that not only are its cricket team a bunch of cheats, but so are its banks. The Banking Royal Commission uncovered a laundry list of misconduct across the industry. The mortgage industry, dominated by the 'Big Four' banks, had brokers falsifying documents and taking bribes for commissions. The CEO of wealth manager AMP resigned after admitting to deliberately misleading regulators and charging customers for services they didn't receive. The fallout could be costly, with new penalties being announced and new regulatory oversight being drafted, along with politicians calling for the banks to be broken up. Financials are taking it on the chin, with analysts trimming earnings forecasts and issuing some sell recommendations. With the sector accounting for over 30% of the index, Australia will likely see some headwinds in the coming months.

Chart 2: Australia Financials vs ASX 200 YTD



Source: Nikko Asset Management, May 2018

Global bonds

Our Sovereign bond hierarchy is unchanged as we continue to see better value in Australia and Canada relative to the US. However, when we consider an expanded bond universe, another bond market also stands out right here in Asia.

China 10Y bonds yield 3.7%, roughly 200 basis points (bps) better than the Global Aggregate Index and 100bps above USTs. The relative yield advantage, coupled with benign inflation dynamics and impending technical inflows due to its index inclusion, make for an increasingly compelling investment story.

In March, it was announced that the Global Aggregate Bond Index will include China bonds, starting in April 2019. The weight will scale to about 5.5% by the end of 2020, making its weight the fourth-largest in the index. This adds at least USD100 billion of passive investment which could easily grow north of USD250 billion as active investors join the mix and other indices consider adding an allocation to China as well.

China bonds currently appear expensive based on our valuation metrics, but this is mainly because inflation rates remain quite compressed relative to history. During 2017, the Purchasing Price Index (PPI) lifted quite significantly both for the pickup in demand as well as aggressive supply side

reforms. Bond yields followed, but as PPI has begun to ease in the second half, so has the pressure on bond yields, leading to compression as shown in Chart 3.

Chart 3: China yields compress with falling inflation

Source: Bloomberg, March 2018

In fact, during the US inflation scare in early 2018 which caused UST yields to blow out, China bonds were among very few sovereign markets in the world were yields actually compressed over the same period. Are China bonds the new safe haven asset? It is too early to say, but given the positive spread to developed market (DM) equivalents, which is now challenged in its unwind of exceptionally easy policy, investors are certainly taking note.

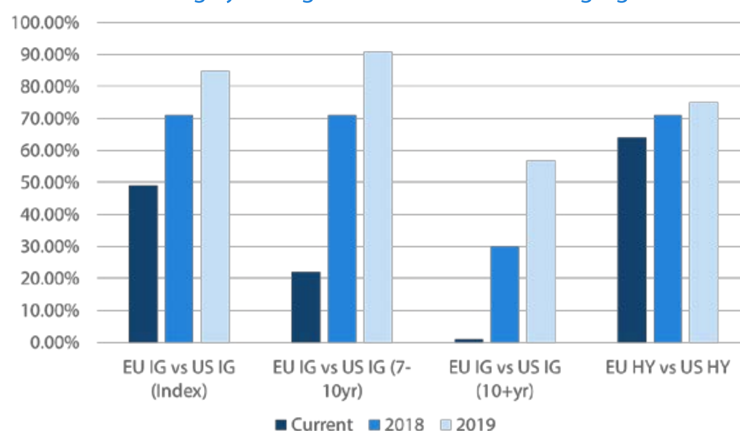
Global credit

EU High Yield (HY) slipped down the hierarchy to join its other high yield brethren as momentum flipped to negative. Conversely, EU Investment Grade (IG) managed to jump thanks to an improvement in macro.

European credit fundamentals remain sound. Compared to their US counterparts, corporates have not been leveraging up as aggressively, with leverage ratios at 1.2x, only slightly above the 30 year average of 1.1x. Unlike the US, corporates also remain at an earlier stage in the cycle. Continued EBITDA growth should help keep leverage and interest coverage from deteriorating over the following year. The softening in data out of Europe has likely extended tapering from the European Central Bank (ECB) and potentially extended out corporate purchases to the end of the year, which should help keep spreads contained.

We've discussed previously the benefit to US credit from 'yield tourists' who have been pushed out from their home country in search of non-negative bonds. However, as the Fed keeps hiking, the cost to hedge USD will continue to rise, making US credit less attractive. As yields rise elsewhere, yield tourists may find longer duration sovereigns or even EU IG more attractive by year end. Chart 4 shows the percentage of EU credit that will yield more than US credit after hedging by the end of 2018 and 2019. Over 70% of both US IG and HY will yield less than EU after hedging by the end of 2018, causing yield tourists to go home.

Chart 4: Percentage yielding more than US after hedging



Source: eVestment, Bloomberg, UBS, May 2018

In general we remain positive on spreads but acknowledge risks this late in the cycle. For now our main concern is the underlying sovereign risks.

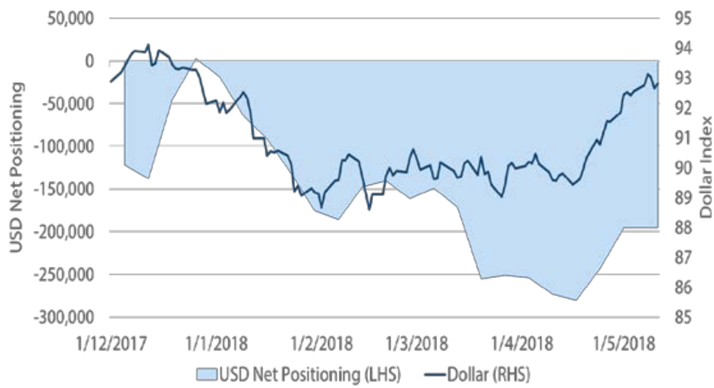
Currencies

The currency hierarchy remains unchanged, despite the recent dollar surge beginning mid-April that challenges our view. As the world's reserve currency, sudden strength in USD has a way of self-perpetuating across EM through a harsh cocktail of tighter liquidity, forced deleveraging and capital outflows. While EM had been outperforming DM through mid-April, dollar strength proved once again to be EM's Achilles heel.

We still think it's early to call a sustained dollar rally driven by a "dollar shortage" due to EM deleveraging. After all, the rally is only a couple of weeks old but the duration and velocity of the rally will be important to watch for its impact on EM. Our view is that fundamentals are much stronger than the last painful rally in 2014-2015 with less outstanding leverage, but we also recognise dollar borrowing is an unfortunate EM addiction, so the risk has not gone away.

It's hard to find a catalyst for the rally on the US side other than hiking rates as expected perhaps, but the impetus may have come from across the pond where European growth has recently disappointed. Last year, surprisingly strong growth seemed to convince markets that the ECB would be withdrawing stimulus much more quickly than its stated plan. Speculators bet heavily long EUR against a USD short. With a growth pause and still weak inflation taking pressure off the ECB, the Euro has unsurprisingly weakened which is a tailwind for the dollar. As shown in Chart 5, heavy speculative positioning against the dollar is starting to unwind, which is partially responsible for driving the dollar rally.

Chart 5: Net USD speculative positioning versus USD



Source: Bloomberg, May 2018

The dollar is still expensive and momentum remains negative despite the recent climb. Fundamentally, while global growth has paused, positive drivers of growth remain in place, which tend to keep the dollar weak. Nevertheless, we watch EM and Europe closely for signs that the tide may be turning.

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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