BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

Uncertainty surrounding Trump policy has reached new highs with global trade wars back on. Steel and aluminium tariff exemptions have been allowed to lapse for Canada, Mexico and Europe, and USD 50 billion in new technology-focused tariffs against China will be detailed by mid-June and imposed shortly thereafter. This all occurred just over a week after Treasury Secretary Mnuchin called trade wars "on hold", demonstrating just how unpredictable the US administration has become.

Most analysts agree that a full-on trade war is still unlikely for the simple reason that no one wins and everyone loses, but initiating tariffs risks tit for tat responses that can eventually spin into the trade war that no one wanted.

Relations with Canada, Mexico and Europe have reached new lows on the allowed lapse of the exemptions that comes on the heels of two other bones of contention – the US making unrealistic demands on Canada and Mexico in NAFTA negotiations and Trump's unilateral withdrawal from the Iran deal despite European leadership imploring him against it.

The latest tariffs against China take direct aim at the "Made in China 2025" initiative designed to leverage technology development as a means of working up the manufacturing value chain – an initiative deemed critically important by President Xi himself where relenting to US demands seems highly unlikely. Policymakers appeared stunned at the latest announcement, and subsequent talks with US Commerce Secretary Wilbur Ross predictably bore no productive fruit.

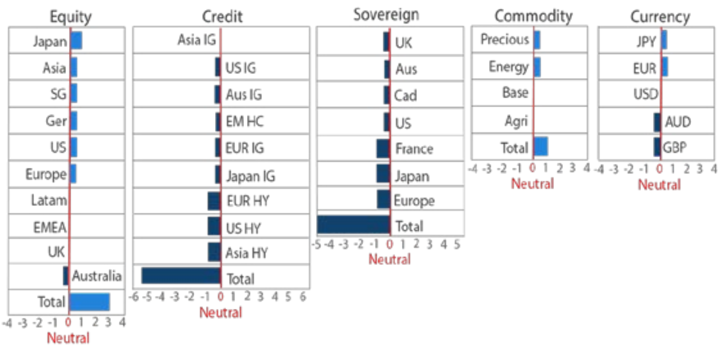
Trump policies and negotiation tactics were not the only sources of uncertainty in May. Count also significant stress events in emerging markets (EM) and the Eurozone where Italy is now more apparent in its populist intentions than markets had previously discounted.

EM fell victim to a rising dollar on the back of already elevated rates. EM is in far better condition than during the taper tantrum in 2013 and the China devaluation in 2015, but with certain notable exceptions, including Argentina and Turkey which both rely on foreign flows to fund high current account deficits. A sell-off devolved into a panic with flows suddenly reversing, forcing Argentina to call on the International Monetary Fund (IMF) for support and Turkey to hike rates significantly to stem outflows – both averting a crisis for the moment. Most of EM notably holds a surplus or a minor deficit with respect to foreign accounts, so these types of broad sell-offs generally present a buying opportunity, particularly as EM remains healthy and early in its growth cycle.

Italy stirred panic when the 5-star-League coalition failed to form a government, threatening a worse populist outcome through early elections. Ultimately the coalition did manage to form a government, helping to soothe markets. Even so, populist rhetoric and EU challenges still seem likely to bubble to the surface periodically to keep markets jittery. The worst fear is an Italian exit from the EU. However, while Italians might be willing to agitate Brussels for small concessions at the margin, few would be willing to push for a full exit. First, Italians are very wealthy in Euros but would be much less so in Liras. Second, what Italy really needs is growth, and reforms necessary to attain it are much more easily executed from within the EU than without. For these reasons, an Italian exit in the near term seems highly unlikely.

The confluence of these political and market events was exacerbated by recent dollar strength. Global growth has gone through a bit of a soft patch, while the US has surprised to the upside on the back of Trump tax cuts, triggering a massive short squeeze on the dollar. However, the short covering has largely run its course, and while we still believe that structural dollar weakness is most likely to return, we are also mindful that the dollar can overshoot to the upside leaving pain its wake – particularly in EM.

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.

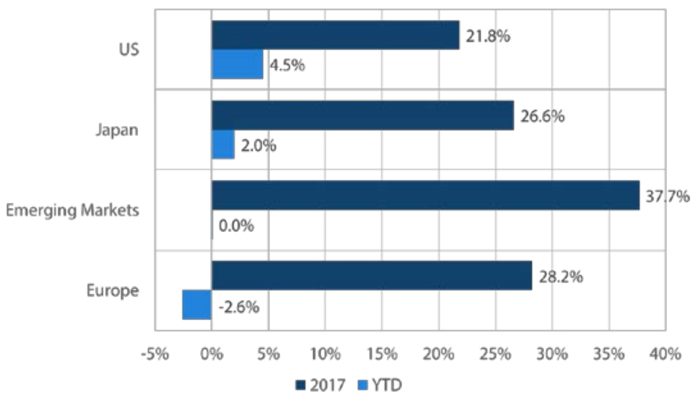
Research Views

The hierarchies remain broadly the same with only minor adjustments.

Global equities

Asia remains second on our hierarchy, just behind Japan, with equity market performance this year serving as a good reminder of the fact that equity markets abhor uncertainty. Chart 1 compares year-to-date (YTD) performance to last year in USD terms for major markets globally.

Chart 1: Major equity market performance YTD versus 2017



Source: Bloomberg, June 2018

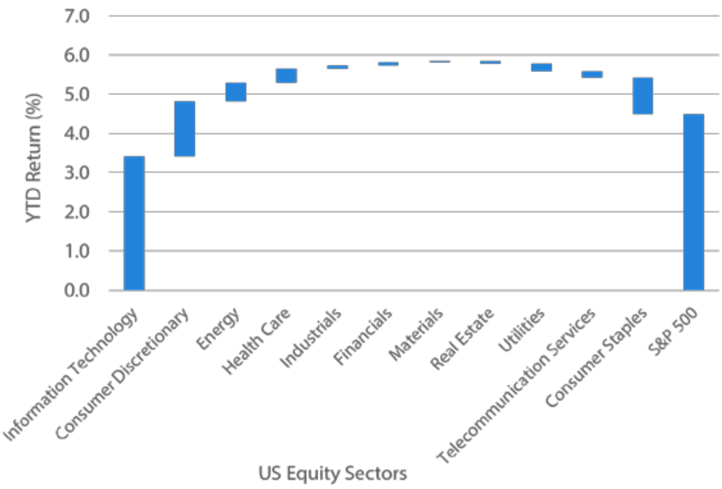
Improving fundamentals in EM and Europe buoyed their equity markets, which gained 38% and 28% respectively. This year EM equities have turned in a flat performance while European equities have slipped by 2.6%. Arguably the fundamental backdrop has deteriorated somewhat. However the biggest change is perhaps that markets have finally woken up to higher macroeconomic uncertainty and geopolitical risk through both an elevation of volatility and deterioration in returns.

Japan equities remain at the top of our relative equities hierarchy. So far this year the index has managed to eke out a small gain. However the biggest surprise has been the strong performance of US equities that we have tended to rate less favourably due to concerns around stretched valuations.

Indeed our long term expected returns framework suggests US equities are likely to deliver returns of under 3% per annum (p.a.) over the next five to seven years. However US equities have already risen at an annualised 9% p.a. run rate in 2018. This is reason enough to demand an explanation or an update to our view.

In Chart 2 we decompose US equity market performance into the GICS sector groups. This analysis reveals the strong performance of US equities is almost entirely attributable to gains in share prices of companies within the Information Technology sector.

Chart 2: Sector decomposition of US Equity Sectors 2018 YTD



Source: Nikko AM, Bloomberg, June 2018

At first glance technology-led market gains would seem exactly opposite of what one would expect from an expensive equity market in an environment of higher volatility. Not only are the glamour FAANG (Facebook, Amazon, Apple, Netflix and Google) stocks some of the most expensive in the equity market, but it is also the case that when market perception of risks rises it is the stocks that have gone up the most that are most vulnerable.

Our deep dive into sector valuations within US equities suggests otherwise. The IT sector appears fairly valued on our history-relative valuation model currently, while the broad market appears very expensive. Shares of Apple at 18x current earnings are trading below the valuations of the aggregate market as an example. 1Q2018 earnings growth of near 30% for the technology sector handily beat the broader market earnings growth of 23%. Expectations for 2Q2018 are similarly skewed in favour of technology companies at 28% versus 20%.

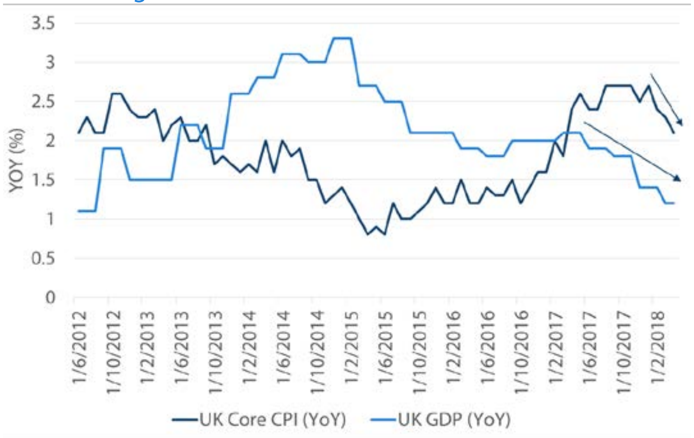
Continued earnings growth and positive cash flows of US technology companies may be one source of certainty for investors amid a more uncertain world. As such, while we retain our continued cautious outlook on the US equity market as a whole, we are upgrading our views on the US Technology sector. In a similar vein, we expect future editions of the Balancing Act to offer a more granular view on equity market opportunities going forward.

Global bonds

An improvement in our valuation of UK government bonds has elevated UK Gilts to the top of our hierarchy alongside Australia. Also supporting this change is slowing economic growth in the UK and inflation readings which look to have peaked.

The UK economy held up quite well in the aftermath of the Brexit vote in 2016, with annual GDP growth averaging 2% for the first half of 2017. A sharp devaluation of the pound helped with that result but it also spurred a rise in core inflation. As a result, the Bank of England (BoE) tightened monetary policy in late 2017 by 0.25% to 0.5%.

Chart 3: UK growth and inflation



Source: Bloomberg, April 2018

Early in 2018, the BoE was expressing more confidence in the economy and market pricing suggested that further rate rises would follow. Around this time UK 10-year Gilt yields peaked at 1.65%. More recently however BoE officials have been less sanguine about the UK economy. Uncertainty around ongoing Brexit negotiations and a recovering currency has knocked GDP growth back below trend and core consumer price index (CPI) has started to trend lower.

The combination of a weaker UK economy and a more balanced BoE has led to our upgrade in the outlook for UK Gilts relative to the rest of the developed sovereign bond universe.

Global credit

Asian and US Investment Grade (IG) have been upgraded above Australian IG, while Emerging Market Hard Currency (EM HC) USD sovereign debt has been lifted up the hierarchy due to improving valuations.

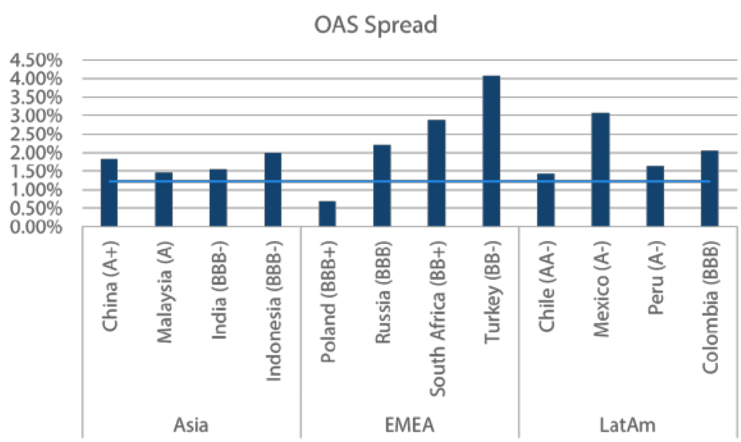
Spread widening improved valuations both for US and Asian IG credit from a double to a single negative. While hardly compelling, they still rank least expensive outside of Japan IG and EM HC from a spread perspective. The underlying US treasury has also seen valuations improve to neutral over the year, and while we do see further yield pressure in the US, most of the near-term adjustment is likely complete. We remain more concerned about yields creeping up in Europe and Japan as the European Central Bank (ECB) and Bank of Japan (BoJ) contemplate the removal of their own quantitative easing programmes. While we prefer Australian IG from a macro perspective, we lift Asia and the US to the top of the hierarchy based on valuations.

EM HC have been upgraded due to more attractive valuations as well. Spreads widened significantly in EMEA and LATAM in particular, lifting valuations to neutral. Combined with more attractive treasury yields, the asset class shows reasonable value. The selloff was broad and driven more by sudden risk aversion to EM, owing to large sell-offs in Turkey and Argentina. Both economies share significant imbalances, so local stress under tight financial conditions was not a surprise, but the broader selloff is less rational.

Most EM countries have pushed significant reforms and undergone sizeable economic adjustments, which the latest broad selloff failed to distinguish. We see interesting opportunities in Asia, in particular, where macro fundamentals still remain supportive.

There are opportunities outside of Asia as well. Take for example the Chilean government HC, an AA- credit, which currently yields 1.4% option-adjusted spread (OAS) above Treasuries. Yet, the US IG, which averages a lesser credit rating of A-/BBB+ yields a lesser OAS of only 1.2%. Clearly, there are irrational dislocations which create opportunities. While we still prefer corporate bonds in general, we upgrade EM HC bonds for value opportunities, albeit with the caveat that country selection remains key.

Chart 4: EM Hard Currency OAS vs US Investment Grade OAS



Source: Bloomberg, J.P. Morgan, S&P, 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.

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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Important Information