July 2018

Multi-Asset Team

nikko am
Nikko Asset Management

BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

Financial markets continue to come to terms with a more protectionist and less globalised world. The surprise perhaps is not that tariffs have finally been imposed by the US on its trading partners, but that it took so long for a key campaign promise to become reality in spite of Republican control of the House, the Senate and the White House since November 2016.

According to one school of thought the Trump administration may have bought itself some cover prior to firing the first salvo of this trade war by first goosing up the economy through tax cuts and fiscal stimulus, even as economic activity in Europe and China has cooled. Domestic supporters of Trump's trade actions consider this to be Advantage US, tactically speaking.

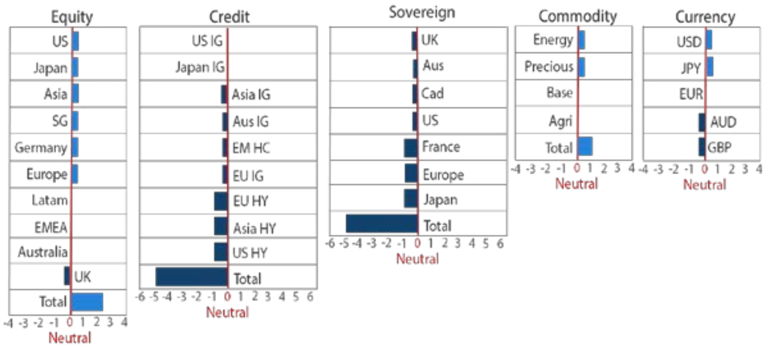
The structural advantage comes in the form of the US trade deficit. Perhaps this is one reason President Trump's tough talk on trade has not received much pushback domestically and his approval ratings have kept on rising. The hope is that the structural trade deficit and cyclical economic strength will both play to the advantage of the US and the trade war will be quickly won.

Nothing could be further from the truth in our opinion. The experience of US-Japan trade skirmishes of the 1980's suggests trade renegotiations will likely be protracted even if sufficient common ground can be found quickly. From just this fact alone one can conclude that any escalation in trade wars will leave more losers than winners globally due the uncertainty.

The "uncertainty channel" can be understood as follows. The direct effects of tariffs on global trade and growth is likely to be limited. The tariffs are expected to shave global GDP growth by under a few tenths of a percentage point. However indirect effects through a slowing in business investment would be significant. Disruption in global supply chains would leave global multinationals scrambling. This uncertainty will weigh on business spending and could slow global growth significantly below the 2-3% range expected in economist polls currently. Our modelling suggests a 50 basis points (bps) cut to US GDP growth projections could result in pre-tax US corporate earnings falling short by at least 100 bps below the 10% that is forecast for the next twelve months. This is the "fair value" estimate revision to earnings from lower GDP growth. In reality we know the earnings downside could be a lot bigger as negative sentiment may further lead to analyst downgrades. Markets have started pricing these scenarios in recently. The surprise perhaps is not that they are doing so, but that they have taken so long to get there.

A full scale trade war and an ensuing earnings recession is still not our base case. Nevertheless we believe greater caution on risk assets is warranted at this time in the interest of protecting portfolios from potential downside scenarios.

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 this month except for an upgrade to US equities and credit compared to their asset class counterparts in economies that are more externally focused and export driven. We believe domestic US exposure provides relatively greater downside risk protection relative to Japan and Asia ex-Japan from disorderly market corrections in the event of an all-out trade war.

Global equities

We upgrade US equities to the top of our equities hierarchy together with Japan, and above Asia ex-Japan and Germany. Our analysis into the potential upside/downside to earnings outlook has led us to downgrade most equity markets on their earnings score this month. Projections of earnings growth remain robust but there is increasing risk that actual earnings will miss expectations. US ranks relatively better on our earnings scores compared to international markets.

A comparatively better earnings picture, stronger fiscal tailwinds and strength of the consumer contribute to the US ranking highest on our macro research models. Equity market momentum in local currency terms has switched to neutral from positive across most markets globally. However US equities have the added support of a stronger USD.

Where our call to upgrade the US gives us most concern is valuations. Our models still suggest US equities remain expensive relative to history and relative to other markets, particularly Japan. However as discussed previously, we believe the wide dispersion in valuations across stocks and sectors make history-relative valuations at the broad market level too blunt a tool to rely on at present.

Japan equities are inexpensive and rank just below the US on our macro models. Hence we assign them the joint top place on our hierarchy with the US.

Our relative downgrade to Asia ex-Japan stems from rising concern around both a tightening in monetary policy and in liquidity. Externally driven Asian economies such as Singapore, Taiwan and Korea are susceptible to slowdowns in both global trade and corporate capex.

Chinese equities may well march to a different beat however, as valuations are nearing attractive levels while further easing in monetary policy and weakness in the RMB could more than offset the headwinds from trade. In addition, the composition of the Chinese equity market has already pivoted significantly from investment to consumption and old economy to new economy, as we have discussed in our previous reports.

The outlook for EM ex-Asia is less encouraging as long as the dollar remains strong. Dollar strength is a headwind of varying force – clearly with the weakest links such as Turkey and Argentina being among the most exposed. However, despite divergent outlooks, capital flows tend to distinguish the brighter spots less as dollar strength accelerates, instead punishing the asset class in general. Continued dollar strength is a clear negative across the complex still, but it is important to remember that EM growth is much healthier than where it stood in 2015 while valuations are becoming quite attractive.

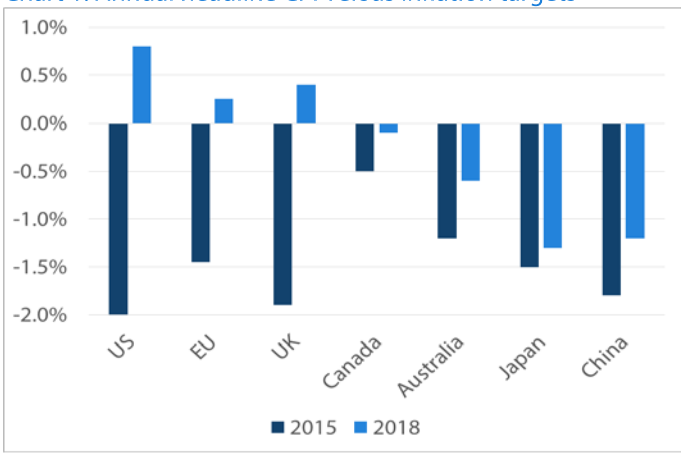
We remain cautious, but any measure of relief could be welcomed with significant upside.

Global bonds

Global bond yields stuck to narrow trading ranges in June, largely sitting out the volatility that rippled through risk assets. As a result, our sovereign hierarchy was unchanged with Australia and the UK remaining on top.

We continue to expect sovereign bonds to struggle to generate attractive returns as pressures remain for higher bond yields. One reason for this is that while inflation remains low in many countries, it has been climbing steadily over the last three years. This has left central banks with less margin for error in running a mix of stimulatory policies that have become so commonplace in the world’s largest economies. Chart 1 looks at annual headline inflation rates less the stated inflation targets of the respective central banks in 2015 and today.

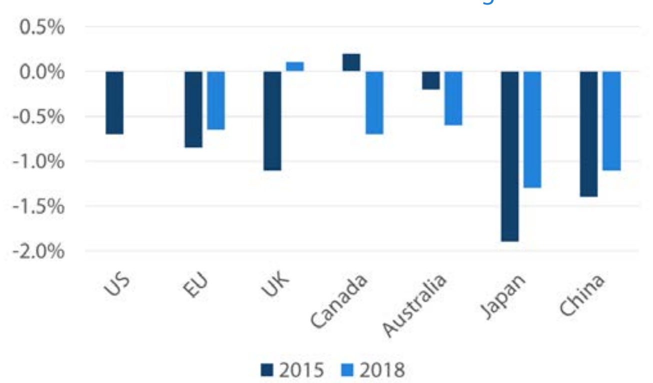
Chart 1: Annual headline CPI versus inflation targets



Source: Bloomberg, US Federal Reserve, ECB, Bank of England, Bank of Canada, RBA, Bank of Japan, PBOC, June 2018

Significant progress is evident in the US, UK and EU where headline inflation now exceeds the targets and all countries have been successful in generating inflation. However, we know that headline inflation rates can be significantly impacted by volatile energy and food prices so it is important to also consider core inflation measures, as many central banks do. Chart 2 substitutes the headline inflation measures with core measures against the same targets.

Chart 2: Annual core CPI versus inflation targets



Source: Bloomberg, US Federal Reserve, ECB, Bank of England, Bank of Canada, RBA, Bank of Japan, PBOC, June 2018

On the basis of core inflation, the US is right on its target and the UK is just above it. The other countries have also shown progress, with two exceptions. Core inflation in both Canada and Australia have actually moved further away from the targets, seemingly against the trend. Looking into the possible reasons for this divergence, we see that core inflation had a much higher starting point than the weak outcomes found elsewhere. So in effect, a normalisation of core inflation in Canada and Australia resulted in a fall from elevated levels. The question then becomes: why was core inflation higher in these countries to start with?

We have identified two important factors which likely contributed to higher core inflation in both countries. The first is that both had just been through a boom in commodities prices prior to 2015 - specifically energy prices for Canada and mainly iron ore for Australia. The second factor was that both countries maintained higher and slightly rising household debt to GDP ratios in the post-global financial crisis period that supported stronger growth and inflation. Conversely, these ratios fell quite heavily in countries like the US and Germany.

Although it is certainly true that inflation in many countries remains historically low, it is equally true that both headline and core inflation are closer to central bank targets than they were three years ago. In the event that we continue to see solid global growth outcomes, the world's central banks will have to deliberate on monetary policy accommodation knowing that the gaps between inflation and their targets are steadily closing.

The risk to this cautious view on sovereign bonds comes from the downside scenarios to global growth discussed in the introduction. Even then we believe that investors will be better served if they are selective in their sovereign bond exposure given the divergent inflation dynamics discussed above.

Global credit

The credit hierarchy saw a few changes as spread widening lead to valuation upgrades across a few markets, however we remain cautious overall.

US investment grade (IG) was upgraded to the top of the hierarchy primarily based on valuations. The underlying sovereign and the credit spread both rank neutral on our valuation metrics. However, we still believe the underlying sovereign yield has further to rise and that spreads may widen further so remain cautious, preferring high quality and low duration. US IG corporates remain highly levered, but higher quality companies are generating high levels of free cash flow and have been hoarding cash, making them more resilient than is typical at this stage in the cycle. IG corporates have benefited from a more stable EBITDA profile over the past few years and have participated in line with companies in the S&P 500 in the recent upswing. However, for all the talk of improving US corporate earnings, speculative grade corporates have seen EBITDA decline to cycle lows, increasing the divergence between IG and high yield (HY) fundamentals.

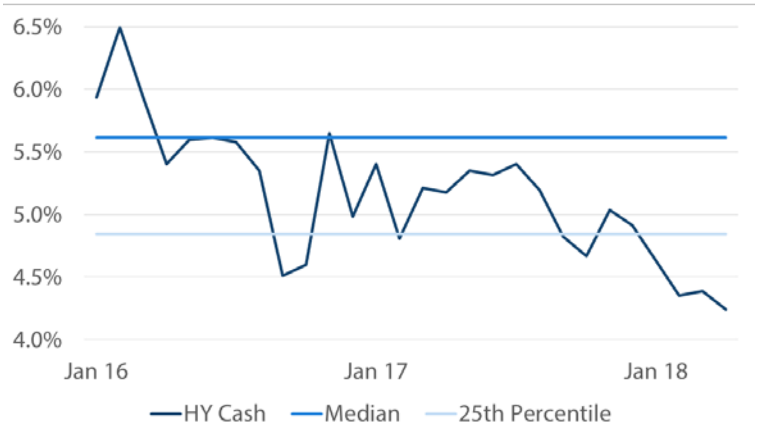
We remain cautious on HY bonds in general, but have lifted up Asian HY after valuations have improved to neutral, from double negative two months ago, after spreads widened around 200bps. US HY has fallen to the bottom.

Chart 3: EBITDA for Equities, IG and Speculative Grade Corporates

Source: Bloomberg Barclays Index Svs Ltd, Worldscope, FactSet, UBS, Jan 2018

Despite record tight spreads and deteriorating fundamentals, US HY continues to be to top performer for the year. What is more surprising is that HY funds globally, and US HY in particular, are seeing strong outflows. The first factor keeping spreads well contained is US HY issuance is down 30% year-to-date, allowing existing issues to remain well bid. Furthermore, to offset over USD 20bn in US HY fund outflows, HY fund managers have instead been drawing down cash balances, well below the 25th percentile seen since 2000. While these technical factors have helped support US HY, given the low level of cash already held and the upcoming supply expected in the remainder of the year, this support will likely wane.

Chart 4: HY Manager Cash (ICI Liquid Asset Ratio)

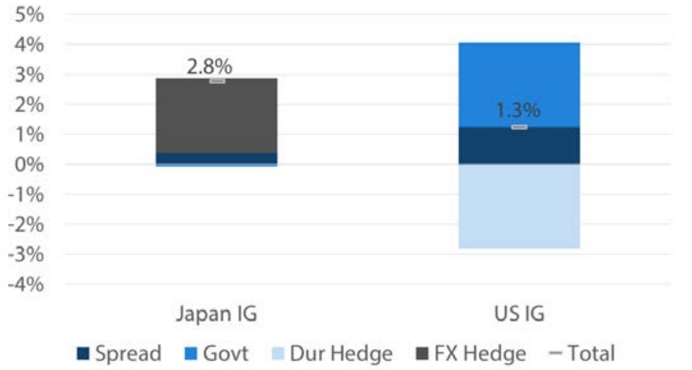


Source: ICI, UBS, Median and Percentile since 2000, April 2018

Finally, Japan IG has been upgraded to second place on the hierarchy. For the past few months Japan IG spreads have seen a rare positive valuation signal, separating them from the pack. However, with the underlying JGB sovereign likely the most expensive sovereign we monitor, we were reluctant to upgrade given the potential absolute loss if the Bank of Japan were to change its yield curve control programme. Now with neutral momentum, another rarity amongst credit, we have upgraded Japan IG accordingly.

Given the near zero yield for JGBs, hedging out the sovereign exposure from Japan IG is practically free. On a spread only (sovereign hedged) and currency hedged to USD perspective, we find Japan IG more attractive than US IG. However, given our tendency to discuss the whole cash credit investment in this article, we continue to prefer US IG marginally given the slightly higher spread buffer, but remain cautious overall.

Chart 5: USD Yield, FX and Duration Hedged



Source: ICE BofAML, Bloomberg, June 2018

Currencies

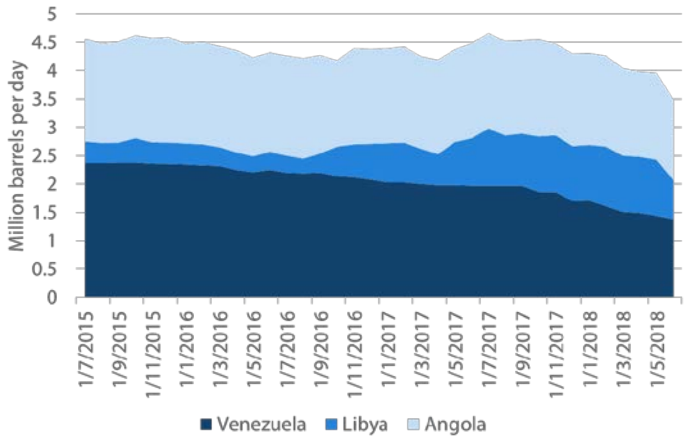
The USD was lifted up the hierarchy as a function of two important developments this month. First, monetary policy has further diverged with the People's Bank of China (PBOC) first declining to follow the US Federal Reserve (Fed) in its June rate hike as it typically has done, while applying several measures to ease conditions including cutting the reserve requirement ratio. The Renminbi weakened on the policy shift, while continued ECB dovishness added renewed upward pressure on the dollar. The second development this month was the escalation of trade wars, adding significant uncertainty and in the process lifting the dollar as well.

Despite the upgrade, we believe the dollar will ultimately return to weakness once these newly applied pressures begin to ebb. Disappointing growth outside of the US earlier this year seemed to be the catalyst shifting the dollar from weakness to strength. However, while the US was the beneficiary of an extra growth boost from tax cuts, it is unlikely to be a lasting catalyst – particularly given that trade uncertainty has already shown signs of impeding capital expenditure. We still believe global growth remains relatively healthy which will ultimately lead to less divergent growth outlooks, allowing the dollar to again return to weakness. Our only concern is that the extended dollar rally, coupled with rising trade concerns, has the potential to derail the global recovery.

Commodities

This month we have moved energy above precious metals. In its June meeting, OPEC agreed to boost output by 1 million barrels a day, and crude rallied subsequently. This is surprising to many, however, we believe that markets should continue to be supported, as the increase is only offsetting production losses in some OPEC countries. These losses added to an over-compliance of 152% of the November 2016 production cut, according to OPEC. As shown in chart 6, Venezuela, Libya and Angola together have removed 1 million barrels from the market since mid-2017. Domestic crises have hampered their production capacity, as investments were shelved and facilities poorly maintained. It is difficult for their production to recover meaningfully in the near term. On top of this, sanctions on Iran will take effect in August 2018. The production constraints are tailwinds to crude oil prices.

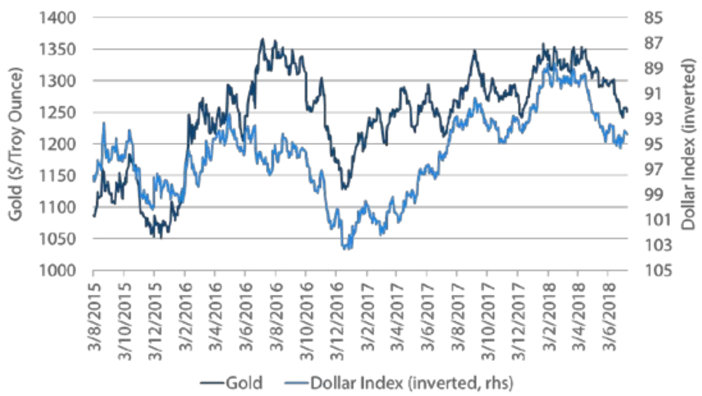
Chart 6: OPEC Crude Production



Source: Bloomberg, June 2018

Gold performance has been lacklustre in recent months given the strength in the US dollar. While a stronger USD could be a near term headwind, rising geopolitical risk and higher inflationary pressure are likely to keep the downside capped. Hence we continue to retain gold towards the top of our commodities hierarchy, not least for its usefulness as a portfolio diversifier.

Chart 7: Gold vs Dollar



Source: Bloomberg, June 2018

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 +		

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 realised. 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, Nikko AM NZ Wholesale Investment Scheme and the Nikko AM KiwiSaver 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 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.