BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

As markets continue to grapple with the potential for a protracted trade war between China and the US, central banks have stuck to their task of setting monetary policy. The ultra-accommodative policy settings that have prevailed since 2008 are being gradually unwound in the US and are being actively reviewed in most other developed countries.

After the US Federal Reserve aggressively eased the funds rate to near zero, it was left unchanged for seven years until the first hike in 2015. So far, the Fed's normalisation process has raised rates by a quarter point seven times, lifting rates from 0.25% to 2%. We expect that the Fed will make that eight times at its late September meeting, bringing the rate to 2.25%.

With this normalisation process well underway, many are beginning to contemplate when the tightening cycle might end. The Federal Open Market Committee itself provides some guidance on this question through its semi-annual Monetary Policy Report where "dot plots" and expectations for longer run rates are revealed. The longer run Fed funds rate projection contained in the latest report was 2.75%-3%, indicating an expectation for further rate hikes to come.

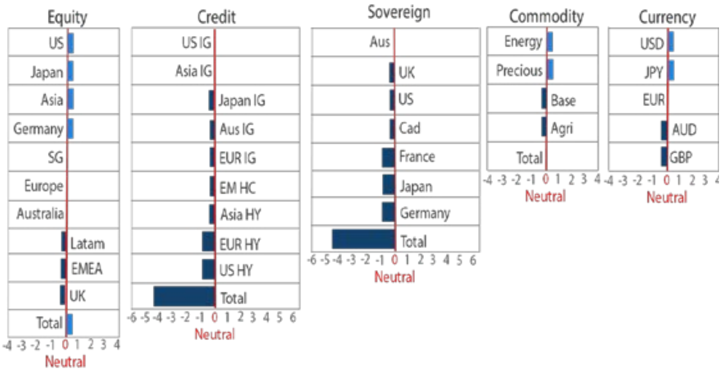
When judging an appropriate path for the Fed funds rate, determining whether current policy is stimulatory or contractionary is an important consideration. The concept of a natural (or neutral) rate of interest is often used to make this determination by comparing this rate to the current real Fed funds rate. The neutral rate is a level of interest rates that is neither stimulatory nor contractionary and equates to long run trend economic growth with stable inflation. Where the real Fed funds rate is below the neutral rate, monetary policy is thought to be stimulatory and supportive of stronger economic growth. When it is above the neutral rate, monetary policy is contractionary and works to slow the economy.

While this all sounds pretty straight forward, there is unfortunately a catch. The neutral rate is not constant and cannot be observed directly, it needs to be estimated. This question has kept many an academic researcher occupied in the last 20 years after the concept was first introduced over a century ago by Swedish economist Knut Wicksell. So much so that some observers question the usefulness of the measure altogether because of the difficulty in estimating the neutral rate. However, just because the measurement is uncertain doesn't mean that central bankers shouldn't try to approximate the current stance of policy. Developing a view on how accommodative current policy settings may be remains an integral part of the process, difficult or not.

Although there are a number of different approaches to estimating the neutral rate, a common thread is that the rate has been trending down over the last two decades. Taking one well known measure, the Laubach-Williams natural rate of interest, we find that the rate has fallen from 3.5% in 2000 to the current reading of 0.61% at the end of June 2018. If we add the Fed's inflation target of 2% onto these real rates, this implies a neutral Fed funds rate of 5.5% that has fallen to 2.61%. While the reasons for this fall are varied, economists often point to a lowering of the potential US GDP growth rate as a primary reason.

Taking into account the Fed's longer run projection of 2.75%-3% and this Laubach-Williams estimate of 2.61%, we surmise that the neutral Fed funds rate is likely in the range 2.5% -3% currently. Market pricing suggests that the Fed funds rate target is likely to hit 2.5% by year's end and approach neutral territory. Considering this analysis, we view US monetary policy as still stimulatory but it will soon be at a more neutral level over the next six months. If this proves to be correct, we won't have to wait too much longer to see if this Powell-led Fed wears the wings of a dove or a hawk.

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. Equity and Sovereign changes were mainly driven by changes in momentum, whereas valuation changes drove changes in Credit.

Global equities

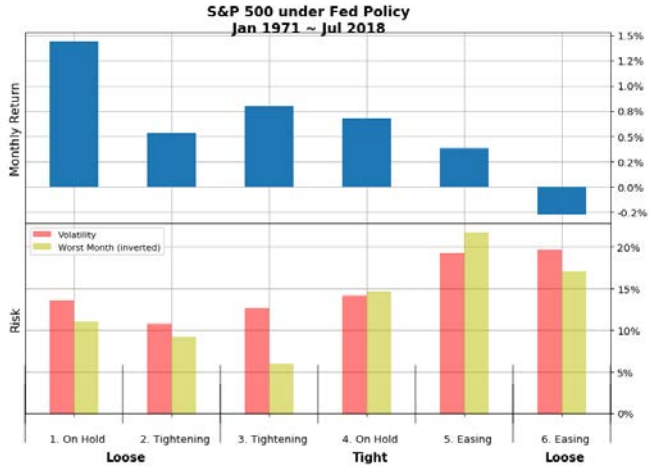
There is only a marginal change to our equities hierarchy this month. We move the US to the top spot instead of the joint top-place with Japan of the last few months. There are no changes to underlying model scores for either market. The adjustment is motivated instead by the results of research we have just completed on the relationship between monetary conditions and equity market performance in the US.

The study was prompted by concerns around the impact on US equity performance from continued tightening of US monetary policy. The results suggest that the evolution of monetary policy alone, as currently envisaged, is not likely to put the brakes on US equity performance anytime soon.

A summary of the analysis is shown in Chart 1. The bars on the top panel show average monthly returns on the S&P 500 when policy has ranged from stimulatory to restrictive. The classification of the entire data since 1971 into six different regimes is done based on the relative levels of real Fed Funds rate and the natural rate as discussed in the introduction and shown in Chart 2.

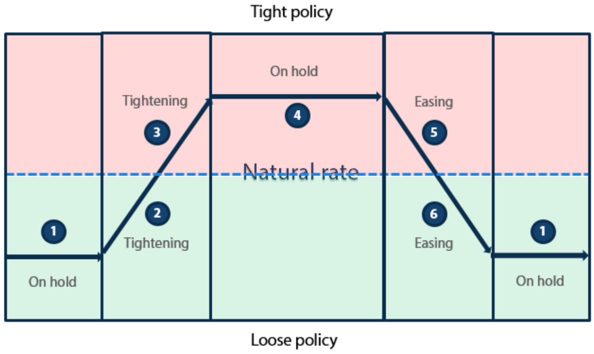
The results confirm that strongest equity market returns have come when monetary conditions have been stimulatory. However returns have remained strong even when policy settings have switched from loose to neutral as we expect them to do in the near future.

Chart 1: Fed policy and US equity performance



Source: Bloomberg, August 2018

Chart 2: Stylised view of US monetary policy cycle



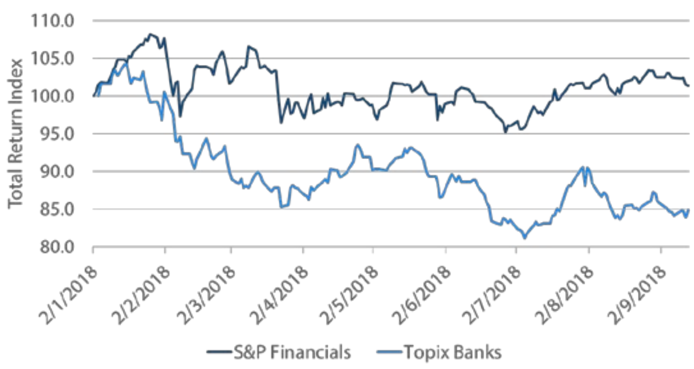
Source: Bloomberg, August 2018

Non-monetary tailwinds to US equities such as strong economic growth and corporate earnings add to the above rosy picture. We believe these not only explain much of the US exceptionalism seen this year but are also supportive of a continuation of the same trend.

Japan equities offer more value but rank below the US on our momentum models. The macro backdrop is largely similar. The US scores better on earnings and on the strength of the consumer. The tie breaker comes in the form of the interplay between monetary conditions and liquidity and has the effect of pushing Japan down a notch.

Monetary policy can be compared to the settings on a "financial tap" with the resultant liquidity conditions akin to the actual water flowing through the taps. The measurement of financial market liquidity is more art than science. However the performance of financial stocks is often a reliable proxy of liquidity conditions given their role as a facilitator of credit and liquidity in the real economy. On this barometer and as shown in Chart 3, liquidity is significantly tighter in Japan at present than in the US.

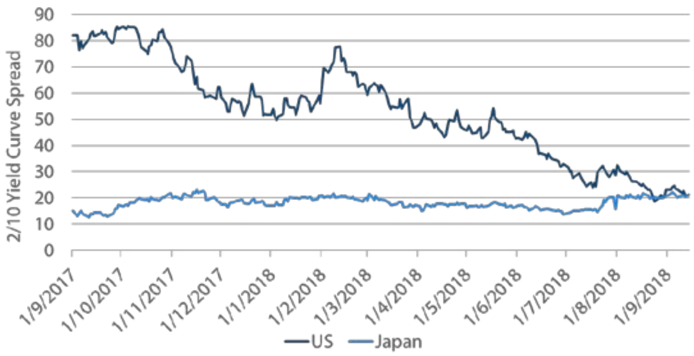
Chart 3: Japan Banks versus US Financials



Source: Bloomberg, September 2018

Comparing the 2/10 yield curve between Japan and the US is also instructive. As shown in Chart 4 the yield curves in both Japan and the US have converged to around 20 basis points (bps) despite significant differences in monetary settings, growth and inflation between the two economies.

Chart 4: Japan versus US 2/10 yield curve



Source: Bloomberg, September 2018

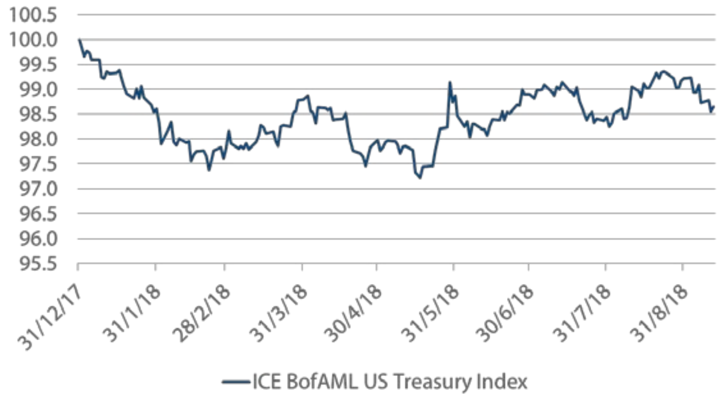
Is the flatness of the US yield curve signalling an imminent recession in the US or is it merely mirroring the flatness of a global yield curve that is held down by continued easy monetary policies in Japan and Europe? There may well be some element of both at play here. To the extent that long term bond yields in the US are lower than what would be warranted by economic conditions alone, we can again conclude that liquidity conditions continue to be supportive.

Global bonds

For much of this year we have preferred a number of other Sovereign bond markets to US Treasuries, where our outlook has been negative. However, in our latest hierarchy we have become more constructive on US bonds by upgrading them to a more neutral outlook. At the same time we have downgraded French government bonds to our least preferred group that includes Germany and Japan.

US Treasuries have been the worst performing of the major developed government bond markets this year. The damage was essentially done in the first two months where US 10-year yields rose over 50bps to about 2.9%. However since that time, yields have held a fairly tight range between 2.8% and 3%, with only brief periods above and below that range. The result has been a negative return for US Treasuries in the year so far.

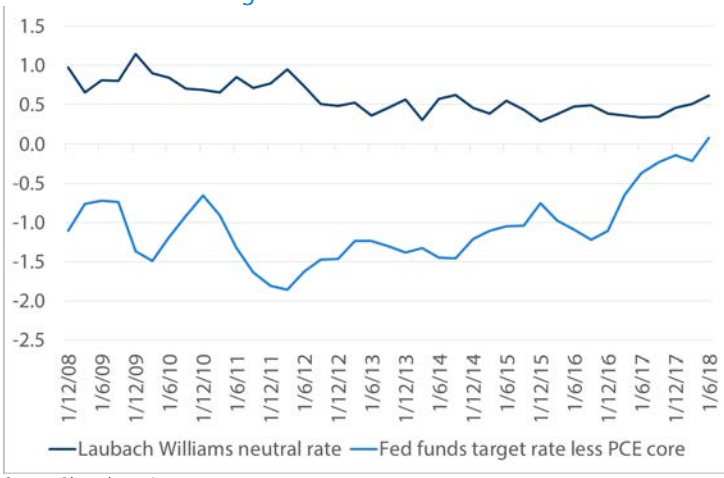
Chart 5: US Treasuries performance (indexed to 100)



Source: Bloomberg, September 2018

One of the primary reasons we have become more constructive on US bonds is that Fed policy is becoming much less accommodative. As we referenced in our opening, the Fed funds rate is fast approaching a more neutral setting. In the post Global Financial Crisis period the real Fed funds rate was negative to help stimulate US economic growth, but it has just crossed back to positive after the last rate hike in March. Should the FOMC hike rates in both September and December this year as market pricing suggests, the real Fed funds rate will be both firmly positive and no longer as stimulatory as it approaches neutral.

Chart 6: Fed funds target rate versus neutral rate



Source: Bloomberg, June 2018

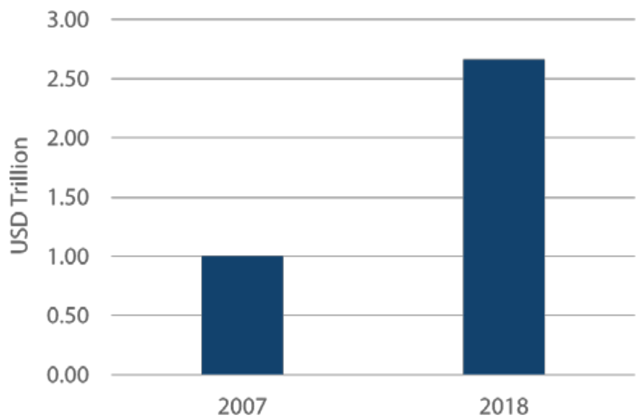
Given that monetary policy tends to affect economic growth with a lag, the Fed's policy changes in 2018 will become much less of a tailwind for growth in 2019. In addition, ongoing global trade tensions are likely to continue to stoke demand for safe haven assets such as US Treasuries. On the flip side though, inflation has been on the rise and core inflation is now at the Fed's 2% target. So although we are not outright bullish on US treasuries, we nevertheless believe that a more constructive outlook is now warranted.

Global credit

The credit hierarchy saw minor changes as valuations on spreads for Asian investment grade (IG) and momentum on Japan IG deteriorated from neutral to negative, pushing both below the US. Increasing our preference on USTs helped keep US and Asian IG towards the top of the hierarchy, although we still warrant caution on credit in general.

The US economy continues to grow strongly. It is possible that with an easier Fed, the economy may be able to reach a higher level of sustainable growth. However, given the large level of issuance and debt on corporate balance sheets, sustainability of cash flows grows more important as we approach the end of the cycle. Some companies are under pressure to borrow more just to sustain top-line growth. When rates rise, cash flows eventually deteriorate on tighter margins, leading to credit downgrades.

Chart 7: Outstanding US non-financial BBB corporate debt



Source: S&P Global Ratings, September 2018

Typically this would have less of an impact in the investment grade space. However, US IG credit quality on aggregate has deteriorated over recent years. In the 1990s, BBB rated bonds accounted for only around 25% of the non-financial bond market. That percentage has since risen to almost 50%. In dollar terms, BBB rated bonds have increased almost three times since 2007, from around USD1 trillion to USD2.6 trillion. To put this in perspective, the entire high yield market is only USD1.2 trillion. In 2016, around 18% of BBB rated companies became 'fallen angels', dropping down to high yield or junk status. According to some estimates, there could be USD80 billion worth of fallen angels in 2018. Given the spread difference of almost 70bps between US BBB and US BB rated bonds, investors could face larger losses than they anticipated from buying 'investment grade' bonds.

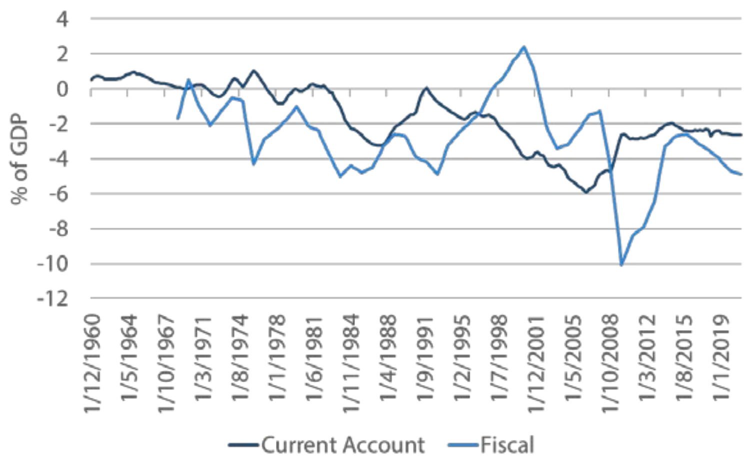
Therefore we continue to be cautiously positioned, favouring higher quality and lower duration credits for now.

FX

USD remains at the top of the hierarchy, but drivers that initiated the uptrend in mid-April may be losing steam. First, as Fed rate hikes are likely to be nearing the end of the tightening cycle, markets will soon be contemplating rate hikes in Europe late next year. Second, US growth remains strong, but it is no longer surprising to the upside and growth in the rest of the world appears more robust than expected. Today, it seems that rising risk in emerging markets and trade concerns are the main drivers keeping the dollar strong.

Trade war risks will not dissipate any time soon as Trump keeps widening the scope of tariffs while the next scheduled negotiation is not until late November. In any case, given the adjustment to date, it is difficult to make a case that the dollar deserves to be stronger given its expensive valuations against rising twin deficits.

Chart 8: Rising US twin deficits



Source: Bloomberg, September 2018

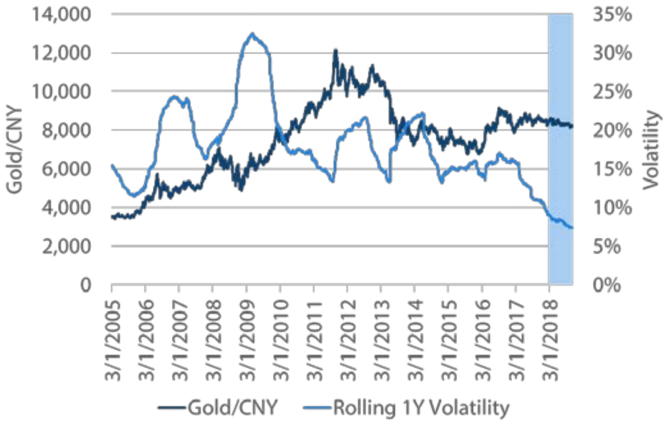
The key signpost for the moment is emerging market stress – whether policymakers can convince markets that risks are contained. Turkey and Argentina appear to be making the hard policy choices required, but time will tell. We are quite convinced that risks in emerging markets are more idiosyncratic than structural and that the broad market reaction is more emotional than rational, but it will require firm policy steps and a bit of time for fears to dissipate.

Commodities

Gold backed Renminbi?

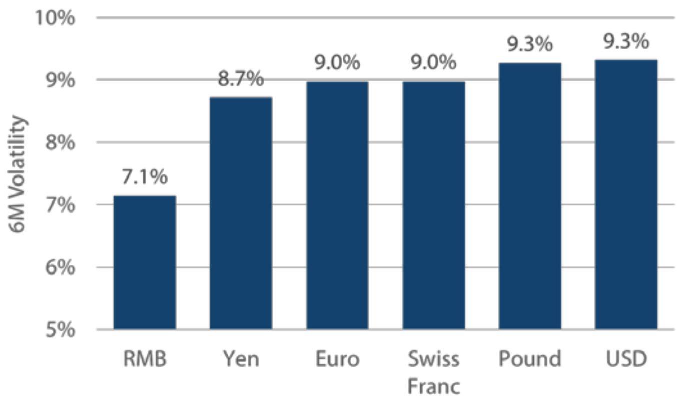
Between April and August, gold has fallen 13% in dollar terms. The lacklustre performance surprised many, as questions were raised about why gold failed as a safe haven at a time of stresses which included emerging market turmoil, trade tariffs, and tensions between US and Iran. Dollar and real yields explain a lot of the moves, however, what has really caught our attention is how gold is trading in its tightest range against the renminbi, historically (Chart 9) as well as against the major currencies (Chart 10).

Chart 9: Gold volatility against CNY



Source: Bloomberg, Nikko AM, September 2018

Chart 10: 6M volatility of gold against major currencies



Source: Bloomberg, Nikko AM 2018

Could this be a new avenue for renminbi internationalisation and part of a long term plan to end dollar hegemony? In March 2018, China officially launched crude oil future contracts trading in renminbi. Before that, in July 2017, we saw Hong Kong starting to trade CNH physical gold futures. As such, global oil exporters are now able to sell crude to China, then convert the renminbi proceeds to gold directly, without intermediating with the dollar. This is critical as it is becoming clearer that fewer dollars will be available outside of the US, as the Fed tightens liquidity, strong US growth attracts significant capital inflows, and the Trump administration focuses on addressing trade deficits.

To some extent, it is also a concern to many countries when the US is willing to weaponise the dollar in dealing with conflicts. While there's still a long way to go for renminbi internationalisation, gold backing (or quasi backing, as Beijing has yet to commit to a fixed rate conversion, and probably never will) does increase its appeal and credibility.

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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