November 2018

By Multi-Asset Team

BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

Global equities corrected downwards by 7.5% in USD terms in October. Stocks in the US ended the month down 6.5% after an intra-month peak-to-trough drawdown exceeding -10%. They still managed to outperform equities in China (-11%), Japan (-9%), Emerging Markets (-8.7%) and Italy (-8%) in a continuation of their outperformance seen all year.

Within the US, a rotation from growth to value and cyclicals to defensives was evident from the relative performance of S&P 500 indices for Growth versus Value and Industrials versus Utilities. The two pairs closed with a monthly performance differential of -5% and -15%, respectively. The NASDAQ index of high-growth technology companies in the US fell by 9% to post its worst monthly returns since November 2008. A rebalancing towards value was also evident globally.

The standout equity market performer was Brazilian equities, which rose 10% in local currency terms (and almost 20% in USD, given BRL strength) in response to the election of Jair Bolsanaro as the next president. Markets greeted the news with a strong rally in Brazilian assets, as he was perceived to be more market-friendly and anti-establishment than the other candidates.

Hedged sovereign bond returns in USD were marginally positive across UK Gilts and German Bunds, but were in the red almost everywhere else, including in the US. The 10-year bond yield in the US gained 8 basis points (bps) to end the month at 3.15%. Credit spreads widened across every market led by high-yield bonds in Asia (+105 bps) and the US (+53 bps). Higher quality bonds did not fare much better with investment grade spreads wider in the US (+12 bps), Europe (+14 bps) and Asia (+8 bps).

Finally, the outcome was no better in commodity markets with copper (-5.2%), Brent (-8.8%) and WTI (-10.8%) all down on the month. The safe haven status of gold (+2%) was sufficient to lure back some investors in spite of a stronger US dollar (+2.1%) and higher real yields (+15 bps).

If the definition of "safe havens" includes all assets which performed well through this risk-off period, then we would add the Turkish Lira (+8.4%), Argentinian Peso (+15%), sugar (+17%), coffee (+10%) and cocoa (+9%) to the list. However, these were all mostly just bouncing off levels that were perhaps much oversold.

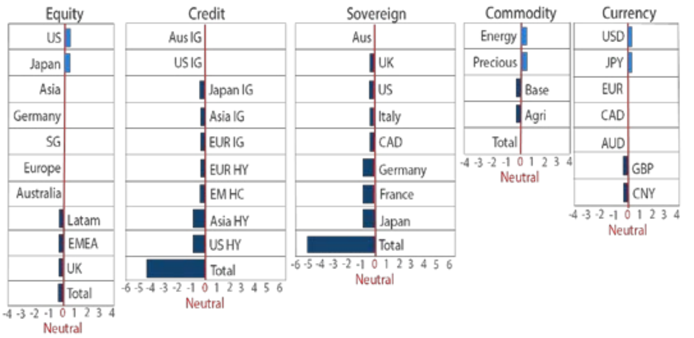
Investors are still looking for a reliable safe-haven asset amid broad-based asset class weakness and rising correlations. Using the perspectives of different base currency investors in research published previously, we came up with an answer.

Readers will recall that we had suggested Chinese sovereign bonds denominated in RMB as an interesting new addition to the list of safe-haven assets. So far this year, they have delivered to our expectations by adding 0.9% in October and 4.3% in 2018 year-to-date in USD currency hedged terms.

In our opinion, "volatility" itself is yet another promising safe haven. The CBOE VIX index of implied volatility on the S&P 500 index jumped from 12% to 25% last month. We expect political uncertainty in the US to only get worse, given the results of the US mid-term election. We see a busy political calendar and elevated policy uncertainty as potential risk-off catalysts, even outside the US. This is true even in a benign economic growth environment, which itself is nowhere near certain, given the ongoing trade frictions between the US and China.

Against this backdrop, we believe investors can benefit from the magical mean revision properties of volatility by adding to portfolio hedges, such as put-option structures on equity market indices, each time volatility subsides. We would note that at the time of writing this, the VIX has already retraced 50% of its October jump while the all-clear on risk assets is yet to be heard.

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

We make adjustments to our asset class views and hierarchies as discussed below.

Global equities

Our equities hierarchy remains unchanged, as do our broader equity views.

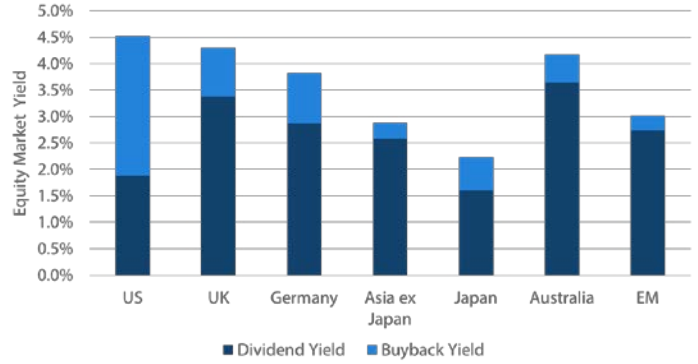
We became incrementally more cautious on risky assets last month. While we didn't anticipate the October correction itself, we did believe that the backdrop for strong equity market gains was looking increasingly shaky.

Germany and Asia ex-Japan were downgraded last month to neutral on deteriorating momentum. These are also markets which bore the brunt of the correction. The US and Japan are the only equity markets that we rate as better than neutral across the entire developed equities complex. The position of the former on the top of our hierarchy was validated even last month. We retain our constructive view on Japan equities, although prospects of a recalibration in Bank of Japan monetary policies, the increase in GST and sensitivity of Japan exporters to escalating trade wars are some risks to watch.

The good news is that valuations have improved significantly after the October correction, and are now neutral or better everywhere except the US on our valuation models.

While the increase in US bond yields receives much attention, there are many equity markets offering a dividend yield, and total yield when including buybacks, that still represent a significant pick up over bond yields. Additionally, equities have positive sensitivity to rising inflation, while bonds do not.

Chart 1: Equity market yields



Source: Bloomberg, October 2018

Global bonds

We make some minor changes to our bond hierarchy this month, with Canada falling one place and Germany rising from the bottom, ahead of France and Japan.

Alongside the US Federal Reserve, the Bank of Canada (BoC) is one of the few central banks that is tightening monetary policy. At its meeting in October, the BoC raised its official cash rate by 25bps to 1.75%, citing a strong economic outlook and inflation pressures. While the recently agreed update to NAFTA was undoubtedly good news for Canada, the BoC remains concerned about the lack of slack in the Canadian economy. The spare capacity that has existed in the last five years has diminished, with actual output now matching estimates of the economy's potential while maintaining stable inflation.

Chart 2: Bank of Canada output gap

Source: Bloomberg, October 2018

Canada's headline and core inflation rates are on or slightly exceeding the BoC's target mid-rate of 2%. Should the economy continue to grow as the BoC expects over the next year, then inflation pressures may intensify, prompting the BoC to raise interest rates at a faster pace than is reflected in market pricing. This potential risk of stronger central bank action contributed to a small downgrade to Canadian government bonds.

While the outlook for Canada's bonds has become less favourable in recent months, the opposite has been occurring in Germany, where its economy has hit a soft patch. Annual growth in industrial production has fallen this year and trade worries have taken a toll on business confidence in Germany. The recent uptick in industrial production may be the beginning of a recovery, as German automakers increase production after a period of retooling for emissions rule changes, but this is certainly an area to watch.

Chart 3: Germany industrial production and expectations

Source: Bloomberg, October 2018

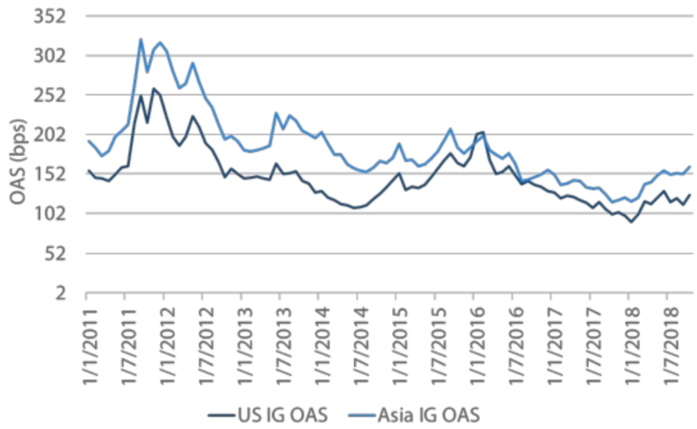
German bunds, along with JGBs, are the low to negative yielders in the developed market universe. For this reason, we continue to stay underweight Germany. That said, a softer German economy can potentially lend some support and warrants a small lift in Bunds to above Japan.

Global credit

The credit hierarchy saw minor shifts in macro lead to a downgrade in US Investment Grade (IG), below Australia IG. Valuation improvements in Europe High Yield (HY) and emerging market hard currency (HC) bonds were enough to upgrade their score, but not enough to shift their position on the asset class hierarchy.

The US macro backdrop has been strong for many months. Tax reforms leading to robust earnings and improving growth have been discussed here ad nauseam. However, slight declines in retail sales, slowing new orders, lower trade and forward guidance being adjusted down, were enough to slightly reduce our corporate outlook. This was somewhat offset by a modest upgrade to the underlying sovereign outlook, as wage and inflation momentum appears to moderate. Concerns over rising default risks, increased borrowing costs and rating drift in the lower portion of IG were enough to tip the overall macro score down half a notch. US IG spreads have started to widen but still remain expensive, although this is no different from most other markets given late-cycle dynamics.

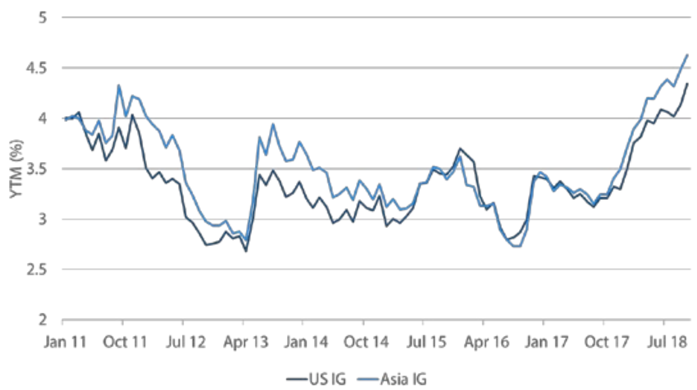
Chart 4: Investment Grade option-adjusted spreads (OAS)



Source: ICE BofAML, Bloomberg, October 2018

However, absolute yields are starting to look attractive across the USD space. US and Asian IG yield to maturities are the highest they have been in almost a decade. For yield investors, pricing has become attractive, which bodes well for medium-term performance. While hedging costs for Japan and Europe investors may make US IG less attractive, Asian investors should remain supportive of both.

Chart 5: Investment Grade yield to maturity



Source: ICE BofAML, Bloomberg, October 2018

We continue to remain conservatively positioned, favouring high grade and low duration credit.

FX

We again lifted JPY up the hierarchy, above EUR, mainly on the premise of financial conditions continuing to remain tight: this tends to keep Japan capital at home in support of its currency.

Concurrently, while the European Central Bank (ECB) says it will stay the course to end quantitative easing by year-end, regional growth has remained surprisingly weak. In fact, the ECB has been shifting from tightening liquidity to easing, while markets have pushed expectations for a first rate hike from June to September 2019. Credit seems hampered by ongoing weakness in financials, while uncertainty surrounding Brexit and the rise of populism in Italy suggests that caution is well-warranted.

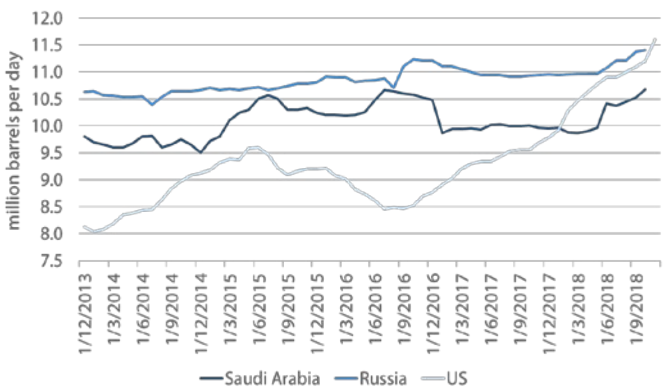
This month, we expanded the hierarchy to include CNY as well as CAD. CNY was placed at the bottom of the hierarchy for central bank easing and some negative pressure on the currency driven by capital outflows, though we expect no significant devaluation.

As a commodity-based currency, CAD behaves similarly to AUD – the former driven by oil and the latter by metals. For the moment, more hawkish monetary policy in Canada versus Australia ranks CAD just above AUD in the hierarchy. Recently weak pricing dynamics across the oil complex keep CAD ranked just below EUR.

Commodities

The crude oil market has had a rough month given geopolitical events in the Middle East. When news broke of the death of respected Saudi dissident and journalist Mr Jamal Khashoggi, Saudi Arabia was quick to pledge to make up for any lost supply from Iran. This was an apparent attempt to appease President Trump with lower fuel prices leading up to the US mid-term elections. However, the market was taken by surprise when the US granted sanctions waivers to seven countries, including South Korea, which had already cut purchases from Iran to zero, for six more months. To make the demand and supply situation worse, inventories rebounded and US production continued to surprise to the upside, lifting the US above Russia as the world's top crude producer.

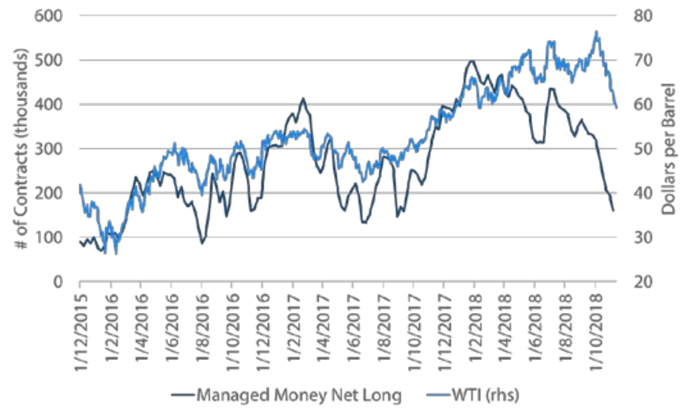
Chart 6: US is now the world's top crude producer



Source: Bloomberg, November 2018

The lower-than-expected supply risk led to a sharp cut in speculative long crude positions, which fell to their lowest level in nearly five years.

Chart 7: Managed money net positions in WTI contracts



Source: Bloomberg, 2018

As we have written previously, the crude market is very tight and thus fragile to any easing of supply risk. Nevertheless, the violence of the correction still surprised us given the waiver is only temporary, spare capacity is tight in OPEC and Saudi Arabia does not have proven capacity to absorb Iranian losses. We expect sanctions to increase as the US adds more pressure on Iran and the bottleneck of US pipelines to become more acute over the following months. As such, the adjustment in oil prices is likely mostly over, and we retain energy together with precious metals at the top of our commodities hierarchy.

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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