



# BALANCING ACT

Nikko AM Multi-Asset's global research views.

## Snapshot

In the continuing aftermath of the US Presidential elections, it is easy to overlook the many other macro-political events that made 2016 such an exceptional year. The year started with investors quickly realising that their fears of a global recession and emerging market collapse were unfounded. Growth continued to stabilise, led by the US in developed markets, and by India and commodity producers in emerging markets. Surprisingly, the first shock to global markets came from Japan. The announcement of the Bank of Japan's (BOJ) negative interest rate policy (NIRP) in January was an ominous foreboding that all was not well on the monetary front.

The realisation that monetary policy may well be at its limit of effectiveness sank in even further when the European Central Bank (ECB) refused to ease rates at the start of the year. In contrast, the US Federal Reserve (Fed) blinked in keeping interest rates on hold, despite the US economy continuing to recover. This was defended by claims that the Fed needed to adopt a more global perspective when considering appropriate monetary policy settings. However, this last crutch of policy support too fell away, with the return of market and economic stability. With the election of Mr Trump in November, it finally became evident that the baton had already passed from monetary to fiscal policy at some point during the year – one of our key calls for 2016.

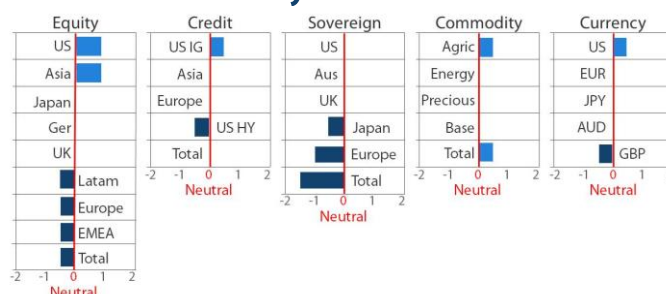
To the extent that fiscal policy takes over more of the heavy lifting from monetary policy, we believe that is a good thing. As we have previously discussed, central bank manipulation of bond prices has led to fragile market equilibrium since the Global Financial Crisis of 2007/08. Jolts to this false sense of calm were varied and included the collapse in energy prices, the resurgent US dollar and the surprise devaluation in the Chinese Renminbi. There is much for markets to cheer about if 2017 becomes a year of more fiscal, and less monetary, stimulus – something not without risk, as rates continues to normalise.

The rise of populism is the other trend that was in place last year, as seen by Brexit in June, Mr Trump's election in November and the Italian Referendum's 'No' result in December. The political calendar for 2017 is also heavy, particularly in Europe with Presidential elections in France and Germany, as anti-establishment support in both countries continues to gain momentum. This uneasiness isn't good for markets, given the increase in geopolitical risk premium and macro-political uncertainty.

What does this mean for assets?

In a nutshell, bond yields are likely to continue moving higher, equities will need to see earnings growth to offset pressures of rising interest rates and a stronger US dollar, while commodities will need to see continued supply-side rationalisation and supportive economic growth.

## Asset Class Hierarchy

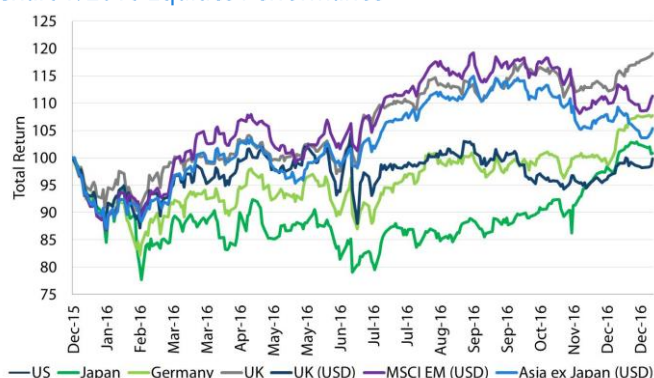


**Note:** Sum of the above positions does not equate to 0 in aggregate – cash is the balancing item.

## Equities

Equities had rough start to 2016, but managed a rally after January, on the back of easy Fed policy, and then promises of fiscal support and improving growth. The S&P 500 delivered around 12% in total return for the year, while across the Atlantic, Germany and the UK returned almost 7% and 20% in local currency terms respectively – though the latter was just about flat in US dollar terms, given the Sterling's decline following BREXIT. Japan lagged its developed peers, recouping first half losses to end the year flat. Emerging markets posted 11% for the year in US dollar terms, their best year since 2010.

Chart 1: 2016 Equities Performance



Source: Bloomberg 2016

## Japanese equities macroeconomic conditions are improving

Despite being up 15% in the fourth quarter, Japanese equities ended 2016 flat. As is often reported, earnings expectations are heavily influenced by the direction of the Yen, and as shown in Chart 2, the Yen's fourth quarter 13 % decline, relative to the US dollar, bodes well for an earnings boost.

Chart 2: Japan Equity Earnings



Source: Bloomberg 2016

The macro dynamics in Japan have greatly improved, mainly on the back of the BOJ shifting policy levers from negative rates to a managed yield curve. This move ensured the Yen was weaker in the fourth quarter in a rising rate environment, with the BOJ forced to apply a fair amount of quantitative easing (QE) to hold the 10-year interest rate at its targeted 0%.

Despite the BOJ's easing, it is difficult to argue that this will be the magic bullet that raises inflation expectations, which is what policymakers have been aiming to achieve since Abenomics began. However, it helps that external drivers like rising commodity prices and inflation expectations continue to lift around the world.

The implications of President-elect Trump's policies for Japan are mixed. The shift from monetary to fiscal policy could embolden Japan to double down on the same, providing a near-term boost albeit with nominal productivity gains. About 14% of Japanese company profits come from North American production, so a big tax cut would go straight to the bottom line. Longer term, the direction of trade policy remains the vexing question. Japan-US relations remain positive, particularly compared to China, however US protectionism would be ultimately negative for Japanese exporters.

Momentum remains negative as valuations are no longer cheap and, although the macro dynamics have improved, earnings have some work to do to catch up, given such a significant move in the Yen.

## Latam equities earnings estimates are ambitious, given the underlying fundamentals

Emerging markets (EM) were among the top performing equity markets for 2016, with MSCI Latam the top performing region, rising 31% versus 11% for MSCI EM. In US dollar terms, MSCI Latam still remains the worst regional EM performer since the EM peak in the Spring of 2011 – down 40% versus minus 16% for MSCI EM, the difference being currency.

In local currency terms, MSCI Latam is actually up 14% over this same period, just behind MSCI EM at +15%. This is surprising at first, but less so when you consider the currency adjustment that is helping to offset the decline in the commodities that it exports.

It is hoped that this currency adjustment will also boost exports – particularly in manufactured goods – but relatively weak global demand has failed to ignite such newfound growth, with domestic demand also remaining weak.

Chart 3 compares local price performance (excluding dividends) to local 12-month forecasted earnings. The increasing divergence implies that, despite the currency adjustment, the earnings outlook has improved but is still relatively weak, making equities look expensive.

Chart 3: MSCI Latam price performance vs forward 12M PE, re-based to April 20, 2011 (Local currency)



Source: Bloomberg 2016

There are many reasons to remain optimistic about the Latam region, such as the support for commodities. After scraping multi-decade lows early this year, there has been a turn in politics to favour reforms and likely interest rate cuts, outside of Mexico, where inflation is generally in decline. However, this earnings outlook looks challenging relative to expectations already embedded in the price.

Valuations are expensive, and despite significant macroeconomic improvements, we remain concerned that earnings may not deliver due to several headwinds:

- Earnings estimates suggest a V-shaped recovery, implying a commodity recovery that could exceed still tepid levels of global demand.
- Debt levels remain high, with sizable US dollar-denominated debt now weighing heavier due to the recent US dollar strength.
- The economic recovery has so far disappointed, with analysts perhaps underestimating the debt burden impact, and overestimating the near-term effect of reforms and interest rate cuts.

On balance, despite positive momentum and improving macro dynamics, we remain cautious on valuations and the risk of earnings not delivering, and so keep Latam on the lower end of the hierarchy.

### Indian equities: looking through demonetisation headwinds

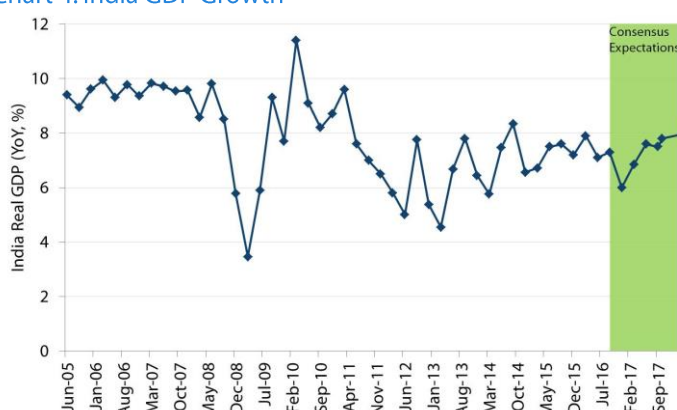
The Balancing Act travelled over 2,500kms across Northern India over the holiday season on a combination of planes, trains and automobiles (both 3-wheelers and 4-wheelers) to study first-hand the crippling effects of the demonetisation of the Rs 500 and Rs 1,000 notes. Together these made up almost 86% of the total currency in circulation prior to the government's surprise policy announcement on 9 November. As explained by Prime Minister Narendra Modi in his address to the nation then, and again on New Years' Eve, this policy was intended to take counterfeit notes out of circulation, crack down on 'black money' and reduce corruption. However, with 95% of the notes in circulation already deposited into banks by the 31 December deadline, it is not clear if any of these lofty objectives have been achieved.

Our on-the-ground research and personal experience, which involved us being stranded in a mid-sized town without any cash, left us with little doubt that investor fears regarding near-term headwinds for growth caused by this 'cash crunch' are well founded.

However we maintain our positive longer-term outlook for three reasons:

First, the growth slowdown is likely to be short lived and shallower than that expected by consensus, as shown in Chart 4.

Chart 4: India GDP Growth



Source: Bloomberg 2017

This is because, by mid-December 2016, new currency equivalent to 40% of the value of the cancelled notes had already been printed and distributed. This is expected to increase to over 60% by next month, which will help to ease the cash crunch. The resilience of India's informal economy is also evident by the ease with which credit was offered by small businesses and merchants to their customers, in the absence of formal liquidity.

The second reason for our optimism lies in the potential strengthening of bank balance sheets. India's banks have been woefully undercapitalised and are the primary culprit behind private investment in key infrastructure. While their immediate equity remains unchanged as a result of the demonetisation, with only deposits increasing, there are grounds to believe that banks and financial intermediaries will significantly benefit from a large proportion of India's economy migrating from cash to formal banking channels.

The State Bank of India and other commercial banks have already cut interest rates by 90 basis points, as well as responding to government calls to boost credit to those areas of the economy most affected by the demonetisation.

We believe this could support corporate earnings outside banks too, through an increase in domestic consumption.



Chart 5: India Bank Deposits



Source: Bloomberg 2017

Third, and perhaps the only unmitigated positive from this demonetisation, is the increase in Prime Minister Modi's political capital, with his rallying calls against black money and corruption striking a chord with the masses.

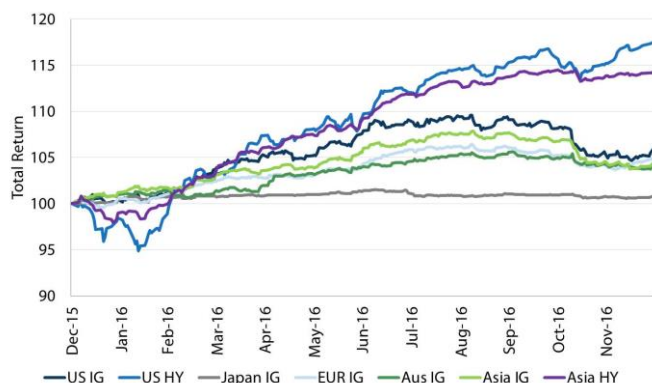
The extent of disarray in the opposition parties is evident by their complete inability to extract any mileage from the inconvenience caused by this policy fiasco. As such, Prime Minister Modi and his ruling Bharatiya Janata Party are likely to consolidate power in the upcoming state elections this year, and should retain power at the next General Elections in 2019. Given the elevated political risk elsewhere in the world, it seems likely that investors will continue to pay up for political stability and reforms in India.

## Credit

### Credit had a strong year, despite some year-end setbacks

Credit markets performed strongly during 2016, High Yield in particular. Like equities and other risk markets, tight financial conditions led to a rough start, but easing conditions and a positive turn in commodities offered a solid lift to High Yield. The rise in yields, which accelerated following Mr Trump's win, weighed on Investment Grade performance towards the end of the year. High Yield brushed off the yield impact, instead focusing on high expectations for the coming fiscal stimulus. High Yield outperformed Investment Grade, with the US returning 17% for the year, versus 14% for Asia. US Investment Grade returned 6%, with Europe and Asia falling just behind.

Chart 6: 2016 Credit Performance

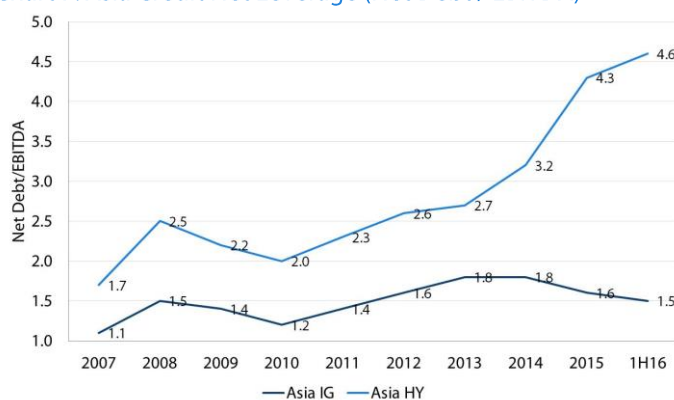


Source: Merrill Lynch 2016

We have long favoured Investment Grade credit over High Yield, which was the correct call for most of the year, until this decision went against us in the euphoria following the US election. Still, favouring low duration was the right call, as was our preference for US exposure over Asia, with the latter suffering not just from rising yields but also from US dollar strength. Despite underperforming, Asian credit is still more expensive than the US, while momentum looks to be turning more negative.

The credit profile for Asian Investment Grade is expected to remain stable, however High Yield issuers should continue to post higher Net Leverage and so are likely to pursue questionable growth initiatives, rather than deleveraging. We expect the divergence in fundamentals between Asian Investment Grade and High Yield to continue in 2017.

Chart 7: Asia Credit Net Leverage (Net Debt / EBITDA)



Source: JP Morgan 2016

While Asia faces headwinds like higher interest rates and a stronger US dollar, it is better placed to deal with these external pressures than it has been in the past. Structural reforms have continued to advance and, while monetary easing is most likely over, fiscal stimulus remains an available source of growth, unlike most other emerging markets. Over the long term, we believe that countries relying on exports to the US, such as in North Asia, are at risk of a protectionist US trade policy, but near-term most will continue to benefit from trade normalisation. South Asia is a mix of varying political risk and growth channels, making country and issuer selection an increasingly important consideration.

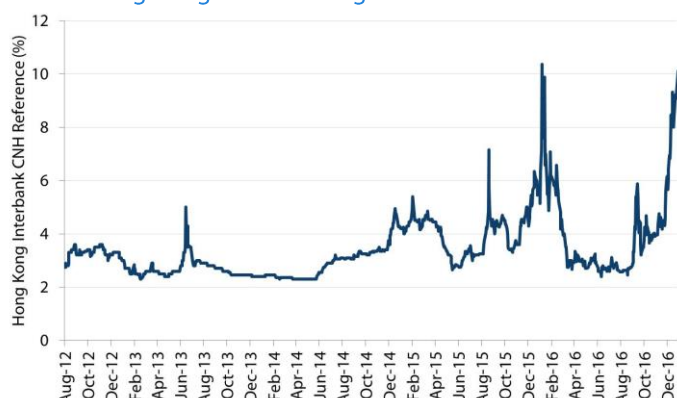
Chart 8: China Stress



Source: Bloomberg 2016

China is coming back into focus as a rising risk, given US dollar strength and rising yields. Capital outflows have accelerated, as have hedge fund bets against its currency. Like last year under the same conditions, the People's Bank of China (PBOC) has pushed up the cost of funding to squeeze out short sellers, as shown in Chart 9. Simultaneously, authorities are also aggressively adding to capital controls. For the moment, China appears to have given up on interest rates and an open capital account in order to regain control of its currency. These developments are not good and we will monitor this situation closely for signs of any adverse affect across the region. Economic growth is much stronger than last year, both in China and across Asia, so our base case is that the region remains stable.

Chart 9: Hong Kong CNH Funding Cost

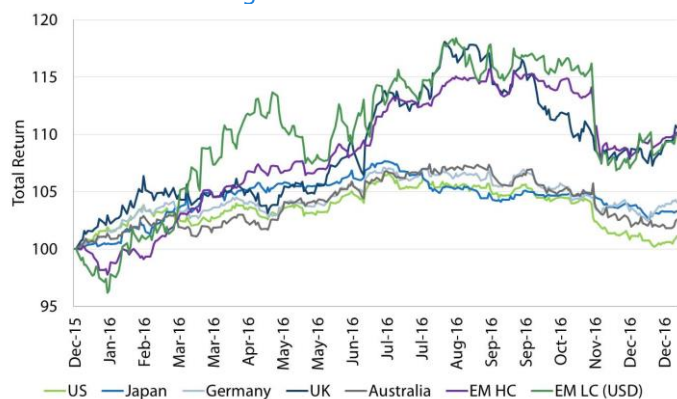


Source: Bloomberg 2016

## Sovereign

Sovereign bonds made a round trip in performance over 2016, with the fear of deflation and uncertainty pushing investors to safe havens in the first half of the year, followed by a rapid rise in rates in the second half, as prospects for inflation suddenly became tangible. The 10-year US treasury yield hit a record low of 1.35% in early July, but managed to end the year at 2.45%, 17 basis points above where it started. Gilts delivered the best return (10.6%), followed by German bunds (4.1%) and Japanese Government Bonds (3.3%). Despite higher yields, US treasuries were still positive at 1.1%.

Chart 10: 2016 Sovereign Bond Performances



Source: Bloomberg 2016

## Sovereign bonds suffer a dramatic repricing

Sovereign bond yields stabilised in December, following their November spike that was attributed to Mr Trump's surprise election win, with his campaign promises adding fuel to already building inflationary concerns.

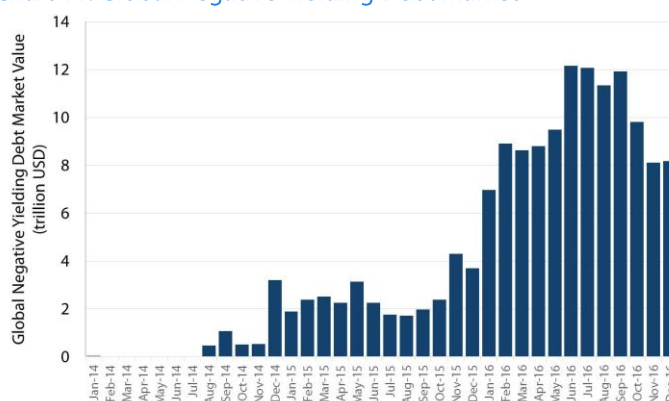
If anything, December's events have served to reinforce the litany of factors driving inflation expectations higher:

- inflation continues to increase in most developed and emerging markets, outside of Latam.
- wage pressures continue to build as the cycle matures, with the US now having the highest wage growth since the global financial crisis. Minimum wage hikes will rise for many states in January.
- the European Central Bank extended QE to the end of 2017, with a moderate reduction but still not enough to remove its dovish tone.
- output gaps across the world are not as wide as thought, given the anaemic level of corporate capital expenditure.
- bond prices have been heavily manipulated for a number of years and are at risk of re-pricing.
- effects of commodity declines in early 2016 are rolling off, adding to headline inflation and inflation surprises.

Bonds are far from having normalised, but they are slowly coming back on rising inflation expectations, as shown by the decline of negatively-yielding bonds in chart 11.

While the Fed may be tightening, the ECB and the BoJ are standing firm in their easier policy stance, although this could be tested depending on how inflationary pressures and fiscal policies evolve.

Chart 11: Global Negative Yielding Debt Market



Source: Bloomberg 2016

With bond yields having stabilised at year-end, where to next?

While inflation expectations should continue to normalise, they are likely to remain tempered, given tightening financial conditions that are ultimately deflationary. As shown in Chart 12, it is not just yields but also the US dollar that is now exceeding the already tight levels from where it began in 2016.

Credit spreads have also remained tight, most impressively in High Yield, which has received a boost from higher energy prices. Markets are still sanguine for the anticipated fiscal impulse, but the timing remains an open question. Any concerns on this front could potentially inflict another wave of deflationary concerns.

Chart 12: US 10Y Treasury Yield and Dollar Index



Source: Bloomberg 2016

The mix of inflationary (and partly deflationary) forces, coupled with a shift to expansionary fiscal policy around the world, means we, in our view, are likely to see a period of substantial volatility in bond markets.

We will maintain our neutral view on sovereign bonds until valuations reflect the change in fundamentals or their role as a defensive asset becomes clearer. Cash remains our favoured defensive asset.

## Commodities

Commodity performance was dramatic during 2016. The crude oil price doubled from its lowest level in a decade, struck back in February, returning 45% for the year. Industrial metals posted strong gains of 17.6%, lifted by a fresh round of Chinese stimulus and hope around President-elect Trump's infrastructure spending promises.

Gold peaked during the year, returning almost 30% by early July, however it gave back most of these gains to end the year up just 8.1%. Agriculture ended the year down 4.2%.

Chart 13: 2016 Commodity Performances



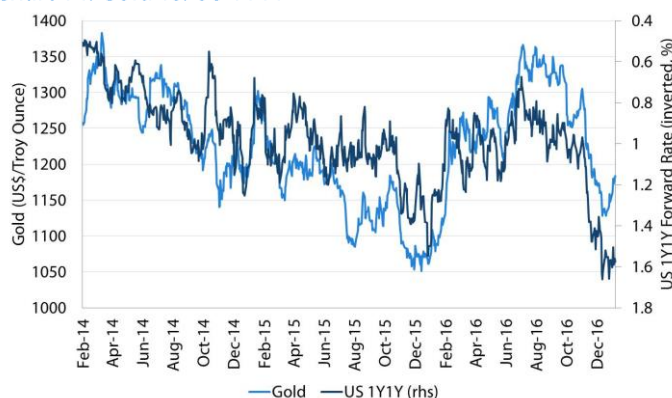
Source: Bloomberg 2017

## We downgrade Precious Metals, upgrade Energy

We maintain our positive view on commodities as an asset class, given their improved supply/demand fundamentals. Supply growth has slowed considerably across many parts of the energy, base metal and agricultural sectors. Persistent oversupply appears to have been addressed through production cuts, while deflation in cost curves also appears to be abating. This means that commodity price inflation is likely, even if we see only a marginal acceleration in global growth.

Within our commodities hierarchy, we have downgraded Gold and Precious Metals, and upgraded Energy. The shift from monetary policy to fiscal policy discussed in the introduction lies at the heart of our Gold and Precious Metals downgrade. Gold prices have historically been correlated with changes in the US dollar and short-term interest rates. However, as shown in Chart 14, the gold price correction has lagged the US dollar rally and rise in interest rates, which could result in some near-term weakness in Gold.

Chart 14: Gold vs. US 1Y1Y



Source: Bloomberg 2016

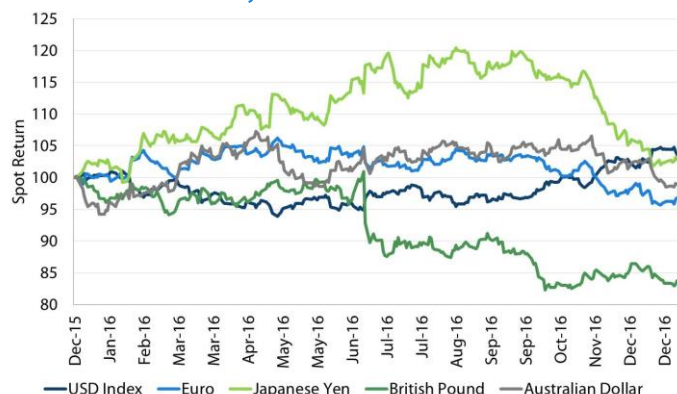
We are cognisant that speculative positioning in Gold is still very net long, as investors continue to hedge policy uncertainty with their Gold holdings. We have much sympathy for this view ourselves and continue to maintain a neutral view on Gold. However, Energy can also serve as a useful hedge for geopolitical risk, especially as the recent OPEC agreement to cut supply should support prices. As such, we swap the relative positioning of Gold and Energy on our hierarchy, while leaving Agriculture on top and Base metals at the bottom.

## Currency

As the Fed blinked in 2016, the US dollar first softened and then stayed on the sideline for most of the year, until Mr Trump won the US presidential election in November. The trade-weighted US dollar index strengthened modestly, up 3.6% for the year. This, however, masked the strong currents in a few currencies like the Yen, which rallied 20% against the US dollar after the BoJ introduced its negative interest rate policy, and then retreated in the last 3 months of the year. In contrast, the Sterling plunged to a 30-year low post Brexit and is still clouded by the uncertainties.



Chart 15: 2016 Currency Performances



Source: Bloomberg 2016

### The Yen remains in the middle of the hierarchy

In 2016, high currency volatility reflected surprises both in policy and politics. After a brutal start to the year with excessively tight financial conditions, the Fed opted to pause its rate hikes, allowing the US dollar to weaken. Around the same time, the BoJ seemed to shoot itself in the foot, calling for negative rates that instigated an enormous Yen rally, in complete defiance of its intentions.

Fast forward to September, and the BoJ changed tack, determining that it would hold the 10-year yield at 0%, given treasury yields and inflation expectations were on the rise. So in just three months, a 20% gain in the Yen relative to the US dollar was reduced to only 3% by year end.

Why?

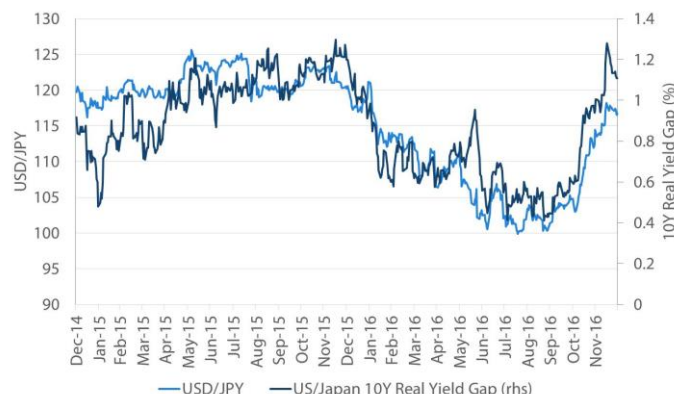
Much of this reversal seems attributable to the spike in US Treasury yields.

As rates rose steeply over the fourth quarter, the BoJ was forced into quantitative easing to hold the 10-year yield at 0%, which invariably weakens the currency. If yields continue to rise from here, as we are concerned that they will, this dynamic could weaken the Yen further.

As we have noted before, relative real yields are an important driver of the Yen's performance relative to the US dollar.

As shown in Chart 16, the relative real yield of US to Japan, as measured by inflation-linked bonds, spiked considerably during the last quarter of 2016, driving the Yen weaker.

Chart 16: US Real Yield Differential vs USD/JPY



Source: Bloomberg 2016

While it is clear that inflation expectations are rising, the continued rise in US real yields is less convincing, as this implies that higher growth expectations are still partly due to President-elect Trump's policy euphoria, which holds much less clarity than inflation.

The Yen is once again cheap, while momentum remains positive, although recent weakness has yet to convincingly shift from prior strength.

Given the ambiguous macro dynamics concerning where real yields go from here, we keep the Yen in the middle of the 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 and ROE | Used to inform valuation model                              | Monetary policy, fiscal policy, consumer, earnings and liquidity cycles |
| Final decision judgemental                  |   |   |
| Example                                     |   |   |
| +   | N   | N   |
| Final Score +                               |   |   |

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