nikko am
Nikko Asset Management

BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

With Donald Trump's victory in the US presidential elections in November 2016, the Republican Party succeeded in consolidating control over the White House, the Senate and the House of Representatives. This stoked expectations that meaningful legislation and reform would soon follow, in contrast to the troubled partisan years of the Obama administration when neither party was in control of all three arms of the government. However these expectations have rapidly faded over the last few weeks. Markets used the crumbling of the Republican healthcare bill as further evidence that the "Trump trade" is unravelling. The pause in the US Dollar, the retracement in US Treasury bond yields and flagging equity markets all seem to point in that direction.

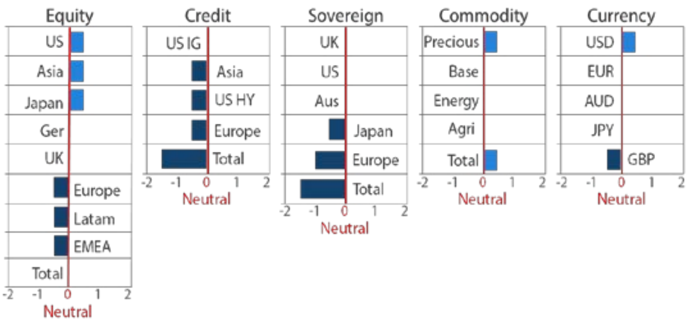
For now we continue to give the benefit of the doubt to the "Grand Old Party" or GOP as the Republicans in the US are fondly known. We think it might be a mistake to extrapolate too aggressively from the early legislative and administrative setbacks faced by the Trump administration because there are other elements on the agenda such as taxation and infrastructure that are less divisive than healthcare reform and hence more likely to get the support needed. Even with thornier issues such as immigration, some progress has already been made. The administration tightened the H-1B visa issuance rules for computer programmers who are seen as displacing local US jobs. This was far easier to do than the travel ban on visitors from six Muslim-majority countries but received little press anywhere other than in India.

Geopolitical risks too have made a comeback with recent headlines from Syria, Russia and North Korea all adding further jitters to the market. We have always readily admitted that a deep understanding and analysis of political risk, geopolitics and policy needs to be an integral part of the investment decision making process. However there may be as much a risk of overemphasizing these risks today as there was of ignoring them a year ago, specifically before the surprises thrown up by the results of the BREXIT referendum and the US elections. This is only natural given the tendency of markets to overreact. However this also creates profitable opportunities that disciplined investors can exploit by taking the other side of the narrative. We seek to do this by balancing political risk and macro considerations with asset class valuations, momentum and other fundamentals.

France is such a case in point. Equity valuations and momentum are both supportive and the macro backdrop has improved markedly yet political risk continues to dominate headlines. On the other hand there is little one can see beyond political risk in many parts of EMEA such as South Africa.

Our overall research view remains one of continued, though somewhat cautious, optimism on the prospects of further global reflation. That would be supportive of commodities and selective equity markets and sectors which have valuation support and which benefit from reflation. It would be a challenging environment for the bond market, but with the caveat that the repricing higher in bond yields will be punctuated by periods of intermittent "safe haven" bids and positioning unwinds.

Asset Class Hierarchy (Team view[1])



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

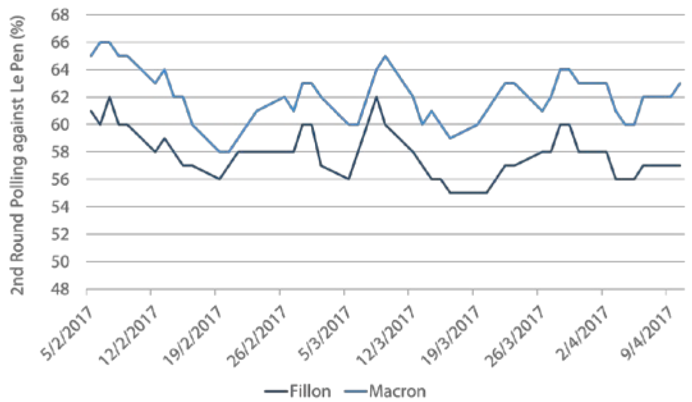
[1]The asset classes or sectors mentioned herein are a reflection of the portfolio manager's current view of the investment strategies taken on behalf of the portfolio managed. These comments should not be constituted as an investment research or recommendation advice. Any prediction, projection or forecast on sectors, the economy and/or the market trends is not necessarily indicative of their future state or likely performances.

Equities

EU equities – tug of war between political risk and an improved bottom-up perspective

The first round of the 2017 French presidential election is set to be held in a couple of weeks with the top two candidates then to face each other in a run-off election on 7th May. The prospects of a win for Marine Le Pen, the far-right leader of the National Front party has kept markets on edge given her campaign promises to pursue an aggressive programme of populist policies such as curbing immigration and taking France out of the European Union. Polls suggest that Ms Le Pen is likely to make it to the second round although with each passing day the race gets thrown even more wide open. In the case that she does end up among the top two in the first round, polls indicate she is all but certain to lose in the second round run-off.

Chart 1: Polls point to Le Pen losing in the second round

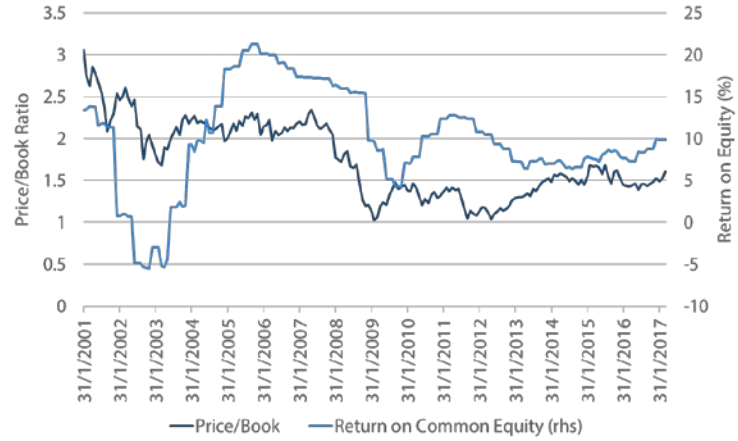


Source: OpinionWay, 2017

Given recent experience with polls, one is well advised to take these forecasts with a grain of salt. However a plausible factor in their defence is that the polling gap between the two outcomes here is significantly larger than what was seen going into both the BREXIT referendum and the US elections.

However, betting against a Le Pen victory is not the only reason to adopt a more constructive view on France. Two better reasons are inexpensive valuations and strong earnings growth. Earnings-based valuation measures on European equities such as Price to Earnings (P/E) ratios have been volatile over the last few years and not very useful in drawing an opinion on how cheap the market is at present. This is because the earnings collapse through the Global Financial Crisis and the European Sovereign Debt crisis have rendered comparisons of current P/E ratios relative to history quite meaningless. On the other hand, as shown in Chart 2, the Price to Book (P/B) ratio has been more stable and has consistently suggested that French equities are inexpensive.

Chart 2: French equity Price-to-Book and Return on Equity

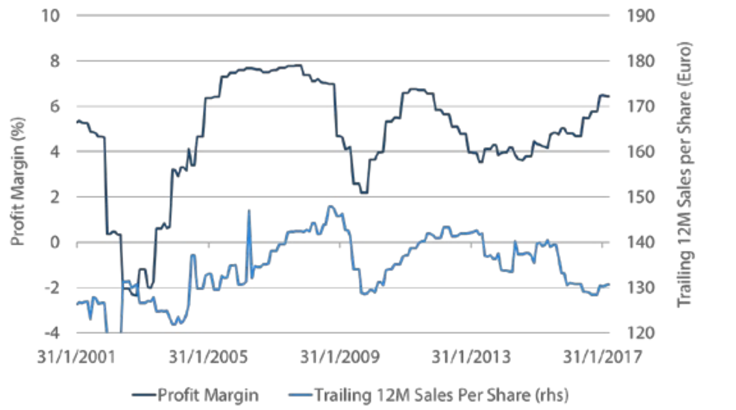


Source: Bloomberg 2017

An attractive P/B ratio is not in itself a reliable indicator of value in an environment of declining profitability, as has been the case in France over the last few years. The encouraging sign here is that after a long period of plateauing, profitability now appears to be picking up.

Lastly and as shown in Chart 3, French corporates have enjoyed a strong turnaround in profit margins since the middle of 2016. Given the simultaneous recovery in revenues we expect earnings will remain in a strong enough uptrend for P/E ratios too to continue improving in the foreseeable future even with some price gains.

Chart 3: Recovery in French corporate profit margins



Source: Bloomberg 2017

We have also turned more constructive on the health of the consumer in France. Unemployment has continued to edge lower, consumer confidence is at its highest level in five years and retail sales have picked up strongly. Subdued wage growth is still a concern but with most survey-based measures of business confidence and economic activity rising strongly, this too might see some strengthening in the coming months.

Hence we think the French presidential election is just a red herring. Equities appear increasingly attractive regardless of the ebbs and flows of the contestants' fortunes. Outside of France, we remain cautious on European markets which explains why we have not lifted European equities as a whole any higher in our equity asset class hierarchy.

EMEA equities – political risk dominates

South Africa is a case study in the reverse. It is a market where political risk has been neglected much to the peril of investors. Rising risk appetite globally had seen flows return to South African assets last quarter despite high political instability and weak macro fundamentals.

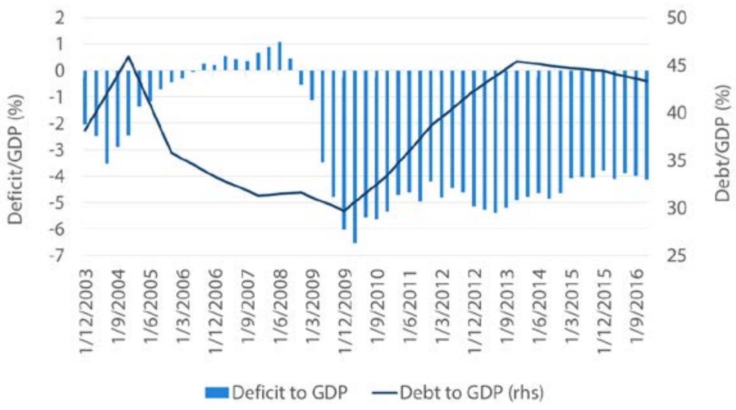
Investors were perhaps justifying this based on expectations that growth was about to return and that this would help alleviate macro pressures. Encouraged by positive momentum, investors grew ever more sanguine and depressed the political risk premium even though the ground reality suggested they do just the opposite. In such situations it is not unusual to occasionally get slapped in the face with a sudden repricing of risk as was the case in South Africa last month.

President Zuma has always been a wildcard. While he has so far been mostly kept in check by strong institutions and by his desire to placate markets so that the country could retain its investment grade status, he has grown increasingly strident recently. Last month he sacked well-respected Finance Minister Pravin Gordhan who was considered a bulwark against government corruption and the main reason South Africa was able to retain any credibility with international investors with regards to fiscal discipline. His departure leaves the Ministry of Finance fairly compromised. It was not a surprise to see S&P quickly downgrade the credit rating to junk. Others are likely to follow.

For South Africa, the primary macro risk is the high level of sovereign debt. Returning growth and fiscal prudence had helped to reduce fiscal deficits to a more sustainable path as shown in Chart 4, but fiscal slippage seems likely given the move and given Zuma's propensity to play the political system that is largely built on patronage.

So far, there are no signs of contagion, but the event will be an important one to follow. The key risk is that if all the agencies downgrade South Africa's credit rating to junk, Zuma may feel that he has less to lose and in the process allow for greater fiscal slippage than markets currently fear. So far, he seems safe in power though there are members of his ANC party seeking a "vote of no confidence".

Chart 4: South Africa Debt to GDP vs. Fiscal Deficit to GDP



Source: Bloomberg 2017

Our relative asset class hierarchy for equities remains unchanged. We rank US equities as the most attractive equity market globally despite stretched valuations and rank EMEA equity markets as the least attractive even though valuations have improved on the margin. Asian equities too rank near the top. They offer the best combination in terms of valuation and momentum but fall behind the US due to a less attractive macro backdrop.

Credit

Valuation for Investment Grade deteriorates

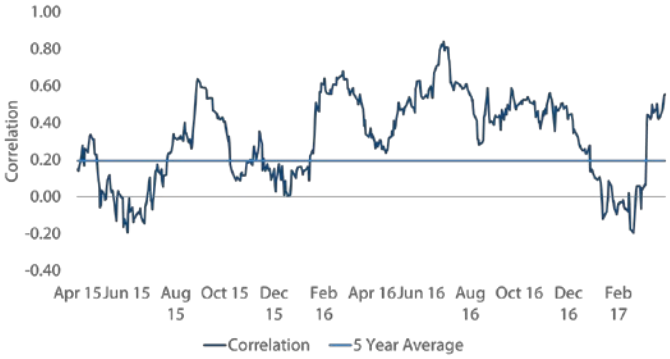
Spreads continued to tighten across the board, causing many credit markets to become less attractive from a valuation perspective. US Investment Grade (IG) has performed strongly over the past few months, almost negating the loss suffered in November after US Treasury yields sold off. The US economy is continuing to see signs of strength – consumer confidence is higher than it has been in over a decade, the ISM index of total new orders hit new heights not seen since 2011 and jobless claims continue to fall. Strong issuances in 2017 have been met with even stronger demand and improving financial earnings for corporates have all contributed to tighter spreads. However, despite the positive macro outlook, valuations have become stretched. US IG spreads have tightened close to 100 basis points (bps). With not much room to move for even tighter spreads, the asset class is likely to resemble rates going forward and therefore has become less attractive.

Chart 5: US Investment Grade OAS

Source: BofA Merrill Lynch 2017

US High Yield (HY) on the other hand saw spreads widen over the past couple of weeks. The positive macro outlook for the US economy should have a greater positive impact on HY corporations than IG. Strong manufacturing PMI should lead to a rebound in after-tax cash flows, improving sales to inventory ratios point to positive industrial growth and lending standards could be turning easy. Fundamentals appear to be improving as well – default rates are plateauing, with Moody's reducing its default expectations. Interest coverage remains elevated and rating drift continues to improve. So what caused spreads to widen? US HY has recoupled with WTI Oil prices.

Chart 6: US HY vs WTI Crude Oil 30 day rolling correlation

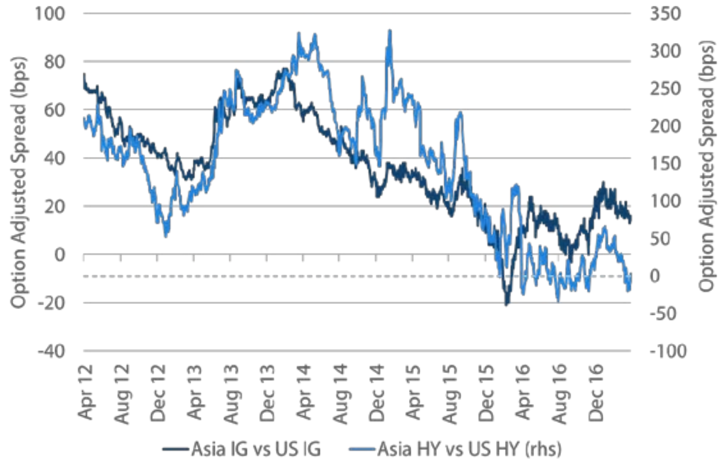


Source: BofA Merrill Lynch, Bloomberg 2017

The recent fall of oil prices brought the US HY market down with it. While Energy only forms 15% of the BofA Merrill Lynch US HY Index, correlation with WTI Oil has jumped to almost 60%, well above the 5 year average. Such a steep move appears to be overdone. Energy companies have undergone numerous cost cutting exercises and potential changes to the US energy industry under Trump should help the industry weather lower oil prices for longer. Based on this move, US HY does appear to be slightly more attractive, although remains expensive overall. Investors should remain wary: given the continual fall of recovery rates, issue selection prudence is becoming more important.

Similar to the US, Asian IG has proven resilient, shrugging off potential US protectionism rhetoric and outperforming the US since the election. The recent US dollar weakness has been supportive for Asian currency pairs, leading to improved sentiment across the region. Exports in Korea and Taiwan have normalised since 2016, leading to an increase in forward earnings expectations. Commodity prices have stabilised and Asia has benefited from a relatively stable political backdrop. However valuations have become quite expensive relative to their own history, especially in Asian HY, where there is currently no yield pick up over US HY. While Asia IG spreads appear expensive to their own history, one may question whether the historical premium to US IG is justified going forward. Asia has proven to have resilient companies based in countries with stable political backdrops, and with policymakers who have the ability to implement the reforms needed to drive their economies forward. Despite being expensive relative to history, a 100bps pick up above US IG offers investors some cushion to potential US rate rises that US IG may fail to protect against.

Chart 7: OAS differentials between Asia and US



Source: BofA Merrill Lynch 2017

Based on spread valuations alone, one would favour Europe or Japan over the US and Asia. However, with absolute yields below 1%, there is little reward for the impending risks, such as the geopolitical backdrop in Europe and the impending European Central Bank (ECB) taper. Therefore despite less favourable valuations for US and Asia, the absolute yield from these assets justifies inclusion in multi-asset portfolios, but the overall outlook for credit has deteriorated.

Sovereign

Sovereigns hinting at a reduction in global QE

While nominal yields have not moved much, it is notable that real yields have risen. Higher real yields might partly reflect improvement in growth prospects through higher demand for credit, but this dynamic does not quite reconcile with downshifting inflation expectations which continue to plumb extremely low levels. The shift in pricing is more likely a reflection of an expected change in central bank policy – namely, the reduction of quantitative easing (QE) in Europe and potentially also in Japan. As shown in Chart 8, real yield spreads of German Bunds and Japan JGBs over USTs have been rising since late last year.

Chart 8: 10 Year real yield spreads of JGBs and Bunds over USTs

Source: Bloomberg 2017

Part of this dynamic is a reflection of the recent fade in the Trump reflation trade we touched upon in the introduction. It is plausible that this would lead to some real yield compression in the US. However it also suggests a possible end of the "divergent monetary policy" thesis that has been a centrepiece of global sovereign bond markets over the last couple of years. Europe, and perhaps Japan, may need to heed evidence of returning growth and higher inflation.

In Europe, the argument is more credible as inflationary pressures return (mainly in Germany) and growth genuinely picks up in exports and domestic credit. It is likely that headline inflation will ease as commodity-related base effects roll off, but the hawkish German Bundesbank is still likely to add pressure on the ECB to taper QE sooner rather than later. The notion of Japan QE tapering was fuelled by a Bank of Japan (BOJ) announcement to shuffle the mix of its asset purchases, intimating a reduction in JGB purchases. However, with inflation nowhere in sight and indications of credit expansion only nascent, the reshuffle looks to be more pragmatically based on the limited supply of JGBs rather than on a desire to begin the tightening cycle.

In both cases, these are important developments to watch due to the monetary tightening that they might cause. Among other things, QE was designed to depress real yields so investors would be forced out the risk curve into riskier assets. Hence even a perception of any reversal would likely reverberate across risk assets.

Our longstanding preference for cash over sovereign bonds as a safe haven asset of choice remains unchanged, as does our relative preference for markets where there is some yield on offer to compensate for the duration risk (US, UK and Australia) relative to markets with lower yields and higher repricing risk (German bunds, Japan JGBs) as discussed above.

Commodities

Energy appears more attractive than Agriculture

Commodities are no stranger to geopolitical risk. However at the moment it is the bottom-up demand and supply fundamentals that are in the driving seat. Seasonality is less supportive of Agriculture while a return of oil markets to a supply deficit is more supportive of Energy. Hence this month we swap the two on the bottom two places of our Commodity asset class hierarchy. Precious Metals and Industrial metals remain our top two preferences for exposure to the commodities complex.

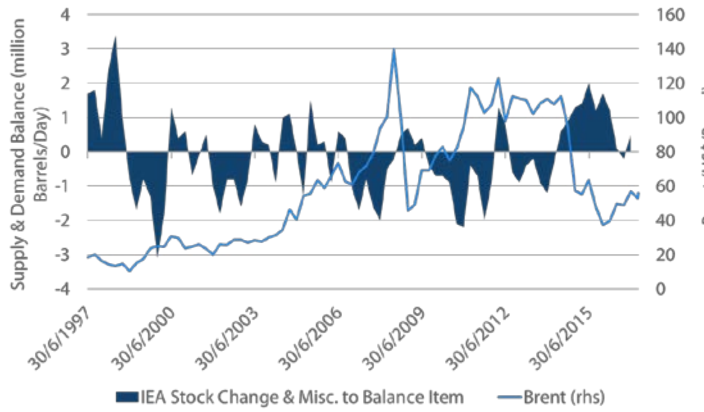
As shown in Chart 9 the supply side picture for oil markets continues to improve given production cuts in OPEC and Russia. OPEC has had a poor record of compliance with agreed supply cuts in the past. However this time they have taken the market by surprise. OPEC members have cut production by more than 2 million barrels, or 6%, since November 2016. Russia too has followed suit, though less aggressively.

Chart 9: OPEC and Russia Crude Oil production

Source: Energy Intelligence Group, Bloomberg, 2017

This will be enough to tilt the market back to deficit from a small surplus in Q4 2016. As shown in Chart 10 there is a strong correlation between oil prices and the supply/demand balance. The recovery in oil prices started early last year just when the market surplus peaked. Since then prices have been supported by a continuously contracting surplus.
So long as OPEC remains committed to production cuts and the market remains balanced or moves further into deficit, oil prices will likely remain supported. In this regard OPEC announcements of supply cut extensions into 2H 2016 will be eagerly awaited.

Chart 10: Crude Oil Balance versus Brent



Source: Bloomberg, International Energy Agency, 2017

A risk to the bullish Energy view comes from US shale producers who added one million barrels of production in the three years leading to the market collapse. It was a period of explosive growth backed by excessive capital expenditure on cheap financing and high oil price. These tail winds have probably disappeared forever. However US shale oil producers are now leaner and more operationally efficient than ever, while production technology continues to leapfrog ahead to make shale ever more competitive at lower prices.

Indeed US shale production bottomed around Q3 2016 and has since added 700,000 barrels back to the market in the subsequent six months. This is clearly a risk on a 2-year view and warrants close monitoring.

Chart 11: US Crude Oil Production

Source: US Depart of Energy, Bloomberg 2017

Currency

USD remains at the top of the hierarchy

In light of possible QE tapering in Europe and Japan, the argument for a stronger US dollar based on continued policy divergence is less compelling. Indeed, US dollar strength has recently dissipated with rising real yields in Europe and Japan. However we still believe the long-term story favours dollar strength and retain it at the top of our FX attractiveness hierarchy.

As the global reserve currency, the US dollar is an important driver of global liquidity conditions. As shown in Chart 12, G7 inflation is largely driven by the direction of the US dollar. A weakening dollar is associated with higher inflation while dollar strength usually leads to lower inflation. We witnessed a significant divergence in this inverse relationship last year with inflation increasing even as the dollar strengthened. However these divergences do eventually close, usually in the direction of dollar movements. We may soon witness this with commodity-related base effects soon rolling out of year-on-year comparisons.

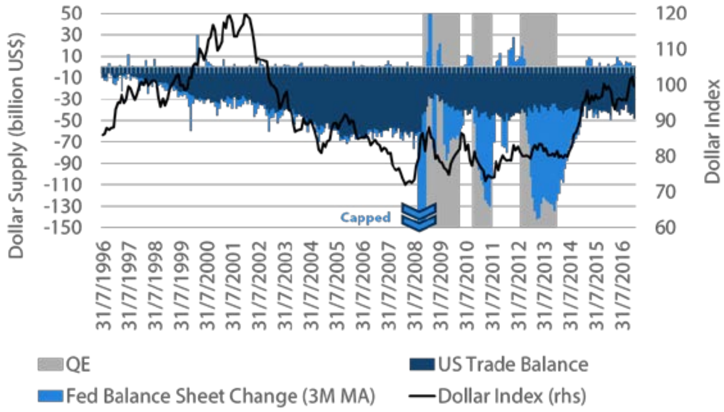
Chart 12: Dollar (Inverted) versus G7 inflation

Source: Bloomberg 2017

The Fed's plans to reduce its balance sheet – in effect, reverse QE - could have a significant impact on the US dollar too. The global financial system is more resilient than in the years immediately following the financial crisis, but a reduction in the Fed balance sheet could reassert dollar strength and squeeze global liquidity.

Chart 13 compares the US current account deficit and changes in the Fed balance sheet against changes in the dollar. Prior to 2008, an increasing current account deficit helped provide an increasing supply of dollars to the world to help nurture growth. Since 2008, the current account deficit was cut in half and has yet to recover, causing a shortage of dollar supply. QE helped to fill the USD supply gap, but the wind down of QE has led to significant dollar strength. Our view is that so long as the dollar remains the global reserve currency, the dollar shortage is likely to persist and could potentially worsen when the Fed begins to pull dollars out of the system through balance sheet reduction.

Chart 13: Dollar versus the US current account deficit and change



Source: Bloomberg 2017

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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